United States General Accounting Office

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Report to Congressional Requesters

October 2000

FOREIGN ASSISTANCE

U.S. Russia Fund Is Following Its Investment Selection Process and Criteria

GAO

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GAO-01-2

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Abbreviations

USAID U.S. Agency for International Development

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United States General Accounting Office
Washington, D.C. 20548

October 2, 2000

The Honorable Ted Stevens
Chairman, Committee on Appropriations
United States Senate

The Honorable Mitch McConnell
Chairman, Subcommittee on Foreign Operations
Committee on Appropriations
United States Senate

The United States established enterprise funds to support private sector development in selected countries of Central and Eastern Europe and the former Soviet Union as they transition from centrally planned to market-oriented economies. Currently, 10 funds cover 19 countries in these regions with authorized funding of about $1.3 billion. Enterprise funds are private, nonprofit U.S. corporations that are supposed to make loans to, or investments in, small-, medium-, and large-sized businesses in which other financial institutions are reluctant to invest.[1] In 1995, the United States established the U.S. Russia Investment Fund by merging two earlier Russian funds—the Russian-American Enterprise Fund and the Fund for Large Enterprises in Russia.[2] The Fund is authorized to receive $440 million through the U.S. Agency for International Development (USAID). Although USAID has primary responsibility for monitoring the Fund's operations, it does not have a direct role in the Fund's investment review and selection process. As of March 2000, the Fund had invested $114.4 million in 30 projects through its direct investment program which provides loans and equity capital to businesses in Russia.

[1]See our prior reports entitled *Foreign Assistance: Enterprise Funds' Contributions to Private Sector Development Vary* (GAO/NSIAD-99-221, Sept. 14, 1999) and *Enterprise Funds: Evolving Models for Private Sector Development in Central and Eastern Europe* (GAO/NSIAD-94-77, Mar. 9, 1994).

[2]The two original funds were established in 1993 and 1994, respectively, under the FREEDOM Support Act of 1992 (P.L. 102-511).

The uniqueness of Russia's economic, regulatory, and legal environments required the Fund to establish an investment selection process and criteria tailored to the Russian market. You expressed concern about the Fund's selection of projects for its direct investment portfolio; in particular, whether it was following an established process for making its investment decisions. At your request, we determined whether (1) the Fund adhered to its process and criteria for selecting direct investments and (2) its selection process and criteria were comparable to those used by other investment organizations operating in Russia. In conducting our review, we examined the files for the Fund's 30 direct investments and a random sample of other direct investment proposals the Fund had not approved since 1994.[3] We designed our sample so that the statistics generated can be projected to the total population of proposals. (See scope and methodology for more details.)

In addition, in response to your specific interest concerning the Russian Far East, we briefly discuss the views of officials from the Fund and other investment organizations in Russia on investment conditions in that region. This information is presented in appendix I.

Results in Brief

Our analysis showed the Fund followed its review process and criteria for selecting direct investments. For approved investments, the selection process included an initial review by the investment team in Russia, a review of the organization's finances and management, and a final review by the Fund's Investment Committee in the United States. For declined proposals, each was reviewed by at least two investment officers and the review often involved the Moscow-based investment team. In addition, although the Fund is not required to document the proposals it does not approve, over 80 percent of the case files contained at least some documentation about the Fund's decision.[4] As shown in its case files, the Fund followed its stated investment criteria in making investment decisions. When specific reasons for decline were cited, the Fund most often cited two reasons—the quality of the proposal's management was

[3]We examined some proposals that had been received by the two enterprise funds that were combined to form the U.S. Russia Investment Fund.

[4]We reviewed 330 case files of the 1,578 proposals the Fund said it had received in 1994-2000 and did not approve; 62 files did not have sufficient documentation to determine why the proposal was not approved.

deemed insufficient or the proposal was not believed to be commercially viable.

The Fund's review process and investment criteria are similar to those used by the five other investment organizations that we visited that were operating in Russia. The Fund and the other investment organizations used a multistep review process involving an investment officer or investment team, a review of the proposing organization's finances and management, and upper-level management or board review prior to approval. These organizations also used similar criteria for selecting investments.

USAID, the State Department, and the U.S. Russia Investment Fund agreed with the contents of this report.

