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Central Asian-American Enterprise Fund

Центральноазиатско-Американский Фонд
Поддержки Предпринимательства

December 24, 1996

COPY

Ambassador Richard Morningstar
Special Assistant to the President for
Assistance to the Newly Independent States
US Department of State
Washington, DC 20521

Dear Ambassador Morningstar:

We are pleased to provide this response to your letter of November 15th, in which you solicited suggestions for measuring the success of Enterprise Funds.

You may recall that last spring, we shared with you some thoughts on this matter in the context of our regular Semi-Annual USAID Review.

Overall, management's thoughts remain basically unchanged. While we recognize that the Congress had some "public policy" purposes in mind when originally establishing Enterprise Funds, management remains convinced that because the fulfillment of these purposes cannot be objectively measured, we need to find other, better measures of success in order to convince the Congress that moneys appropriated for the Funds are a wise investment by the US taxpayer.

Management's concern with addressing these public policy objectives is not that we disagree that they may be important, but rather that we simply do not believe virtually any of them can be credibly or objectively measured. In this case, the Funds become ***omnia omnibus ubique*** - "everything for everybody everywhere". In our opinion, this is one of the reasons the initial review of Enterprise Funds by the US General Accounting Office and the subsequent "DAI" analysis was unhelpful -- no one really understood whether the Funds were "fish or fowl". Did Enterprise Funds exist to serve public policy purposes or were they supposed to be self-sustaining? It did not seem likely they could do both well.

In framing our responses we have tried to be as frank and honest as possible. For example, while the Fund is well-known and has a major presence in each of the five countries in which it operates, at the end of the day, with the GDP of these five countries (for 1995) estimated at over $34 billion, and the net amount of cash we might invest from our Grant, after operating expenses and technical assistance is, at best, $100 - $120 million, or less than 0.4% of GDP, it is unreasonable to believe such a small amount will "promote the private sector", or achieve a country-wide "demonstration" effect in a major way.

Additionally, we are operating in countries which have not yet fully developed the legislation, rules, and regulations needed to make a successful transition to a market economy. In none of the countries in which we operate are there fully functioning capital markets, much less competing financial institutions. Finally, virtually all of the countries remain semi-dictatorial police states which pass most laws by Presidential decree, not by Parliamentary action. The results of this are obvious and the current foreign currency crisis in Uzbekistan is a typical example.

Nonetheless we are keen to share with you our views and look forward to the iterative process mentioned in your letter to arrive at mutually agreeable targets and expectations.

Cordially,

Richard S. Bernstrom,
President and Chief Executive Officer

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OBJECTIVE CRITERIA FOR MEASURING THE SUCCESS OF ENTERPRISE FUNDS

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Overview

Whatever measures of success are finally agreed upon by the USG and CAAEF, the Fund respectfully suggests that these measures be:

- Clear and unambiguous, and not subject to interpretation
- Measurable and objective in a quantitative way
- Repeatable, in that they can be tracked over a period of time

The Fund wishes to avoid vague, unmeasurable, and ambiguous objectives and measures no matter however reasonable they appear. For example, "promoting the private sector" is a very laudable objective, but what do we really mean, and how do we measure this objective? If we have difficulties measuring this objective, how then is the Fund held accountable for achieving it? The same applies to "demonstration" effects.

Management of the Fund believes that in the end, ***measurements of investment profitability will be the most objective and "measurable", and most appropriate to judge the success or failure of the Central Asian Enterprise Fund.***

At the end of the day are we operating to make money or not? If not, we might as well all be USAID employees granting money in the traditional way. The Enterprise Funds were deliberately created to tap private sector experience and skills both at the Board and senior management level. Private enterprise exists to make profits and to create Funds which force vague or unmeasurable non-profit, public policy, or demonstration distractions on private sector management is not a good use of private sector skills and experience.

Fund Management believes that by producing profits, other "good", and measurable effects will follow. And perhaps even some unmeasurable and subjective goals will be achieved as well.

Focusing on profitability will induce management to seek out only those investments which it believes have the highest potential for commercial success, and hence profitability. Focusing on profitability will induce management to disburse money prudently, but quickly because money sitting with USAID cannot earn profits. Focusing on profitability will naturally constrain staff growth, and in turn will restrain overall expense growth. It is the carrot of profitability that will force the stick to expense control.

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Financial measures are important, but are all driven by the success of the investment program. Taking care of the investment program will in turn produce "good" financials.

Staffing levels will also be driven by investment success since the Return on Investment (ROI) includes consideration of salary and benefits expense. Good ROIs will be impossible with a bloated staff.

