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COMMONWEALTH PRIVATE INVESTMENT INITIATIVE: A SECOND PHASE FOR THE SME SECTOR

Paper for the Commonwealth Secretariat*

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INTRODUCTION

The Commonwealth Secretariat and Aureos Capital Ltd (Aureos) have formed a strategic partnership for implementing the Commonwealth Private Investment Initiative (CPII). Established in July 2001, Aureos is the premier private equity fund manager focused exclusively on investing in SME companies in emerging markets. It is a spin-off from the reorganisation of the old Commonwealth Development Corporation (CDC) and for its first five years was a joint venture between CDC and Norfund, the Norwegian development finance institution (DFI). Today, the shareholders in Aureos comprise CDC Group plc, Norfund, FMO, the Dutch development bank and employees.

2. Since 2001, Aureos has increased its funds under management to almost $1 bn and extended its geographical footprint to over 50 emerging markets covering South, East and Central Asia, China, the Pacific, Africa and Latin America, by establishing 16 regional private equity and specialist funds. Apart from its cornerstone shareholders, investors in Aureos funds include institutional investors, bilateral agencies, development finance institutions (DFIs), multilateral development banks, fund of funds, family offices and foundations and high net worth individuals. It has 26 offices around the world, with local management teams, an unrivalled presence on the ground, which distinguishes it from other fund managers. It has become a market leader in frontier markets and is a responsible investor which seeks to improve social and environmental performance, professionalise management and strengthen corporate governance. Aureos is also able to promote South/South investments through its operations[•].

3. CPII was launched in Jamaica at the 1995 Commonwealth Finance Ministers meeting. A series of regional venture capital and private equity funds was rolled out in Africa, Asia and the Pacific, mobilising public and private-sector capital customised to support different investment needs of the developing Commonwealth. The first generation of funds have successfully exited from their investments and fulfilled their objective: to demonstrate that equity capital can make commercial returns in emerging and frontier markets and have a development impact. CPII has had a sound demonstration effect about viable opportunities in economies not usually on the radar screen of private investors. This has pointed the way for greater private sector involvement in these economies.

4. The success of CPII persuaded Commonwealth Finance Ministers to support a second phase. On this occasion, they advocated greater country coverage and a reduction in deal size to focus more on the small to medium segment of the private

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[•] Some notable examples: Aureos helped a Mauritian investee company to buy products from India; a Sri Lankan manufacturing company to expand into Thailand; introduced another Sri Lanka company (proprietary producers of chassis for trailers) to the South African market; introduced its India Fund (high net worth) investors to its aluminium investee company in Panama; took a third Sri Lankan investee company to China; recruited middle managers in India for 3 investee companies in East Africa to train the local staff.

equity market. The Secretariat formed a partnership with Aureos to implement this phase as it is in a unique competitive position to deliver the mandate from Ministers. It is a niche investor in SMEs with a long and successful track record (including as part of CDC) and has a global infrastructure which could be harnessed to develop new markets and opportunities. CPII 2 brings together Aureos' track record and investment acumen with the Commonwealth Secretariat's global footprint and institutional capacity. Together, Aureos and the Commonwealth are working to mainstream private equity as a key tool in economic development, wealth creation and poverty alleviation.

5. Notwithstanding the foregoing, private sector capital flows, although perhaps more tolerant of geographic and political risk than in the past, still tend to concentrate on the major economies and on larger transactions in the emerging markets. Indeed, there remains a gap to be filled in facilitating capital flows to frontier markets, and to the small and medium segment, in particular. In order for the Commonwealth/Aureos partnership to succeed and deliver concrete results, there is a critical role to be played by Commonwealth governments, through the Commonwealth Secretariat, to enable their local pension funds and insurance companies to invest in offshore private equity vehicles like the Aureos funds. This would facilitate buy-in by local institutions, provide them an opportunity to diversify into dollar-denominated assets and participate in investment instruments which bring value-added to the local economy, apart from the direct infusion of capital. Governments also need to facilitate a suitable operating environment for private equity investments including benign tax regimes for unquoted investments. The Secretariat's support for feasibility and due diligence of new Aureos investment products also plays a very useful catalytic role in promoting investments.

THE CREDIT CRUNCH AND OUTLOOK FOR PRIVATE EQUITY INVESTMENTS IN SMEs

6. The current credit crunch has impacted on the larger emerging markets, where there has been a slowdown in the number of private equity deals involving the very largest companies. However, private equity investment in emerging markets in the low- to mid-cap companies is largely insulated from the impact of the credit crunch due to increased local and/or regional demand prompted by a growing middle class and large sections of population under-served by goods and service providers.

7. Emerging markets have demonstrated strong economies over the last five years and growth in these countries is forecast to continue to outperform that of the US and Europe for quite some time. More than half the world's population lives in these areas, and there is a hugely expanding middle class, which is creating a large consumer base in these markets. Per capita income is rising fast and the infrastructure of their stock markets (often the exit route) is maturing rapidly with several of the markets going through reforms. Most importantly, improved macroeconomic fundamentals are creating a strong underlying trend which will support robust growth over the longer term.