Background

The Fund's mandate is to encourage private sector development while assisting the long-term growth and profitability of businesses throughout Russia. Since its creation in 1995, the Fund has drawn $174.5 million from the U.S. government[5] to support two programs—direct investments and financial services. The Fund's direct investment program provides loans, equity investments, and technical assistance to small-, medium-, and large-sized businesses in Russia. The Fund's financial services program (formerly known as Bank Partner and Small Business Lending Program) provides technical assistance to banks and loans, mortgages, and leasing services to small businesses, micro-enterprises, and individuals through the Fund's subsidiary financial institutions and partner banks.

The Fund has invested $114.4 million in 30 direct investments and has recovered $31.1 million in returns on these investments. The Fund values its current investments at $60.3 million.[6] The Fund's smallest investment through this program is $75,000 and the largest is $15.5 million, with an average investment value of $3.8 million. The Fund's 30 investments represent a variety of sectors throughout Russia—from communications to consumer products.

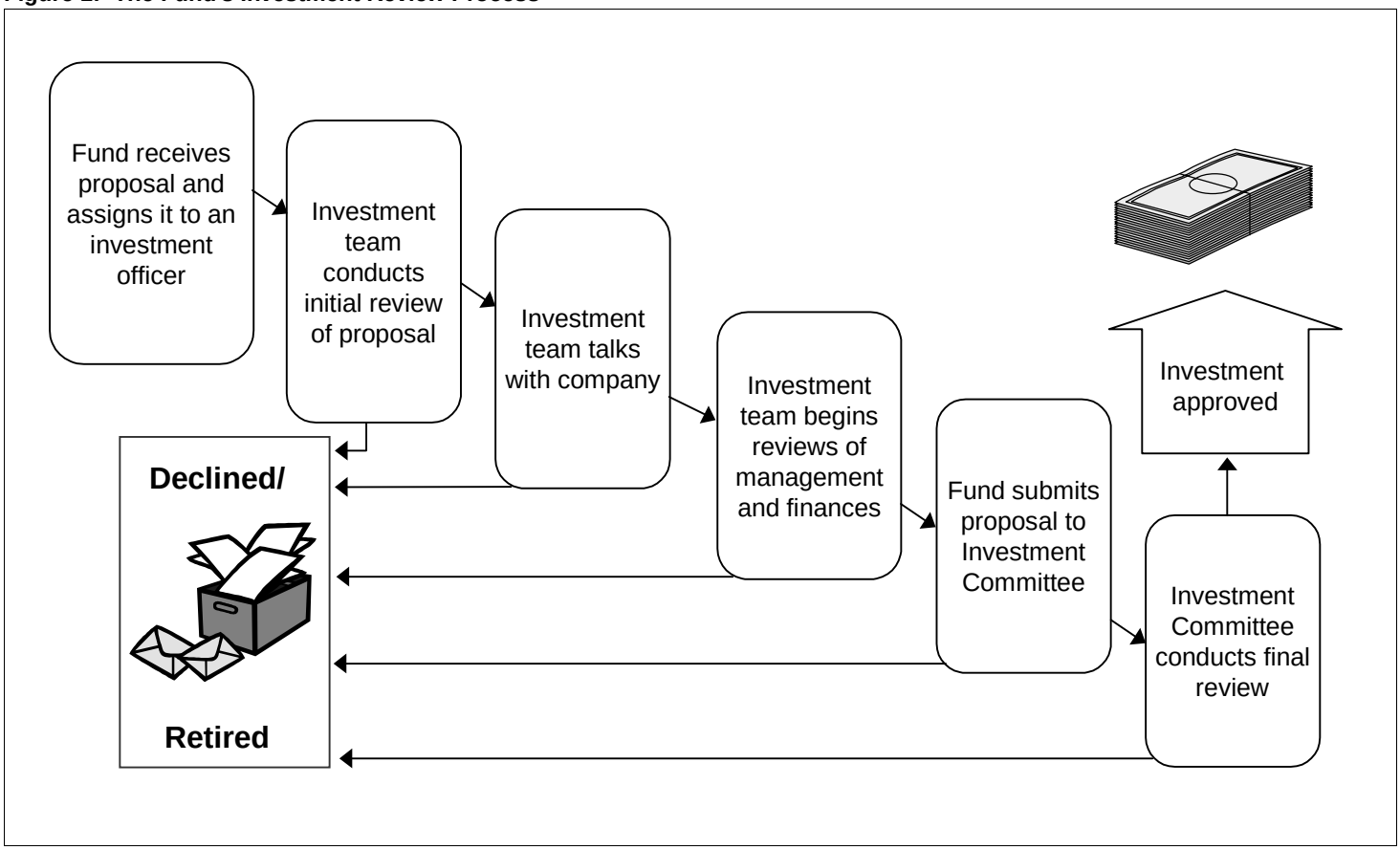
[5]Based on statistics provided by the Fund as of December 31, 1999.