Demonstration and public policy objectives will ultimately be served by focusing primarily on profitability. One of the goals of the Enterprise Fund program is to invest capital where it will be used most effectively. In a capitalistic system, effectiveness is measured by profitability. ***We do no one any favors, particularly the investees, by investing in marginal enterprises, or in enterprises which cannot show profits; regardless of how socially desirable or demonstrative those projects may be.*** If, at the end of the day, we are there to assist these countries in their transition to a market based economy we must expose them to the discipline of the market - "red in tooth and claw".

The Fund's Niche Role

While the Fund currently has a mix of larger-sized direct investments and a robust small business loan program, its experiences over the last two years are causing management to rethink the current investment strategy.

While the Fund has already exited an equity investment at a gain, and expects to exit others, the lack of progress to the establishment of fully functioning capital markets, and the lack of full-service, credit oriented financial institutions, severely restricts exit strategies for equity investments.

At its December, 1996 Board Meeting, management proposed for discussion raising the capital base of the Fund's small loan program's subsidiary, the Asian Crossroads Loan Company ("ACLC") from $10 to $50 million. While the Board deferred discussion on this issue, management intends to raise it again.

Defocusing on investing in larger enterprises, and stressing investing in smaller entrepreneurs will have several benefits for the Fund, and for the countries in which it operates. These include:

- *risk spreading*. With a maximum of $300,000 going into any single venture, possible losses per investment are capped at that level. This will make it impossible to lose, for example $3-4 million on a single bad investment decision.

- *sector diversity*. A greater number of loans will be made. This in turn will allow greater diversity in investing in industry sectors. This lack of industry concentration will work to spread the risk of a single industry failing and wiping out a substantial portion of the Fund's investments all at once.
- *employment impact*. In the US, the largest engine of job growth are small businesses. It is not unreasonable to think this will also be true in Central Asia.
- *improved reflow of principal*. With set amortization schedules of two-three years, the Fund will more quickly see principal reflows allowing it to set a cycle of "planting and harvesting" investment.
- *more certain earnings*. With set interest rates, the Fund is not speculating on future exit strategies which may, in time, turn out profitable or not. The immediate income generated by small loans, while not potentially as great as equity returns, is also less risky and will allow the Fund to begin to cover its expenses more quickly.
- *overall expense reduction*. Since we will be working through local banks, and they eventually will provide loan servicing, the Fund will not have to invest to the same degree in servicing and monitoring personnel and systems. Additionally, commercial lenders' salaries are quite a bit less expensive than seasoned Wall Street venture capitalists.

While no decisions have been made as yet, management believes that it is possible that the Fund's long term niche may be more in lending to smaller enterprises and less to larger ones.

Investment Metrics

<u>Application Processing</u>

From inception through at least Year Two, and perhaps Year Three, the Fund will still be in a "disbursing" mode. The first key investment measure in the earliest years of the Fund would be the time taken from receipt of an original application to presentation to our Board, and from Board approval to disbursing. We would expect these times to decline as investment staff become experienced. Typical times for these metrics are included in the table on the following page.

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Year	Weeks from Application to Board Presentation	Weeks from Board Approval to First Funding
1	14-18	12-16
2	10-14	8-12
3 and after	8-10	6-8

Approvals and Disbursements

The next important measure, is how fast investment assets are put on the books. We believe the following measures are appropriate for disbursement:

	Percent of Total Grant	
End of Year	**Approved**	**Disbursed**
1	Less than 10%	Less than 5%
2	20-30%	10-15%
3	30-40%	15-20%
4	60-70%	40-50%
5	80-100%	75-85%
6	100%	100%

As can be seen, most of the real growth in assets is expected to be in years four and five. By this time, the Fund's operations should be running effectively, and policies and procedures should be in place along with proper disbursing and monitoring systems.

Return on Assets

Depending on the particular country, and its economy, the Fund will split its portfolio between loans and equity investments. The exact split will determine the overall Return on Assets.

Loans are generally made with minimal grace periods, and set amortization schedules. For this reason, it should be easy to calculate gross Return on Asset numbers. The single greatest unanswered question -- and one unknowable in advance -- is the magnitude of loan losses.

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Loans should be priced according to both current market rates for money and adjusted for a risk premium, despite the Fund having a zero cost of capital. The Fund expects to be compensated for risk, and this risk premium will depend on the overall environment by country, and the unique situation of each borrower. When pricing loans, the Fund bases its price on prevailing global base interest rates, then adds the risk premium. On average we would expect the following:

Country	Risk Premium	Loan Losses	Net Yield
Kazakstan	8-12%	10-15%	7-11%
Kyrgyz Republic	8-12%	10-15%	7-11%
Tajikistan	15-20%	20-30%	13-17%
Turkmenistan	15-20%	20-30%	13-17%
Uzbekistan	10-15%	15-20%	8-13%

Notes: 1. Risk premium would be the premium over a base rate such as LIBOR
2. Losses are per year of outstanding balance
3. Net yield also premium over base rate

The above calculations do not imply there are functioning capital markets in these countries, but reflect the Fund's thinking that if it were a global investor, the yield on loans must be based both on what "AAA-rated" clients would be charged plus a risk premium which reflects the Fund's probability of making a profit given the perceived riskiness of the loan.

For equity investments, the calculations are significantly more problematic. This is because investment exits can occur significantly earlier or later than planned. Additionally, there is no guarantee that a proposed, or planned exit strategy will ever be realized. This uncertainty in timing clearly impacts the time value of money, and hence the IRR calculation. Finally, although CAAEF views itself as an intermediate, and not as a long term strategic investor, it nonetheless expects most exits will take five to seven years after initial investment.

On a net IRR basis, CAAEF expects, after losses, to book equity returns in the 20-25% range over time. This will result, by Year Five, in a blended IRR in the 15-19% range. This should also be the minimum acceptable return for each investment or loan the Fund makes in the region.

Financial Metrics

Measures of financial success (or failure) also depend on the Fund's maturity.

In the early years, there will be greater-than-normal disbursing for establishing offices, purchasing equipment, computers, office supplies, and the like. After Year Two, a Fund should have begun to generate investment income, and have begun to level expenses.

The first ratio to be judged on should be income to expense coverage. This is calculated by dividing total operating expenses into total income. This ratio will change over time as the Fund matures.

The second ratio is gross expense load. This is calculated by taking total gross operating expenses and dividing by average outstanding investments over the fiscal year. This ratio will also change over time.

For both calculations, operating expenses are exclusive of Provision for Loan Losses and net revaluations of equity investments.

End of Year	Income Ratio	Expense Load
1	N/A	N/A
2	2-3%	50%
3	4-6%	20-25%
4	70-80%	9-12%
5	100%	7-10%
6	At least 100%	Less than 7%

As with investment ratios, financial numbers, as measures of the Fund's "success" are optimized only after Year Three. This is because there is a long delay between the time a Fund is organized, and investments are disbursed and income booked.

One can see in this table that the Fund expects to be fully self-sustaining by the beginning of Year Six.

Personnel and Organizational Metrics

The Fund has offices in all countries in the region. This is for political, not business reasons. Were the Fund operating strictly on a business basis, it would not have offices in the United States because there is no real business reason to be here, nor in Dushanbe, because of the on-going civil war, nor in Ashgabat due to the lack of a privatization program. Uzbekistan might also be suspect since it lacks acceptable repatriation of hard dollar earnings.

The numbers of administrative staff would be expected to be in the range of one to six per office, depending on the investment volume and number of investment professionals to be supported.

The absolute number of investment professionals cannot be set by the Fund in advance. The number depends on the difficulty of making and monitoring investments in a country, and obviously on the gross levels of investment the Fund makes in a particular country. Thus, specific numbers of staff would be different from country to country, and not subject to a predetermined formula.

Based on periodic review, the Fund expects to shift personnel resources from country to country depending on the country's progress to a competitive market place. We will not leave personnel in a country where there is little hope of making profitable investments.

The Fund also expects to substitute trained local staff for expensive ex-pat staff in order to reduce cost and promote the development of the local staff.

The Fund expects to have a special Investment Monitoring staff in the largest countries in which it operates, now Kazakstan and Uzbekistan. These units will consist of a workout specialist, a trained accountant, and a local national attorney.

Generally, for the Direct Investment Program we would expect each Investment Associate to handle between 7-10 active investments, including the monitoring of outstanding investments. For the Fund's Small Business Loan Program, ACLC, a Loan Officer would be expected to handle 20-25 active loans.

Additional personnel and organizational metrics include:

By the end of Year One:

- all investment and administrative staff should be hired and on board. The majority of which should be local country nationals.
- all US and overseas offices should be established and fully operational
- formal investment guidelines are in place
- computer systems to monitor investments are in place
- personnel compensation and benefits policies and plans are in place
- General Ledger, expense reporting and all accounting policies are in place

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By Year Three:

- local national staff should be trained and capable of moving into positions previously occupied by ex-pats
- local nationals should comprise no less than 60% of total staffing

By Year Five:

- local national employees should be assuming "Head of Office" positions formerly occupied by ex-pats
- local nationals should comprise no less than 80% of total staffing

Public Policy and Other Metrics

<u>Promoting the Private Sector and "Demonstration Effects"</u>

As discussed in the cover letter to this report, the total CAAEF Grant of $150 million is not even 0.5% of the region's Gross Domestic Product. For this reason, it is simply unreasonable to expect the Fund will have a <u>measurable</u> statistical impact on the region. Additionally, although the World Bank and IMF do publish economic statistics on the region, because of the economic perversities of the tax system, significant business activities and income are "underground" and not measured. These would surely greatly distort official figures if they were known rendering current measurements inaccurate with respect to the actual true size of the economies – both below ground and above ground.