[6]This figure is difficult to determine. According to Fund and other private venture capital officials, markets for the Fund's investments—and a way to determine their fair market value—often do not exist in Russia.

The Fund Followed Its Investment Review Process and Criteria

Our review of approved investments and proposals not approved showed that the Fund followed its review process. The Fund uses a multistep process to review and select its investments, as illustrated in figure 1. According to Fund officials, the steps in this process can and often do overlap. For example, the Fund's President often involves individual Investment Committee members, who also serve on the Fund's Board of Directors, early in the review process both to provide them with information and to make use of their particular area of expertise. The Fund continues discussions with the proposing organization throughout the financial, management, and Investment Committee reviews. Further, the investment team periodically briefs board members on the status of potential investments.

Figure 1: The Fund's Investment Review Process



Source: GAO analysis of Fund documents.

Our file review of the Fund's 30 approved direct investments showed that the Fund followed its review process from the initial review by the investment team to the final review by the Investment Committee. Where documentation was sufficient to make a judgment, our file review indicated that the Fund followed its review process for its declined proposals by having at least two investment officers review each proposal. In many of the declined proposal files, we also found documentation showing that the entire Moscow-based investment team reviewed the proposal.

Our review of approved investments and declined proposals showed that the Fund considered its criteria (see table 1) in judging the merits of proposals and making investment decisions. According to Fund officials, the most important factor in any investment decision is the quality of management. The Fund looks for managers who have operational experience in the venture they are proposing, business experience in Russia, and a willingness to cooperate with the Fund. According to Fund officials, the second most important criteria for investment is the commercial viability of the proposal. The Fund's objective is to make a profitable investment, and it will not take on projects that have a poor chance of succeeding.

Table 1: The Fund's Investment Criteria

Criteria	Description
Management	The Fund seeks managers who have experience in the sector; have overseas experience, especially in Russia; and exhibit competence, integrity, and a willingness to cooperate with investors.
Commercial viability	The Fund reviews the proposing organization's current and potential revenue growth and market share and the proposal's viability, regulatory risks, civil liabilities, and potential return.
Sector focus	The Fund seeks a diverse portfolio consisting of businesses from many sectors; however, it generally discourages investments in natural resources, construction, agricultural production, and livestock production.
USAID terms	The Fund's grant agreement with USAID stipulates that the Fund may not invest in companies that sell abortion equipment or munitions; violate international labor, environmental, or human rights standards; or seriously impact the U.S. economy, employment, or national interests.
Location	The proposed investment must be in Russia.
Start-up/concept stage	Historically, the Fund has avoided start-up companies.[a]
Proposal terms	The Fund and the proposing organization must agree on the proposal's terms, including an exit strategy.

[a]One Fund official told us that in the past the Fund only considered proposals that were already generating revenue, thus eliminating start-up proposals or proposals that were in the concept stage. The official added that the Fund would now consider start-up proposals if a Russian entrepreneur with a proven track record in start-ups led the proposing organization.

Our review of documents in the Fund's direct investment files showed that the Fund considered its criteria during the course of its review process.[7] Our file review also indicated that the Fund declined proposals on the basis of its criteria. Although the Fund is not required to keep documentation on the proposals it does not approve, we found at least some documentation about the Fund's decision in over 80 percent of the case files we examined. We reviewed 330 case files of the 1,578 proposals the Fund had received in the years 1994-2000 and did not approve; 62 files did not have sufficient documentation to determine why the proposal was not approved, 7 were retired because the proposing organization withdrew or did not reply to Fund inquiries, and 2 were transferred to another enterprise fund. Of the remaining 259 case files, file documentation indicated that the Fund formally declined the proposal; 179 had one or more detailed reasons for decline, 72 had only a form letter to the proposing organization stating that the proposal was declined because it did not fit into the Fund's current investment strategy, and 8 were declined with no specific reasons indicated. As shown in table 2, when specific reasons for decline were given, poor commercial viability and poor management were cited most often. See appendix II for more information on the results of our file review.

[7]One file did not contain a standard form documenting that the proposal met the USAID grant agreement terms, but we found no evidence to indicate the USAID terms were not met.