This said, the Fund could agree on the following measurements:

In the first year:

- formal policies covering environmental expectations of investees should be in place

By Year Three:

- investments are approved in most major sectors of the economies
- investments have some geographical dispersion outside the capital of each country

- investments are across a size range consistent with investing in small and medium sized businesses, and consist of both loan and equity investments

By Year Five:

- the Fund is working with company managements to implement Employee Stock Ownership Programs, and
- has begun to exit its earliest investments at a profit

<u>Growth of Employment</u>

While discussed in the attachment to Ambassador Morningstar's letter, the Fund does not believe gross levels of employment are appropriate measures of success for an Enterprise Fund.

Socialist run economies and enterprises are well known for bloated payrolls and full employment. "You pretend to work and we'll pretend to pay you" was the joke. For this reason, it is very likely that when CAAEF invests in an existing company total employment -- at first, and for some time -- may actually decrease as non-productive workers are terminated. *Over a period of time, as the business becomes economically rational, employment might still not grow, <u>and in fact decrease</u>, as the result of new labor saving high-tech production equipment.*

No sensible Board of Directors rewards their President and CEO for growing employment. What counts is output per worker and profitability.

While CAAEF understands the attractiveness of growing employment numbers in presentations to Congress, we cannot subscribe to our success being defined as increases in employment of its investees since that concept is economically perverse in a capitalistic system. After all, we are supposed to be teaching capitalism to our investees and "demonstrating" it to the host country governments.

Understanding this, counting total employment in enterprises which did not exist until CAAEF investment might be reasonable, although misleading, as it can never be known with certainty whether an investee could find alternative sources of financing than CAAEF.

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Interface with the Ministries and the Legal System

The responsibility for representing the United States to foreign governments is well-defined and outside the scope of Enterprise Funds. As a private investor, the Fund has a self-interest in some aspects of business conducted in the country, and the business environment, but it does not believe it should participate in the overall political discourse there, nor risk aligning itself with political factions which may not exist in the future.

CAAEF will however, actively educate and lobby various government ministries to pass legislation favorable to business and investing. Since passage of such legislation is beyond CAAEF's power, the measurement here must be in the number of contacts CAAEF has with the host country ministries and the number of specific proposals it makes to those ministries.

Miscellaneous Metrics

Life of the Fund

While limited by the Grant Agreement to a life between 10 and 15 years, the Fund believes it should be a permanent institution, particularly on the small business loan front, in the countries in which it operates. Over the long term, the large equity investments in cotton mills, in factories, and in manufacturing plants will be forgotten. What will be remembered by the citizens of the countries in which we operate will be those smaller-sized entrepreneurs who were assisted by our ACLC loans. These are the future leaders of government and industry, and if the United States government wishes to make a lasting influence and friendship with the citizens of the countries, the ACLC program will be the vehicle to accomplish it. At the least, this program should be self-sustaining and perpetual.

Technical Assistance

Unfortunately, many of the Fund's investments lack expertise in specialized areas such as management, accounting, marketing, and shareholder relations. The Fund expects to spend up to 3-4% of its total Grant authorization in providing this expertise -- in a "jump start" mode -- to its investees. A main goal of providing this assistance will be to insure at the end of each subgrant, that the investee is capable of carrying on this expertise over the long run.

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Raising Outside Funds

While management was at once time hopeful of raising private money early in its life to supplement USG funds, it now believes the environment of the region is at best, five to ten years away from being attractive to purely for-profit investors. For this reason, current plans to raise private money are on hold until the countries in the region make significant progress in their transition to market economies.

Fund management would like to note that the EBRD or the IFC have not been at all helpful, responsive, or accommodating to CAAEF in its efforts to raise a private fund. CAAEF strongly recommends this be taken up at the highest levels of the State Department in formal conversations with EBRD and IFC.

Other Leveraging of USG Funds

While private fundraising is on hold, the Fund does seek opportunities for, and should be measured on its success in attracting for-profit lenders to supply capital to the region's borrowers by CAAEF guaranteeing those loans.