Table 2: Frequency of Reasons Given for Declining Proposals

Reason for proposal decline	Percent[a]
Not commercially viable	37
Management not acceptable	22
Outside sector emphasis	14
Terms not acceptable	13
A start–up company	10
Did not meet USAID grant terms	4
Investment not in Russia	2
Did not fit in Fund's current strategy (form letter only)	28
No specific reason for decline	3

Note: Percentages add to over 100 because some proposals were declined for more than one reason.

[a]We found at least some documentation about the Fund's decision to decline the proposal in 259 of the 330 case files we reviewed. Our statistics project that we would find similar documentation in 1,238 of the total 1,578 case files for proposals not approved. The percentages above can be applied to this subpopulation of 1,238 with a 95-percent confidence level, plus or minus 5 percentage points.

Other Organizations Use Similar Processes and Criteria

The Fund's review process and investment criteria are similar to what five other investment organizations use in Russia.[8] Like the Fund, investment officers at each organization review a proposal and, if warranted, present it to an investment team. The team negotiates with the proposing company on the terms of the proposal. During the negotiations, the investment team reviews the management and finances of the company in which it might invest. The organizations contract much of this review to local law firms, public accounting firms, and security service organizations. After the parties agree to the terms of the proposal, final approval is required by a higher-level investment committee.

The investment criteria used by these other investment organizations were similar to the Fund's criteria. Like the Fund, the two most important criteria were the quality of management and commercial viability of the proposing organization and its proposal. The officials we met with emphasized that they must have confidence in the integrity and

[8]We met with officials from the International Finance Corporation, the European Bank for Reconstruction and Development, AIG Brunswick Millenium Fund, Agribusiness Partners International, and Russia Partners Fund.

competence of the management, and in assessing the proposal's commercial viability, they look at both the current and future profitability of the venture and its current and projected market share. They also stressed that each proposal should contain an exit strategy that provides for an acceptable rate of return on the investment when it is sold.

Agency Comments

USAID, the State Department, and the U.S. Russia Investment Fund commented on a draft of this report. USAID provided written comments (see app. III), which said the report was thorough, balanced, and accurate. Both State's Coordinator of Assistance to the New Independent States and the Fund's President characterized the report as fair and balanced. The Fund also provided technical comments, which we incorporated as appropriate.

Scope and Methodology

To determine whether the Fund adhered to its review process and investment criteria, we reviewed related documentation, interviewed cognizant Fund and USAID officials, and reviewed the files for the Fund's investments and investment proposals. We reviewed documents provided to us by USAID and the Fund on the process and criteria the Fund uses to review and select direct investment projects. We interviewed the Fund's President, Chief Financial Officer, Investment Committee Chair, Board of Directors, and Chairman of the Board; other Fund investment officers; and USAID officials responsible for oversight of the Fund's activities. At the Fund's New York and Moscow offices, we reviewed (1) files for the 30 investment proposals the Fund approved and (2) a random sample (330) of the 1,578 proposals the Fund received and did not approve during the years 1994-2000 (to date). We designed our sample so that the statistics can be projected to the population of 1,578 proposals with a 95-percent confidence level, plus or minus 5 percentage points.

To determine whether the Fund's review process and investment criteria were comparable to other investment organizations operating in Russia, we interviewed officials from the Fund in Washington, D.C., New York, and Moscow; USAID; the State Department; the Overseas Private Investment Corporation; the International Finance Corporation; the European Bank for Reconstruction and Development; AIG Brunswick Millenium Fund; Agribusiness Partners International; and Russia Partners Fund.

We performed our work from May through August 2000 in accordance with generally accepted government auditing standards.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. We are sending copies of this report to the Honorable Madeleine K. Albright, the Secretary of State; the Honorable J. Brady Anderson, the Administrator of USAID; and interested congressional committees. We also are providing copies to the President and Board of Directors of the U.S. Russia Investment Fund. We will also make copies available to others upon request.

Please contact me at (202) 512-4128 if you or your staff have any questions about this report. An additional GAO contact and staff acknowledgments are listed in appendix IV.

Jess Ford, Director
International Affairs and Trade

Investments in the Russian Far East

The Fund's grant agreement with the U.S. Agency for International Development (USAID) requires the Fund to allocate at least $40 million of its $440 million in authorized capital to activities in the Russian Far East. As of March 2000, the Fund had devoted $17.5 million to the region—$11.4 through its direct investment program and $6.1 million through its financial services program. Of the $11.4 million for direct investments, the Fund invested $3 million in a supermarket chain, $0.2 million in an ice cream company, and $8.2 million in a seafood/marine equipment supplier. Of the three, only the seafood/marine equipment supplier has enjoyed any success. Fund officials told us that because of the poor investment climate, risks involved with direct investments in the Russian Far East, and limited success to date of their three investments in the region, leasing equipment offers a better financial opportunity to fulfill their $40 million requirement. As a result, the Fund is expanding its financial services program to target fishing and logging companies in the Russian Far East through an equipment-leasing program.

Officials at all of the organizations we spoke with, including the Fund, cited several limitations to investing in the Russian Far East.

- Markets are limited because of the region's low population density and low purchasing power per capita, making the potential commercial viability of ventures poor.
- The predominant industries in the Russian Far East—natural resources, construction, and fishing—are unattractive to foreign investors due to their escalating costs and susceptibility to corruption.
- Corruption is widespread both within regional government institutions and within the private sector. Companies operating in the Russian Far East have little transparency in their operations and management and often avoid relationships that would force them to become more transparent.
- The remote location of the Russian Far East (eight to nine time zones from Moscow) makes management from western Russia, where most of the Russian economy is based, difficult. In comparison, close proximity gives China, Japan, and Korea a competitive advantage in the Russian Far East markets.

Besides the Fund, of the five other investment organizations we met with, only the European Bank for Reconstruction and Development had made equity investments in the Russian Far East. The Bank has two distinct, separate operations in the region—its Regional Venture Fund for the Russian Far East and Western Siberia, managed from London, and its

primary country operation, managed from Moscow. The Bank's Regional Venture Fund set aside $30 million for equity investments in the Russian Far East and Western Siberia. However, it has invested only $12.2 million and, because of the limitations of investing in the region, has decided not to make any new equity investments at this time. In addition, for similar reasons, the Bank's primary country operation has not made any equity investments in the region.

Summary Information on Proposals

During our file review, we gathered statistical information on the proposals received and investments made by the Fund since 1994. As table 3 illustrates, the Fund received most of the proposals and made most of its investments prior to 1997. Fund officials stated that the number of proposals they received decreased after 1996 due to changes in investors' outlooks, better dissemination of information about the Fund, and the relocation of the Fund's New York direct investment office to Moscow. Primarily because of the August 1998 Russian financial crisis, the Fund made no new investments until January 2000 and instead concentrated on strengthening its existing portfolio.

Table 3: Proposals Approved and Not Approved (1994-2000)

Calendar year	Proposals approved		Proposals not approved	
	Number	Percent	Number	Percent
1994	3	10	158	10
1995	10	33	521	33
1996	3	10	363	23
1997	10	33	126	8
1998	3	10	63	4
1999	0	0	47	3
2000	1	3	32	2
Could not determine year	[a]	[a]	268	17
Total	**30**	**100**	**1,578**	**100**