A major issue with these guarantees, and one which CAAEF will need to work with USAID is the scorekeeping issue.

To induce a commercial bank to accept CAAEF's guarantee, CAAEF might be called on to deposit some amount with the bank possibly up to the full amount of the guarantee, or to agree to limit approvals to funds on hand in the Letter of Credit (as opposed to funds remaining in the Grant). Because of these conditions, under our existing scorekeeping with USAID, guarantees have no real leverage effect. We look forward to discussing this further with USAID with the idea that funds tied up by loan guarantees will be treated separately from normal scorekeeping.

Summary

Management of the Fund clearly understands the attractiveness of absolute metrics to measure performance. However visitors and businessmen in Central Asia, from the days of the Great Silk Road to this very day know that things in Central Asia are not what they first seem, and are almost always linked to something else, or dependent on something else. It is for this reason that management proposes these alternative measures of success.

Appendix I - Analysis of Investment Climate

Country	Climate
Kazakstan	The recent promulgation of new decrees relating to business and exports makes Kazakstan one of the two most favorable countries for investing in the region.
Kyrgyz Republic	Investing climate generally good, convertibility not an issue, work remains to be done on fleshing out company law.
Tajikistan	The continuing civil war provides a severe disincentive for western companies, including ourselves to invest there. Physical safety of Fund personnel is an issue. We have recently decided to close our Direct Investment office in Dushanbe and concentrate only on the more manageable ACLC small business loans. The Direct Investment program in Tajikistan will be run from the Fund's Tashkent office.
Turkmenistan	The glacially slow pace of the privatization program convinces us the country is not yet serious about privatization. We are reviewing the business rationale of continuing to have a physical presence for the Direct Loan Program.
Uzbekistan	Once promising, Uzbekistan has moved several steps backwards with recent decrees and regulations regarding currency conversion. Conversion is now even more problematical and western companies are beginning to hold off on additional investment until this situation is corrected.

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Appendix II - Key Constraints to Investment

Country	Constraints
Kazakstan	Lack of fully developed business law, lack of central registration for collateral, lack of tested case law, lack of fully functioning risk-taking financial institutions, lack of functioning capital markets.
Kyrgyz Republic	Same as Kazakstan.
Tajikistan	Civil war continues, and same issues as in Kazakstan.
Turkmenistan	Lack of credible privatization program and timetable, and same issues as in Kazakstan.
Uzbekistan	Lack of currency conversion, and same problems as Kazakstan.

Appendix III - Other Investment Funds in Country

Country	Investment Funds Active
Kazakstan	EBRD Post Privatization Fund, Defense Conversion Fund, Barring Fund.
Kyrgyz Republic	Anglo-Russian Fund
Tajikistan	None
Turkmenistan	None
Uzbekistan	Anglo-Russian Fund, EBRD Post Privatization Fund being established.

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Appendix IV - Investment Activity by Local Financial Institutions

Country	Financial Institutions Active
Kazakstan	No financial institutions are active in consumer, retail, or consumer mortgage lending. Small business lending is extremely rare on any terms. Some extremely short term lending occurs for larger enterprises.
Kyrgyz Republic	Same as Kazakstan.
Tajikistan	Same as Kazakstan.
Turkmenistan	Same as Kazakstan.
Uzbekistan	Same as Kazakstan

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Appendix V - US Business Presence in Country

Country	US and 3rd Country Businesses in Countries in Region
Kazakstan	Amoco, Arco, AT&T, Bristol-Myers Squibb, Caterpillar, , Chevron, Citibank, Coca-Cola Export, Clintondale Aviation, DHL, Emerson Electric, Exxon, GE International, Hewlett Packard, IBM, John Deere, Koch Supplies, Mobil, Monsanto, Motorola, Oracle, Oryx Energy Company, Procter & Gamble, RJR Nabisco, Santa Fe Pacific Gold, Schering Plough, Sea Land, Sun Microsystems, 3M, UNOCAL, and Xerox.
Kyrgyz Republic	Bristol-Myers Squibb, Cavatel, Coca Cola, Kodak, Norton Enterprises, Pacific Resources, Procter & Gamble, the Sherwood Group, and Xerox.
Tajikistan	Pepsi-Cola.
Turkmenistan	Barash Communication, Inc., BASF, Inc., Boeing Aircraft, Coyne Aviation, Koch Group, Mobil Oil, Monument Oil and Gas Company, Xerox, and UNOCAL.
Uzbekistan	AIG, Bristol-Myers Squibb, Chase Manhattan, Coca-Cola, Enron Oil & Gas, L.M. Ericsson, Newmount Mining, Procter & Gamble, Tomen, Texaco, and Xerox.

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