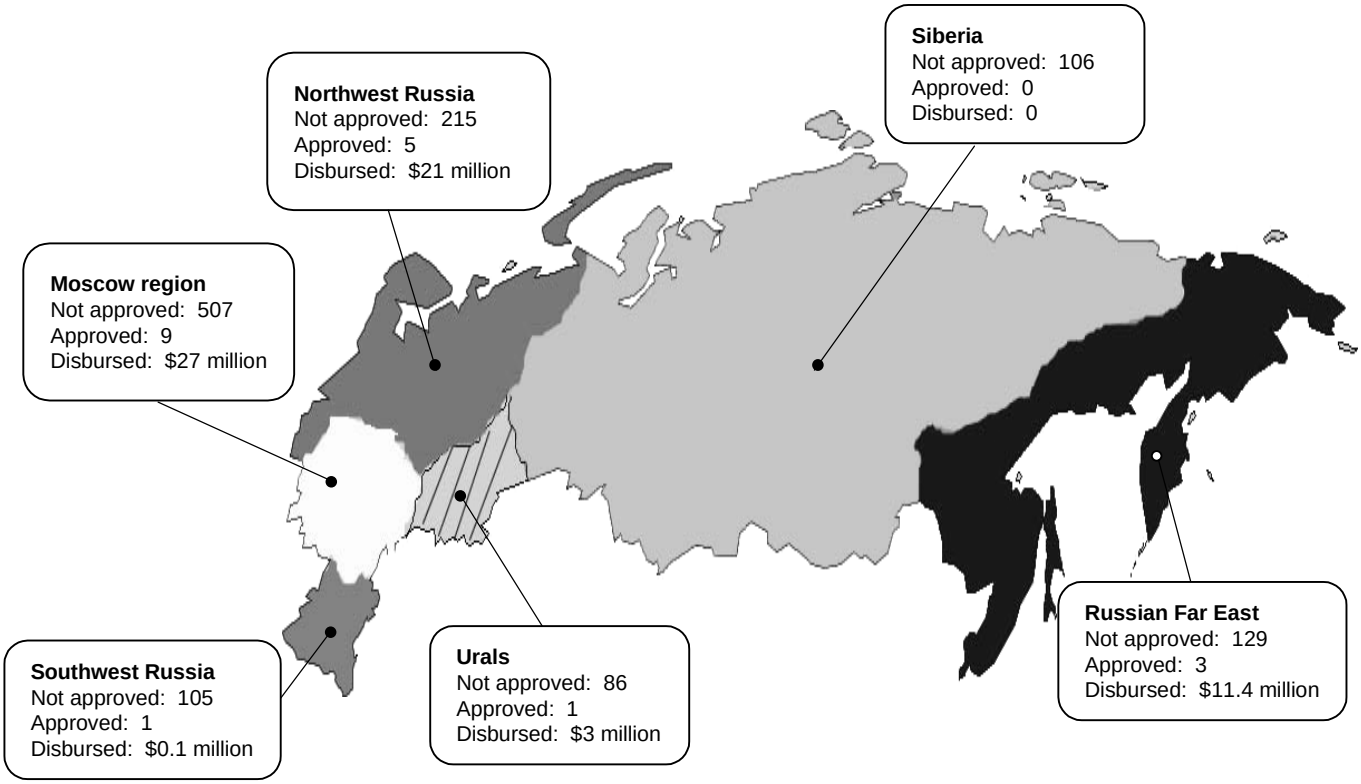
Note: Percentages may not add to 100 due to rounding.

[a]Not applicable.

The Fund received the most proposals from organizations in Russia and invested most often in proposals based in the northwest and Moscow/central regions of western Russia. Fifty-six percent of all investments the Fund made and 64 percent of all proposals it received but did not approve were proposed by organizations in Russia; 30 percent of investments and 23 percent of proposals came from the United States; the rest came from organizations in other countries. Figure 2 illustrates the location of the proposed venture; the location of the Fund's 30 investments; and the value of its investments, by region.[1]

[1]Percentages for the 1,578 proposals not approved were estimated at the 95 percent confidence level, with plus or minus 5 percentage points. The numbers in figure 2 are estimated based on these percentages.

Figure 2: Proposals Not Approved and Approved and Funds Disbursed, by Region



Location	Not approved (Estimated)	Approved (Actual)	Disbursed (Actual)
Total from above	1,148	19	$62.5 million
Multiple regions in Russia	134	11	51.9
Outside Russia	19	0	0
Could not determine	277	0	
Total	**1,578**	**30**	**$114.4 million**

Source: GAO analysis.

Comments From the U.S. Agency for International Development

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

SEP 15 2000

Mr. Henry L. Hinton, Jr.
Assistant Comptroller General
National Security and International Affairs Division
U.S. General Accounting Office
441 G Street, N.W. - Room 4039
Washington, DC 20548

Dear Mr. Hinton:

I am pleased to provide the U.S. Agency for International Development's (USAID's) formal response on the draft GAO report entitled "FOREIGN ASSISTANCE: U.S. Russia Fund Is Following Its Investment Selection Process and Criteria" [September 6, 2000].

Your report on whether or not the U.S. Russia Enterprise Fund is following its investment selection process and criteria are thorough and balanced. The conclusion that the Fund followed its review process and criteria for selecting direct investments and that the Fund's review process and investment criteria are similar to those of other investment funds operating in Russia is consistent with our understanding of their operation. We also note your conclusions that the Fund is one of the few investment organizations operating in the Russia Far East. Despite the difficult investment climate in that area, the Fund has already invested $17.5 million in furtherance of the requirement in its grant that the Fund invest $40 million of its authorized funding in the Russia Far East.

Thank you for the opportunity to respond to the GAO draft report and for the courtesies extended by your staff in the conduct of the review.

Sincerely,

Richard C. Nygard
Acting Assistant Administrator
Bureau for Management

1300 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20523

GAO Contact and Staff Acknowledgments

GAO Contact

A.H. Huntington, III (202) 512-4140

Acknowledgments

In addition to the contact named above, Jody L. Woods, Jim Strus, and Jack E. Edwards also made key contributions to this report.

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