8. The backbone of the impressive growth in these markets is a large and vital SME sector. It is estimated that 60 per cent to 70 per cent of the private sector in emerging markets is represented by SMEs. At the moment, most of the capital flows

are going to the top end of the market, the big companies, leaving the SME sector underserved by private equity. This provides ample opportunities for private equity investors targeting the small and mid-cap segment of the market, and is one of the reasons Aureos is so well placed in the countries in which it operates to achieve above average superior risk-adjusted returns.

9. Many emerging and frontier markets are undergoing major market-oriented reforms, introducing business-friendly policies, improving their macroeconomic fundamentals and increasing their investment in infrastructure – all measures that will create environments in which young companies can more sensibly make investment plans.

10. Trade barriers are coming down within the various developing regions enabling SMEs to expand by trading within these bigger regional markets. For instance, there are currently free trade areas in East Africa, Southern Africa and West Africa and it is only a matter of time before a pan-African free trade area is formed. In fact, it is one of Aureos' investment policies to look for companies that have the potential to become "regional powerhouses" and operate actively across national borders.

CHALLENGES OF OPERATING IN THE SME SECTOR

11. Despite the evolving investment rationale, there are significant challenges, especially for investing in the SME sector. Characteristics which are common across all SME businesses include, management teams lacking a full complement of skilled managers, weaknesses in corporate governance, unsophisticated financial management, general lack of resources due to scale issues, and limited access to long-term debt finance. This is where Aureos typically adds value by providing 'hands-on strategic management' which brings in capital, management skills, leverage for credit, new technology, market intelligence, and better corporate governance. By working with local partners, it also builds local entrepreneurial, managerial and technical skills. Aureos is an exemplar of good practice in this area. Aureos has a formidable track record not only of generating jobs, incomes and exports, but also attractive commercial returns for its investors.

12. Another potential risk factor in frontier and emerging markets is the lack of sufficiently trained or experienced management. Aureos' strategy in addressing this problem is to assume an active role in investee companies at the start, by identifying and hiring key employees, vetting the incumbent management team's capability of taking the company to the next level and engaging in additional recruitment over time. Its recent experience has been that there is an influx of good quality local talent returning from Europe and US having left initially for education. Talented individuals from Africa and Asia, who have trained and honed their skills at investment banks and other financial institutions in London and New York, are now keen to return to the emerging markets to apply their knowledge in their home country.

13. Smaller economies and SMEs are typically ignored by most fund managers because transaction costs are high, the management of risk is more complex, exits for investments are more difficult to achieve, managerial skills are often in short supply and there is, very frequently, limited understanding of the operating environment. However, the need for capital to reach SMEs is greater than ever. The track record of successful investment funds has indicated that apart from the direct injection of capital, SMEs also require support at various levels in order to become sustainable businesses. Commercial viability is always an issue in the SME sector. One of the ways to address this is by providing training and technical assistance resources to assist SMEs in improving performance in various areas, including management capacity, governance practices, marketing, administrative and financial controls, strategic planning and human resource management. The prospects of SMEs would be dramatically improved if these skills are upgraded.

14. In relation to training, a significant development in the Commonwealth/Aureos partnership has been **the generous grant provided by the Government of India, Ministry of External Affairs, (Indian Technical and Economic Co-operation (ITEC)), which was announced at the CFMM in 2006 by the Indian Finance Minister, Mr P. Chidambaran. This grant has provided training to 132 SME managers of 27 Aureos investee companies in 10 countries in Africa and South Asia (excluding India).** The training has been commended by all the participants who believe it will add value to their performance and hence their companies' operations.

IMPLEMENTATION OF CPII 2

15. Following the mandate from Commonwealth Finance Ministers, Aureos launched a second phase of CPII with a series of SME funds under its management. In addition to **Kula II** and **South Asia** Funds, launched in 2006, **Malaysia Fund** in 2007, the **Brunei Fund** was launched in January 2008 and the first close of the **Africa Fund** took place in August 2008 (please see Annex for details of Kula II and the Aureos South Asia Fund). The Centre for Development of Enterprise has assisted with the training of the Fund management team and funded a programme of workshops to raise awareness on the role of private equity in a company's development, conducted in the region during the year. The Commonwealth Secretariat supported the feasibility and pre-establishment phases of Kula II which helped unlock capital from major institutional investors and facilitated subvention funding of US $300,000 per annum from AusAID and NZAID, to assist finance the operations of the Fund's manager.

16. The $25mn **Malaysia Fund** focuses on investments in the $0.5–5 mn range. The capital was committed by CDC and two Malaysian investors, the Credit Guarantee Corporation and the Employees Provident Fund. The management company is a local joint venture between Aureos and the Credit Guarantee Corporation (CGC). As in many other markets, the SME sector in Malaysia is underserved by financial institutions and yet it is central to the Government's economic development plans. Given the local investor base, Aureos is positioned to make a valuable contribution. The Fund is in advanced discussions with regard to several interesting investment opportunities and the Manager anticipates completing a number of transactions soon.

17. A new B$40mn **Brunei Fund**, Aureos (Brunei) Capital Limited closed in January 2008. It is the first SME fund for Brunei and is managed by Aureos BICB Advisers Sdn Bhd, a joint venture (JV) with Brunei Investment and Commercial Bank, a wholly owned subsidiary of the Brunei Investment Authority (BIA). Aureos will be pioneering private equity investment in the SME sector in Brunei. There are many interesting opportunities for the Fund in Brunei. Strengthening the SME sector is seen as a priority for the economy. In addition, Aureos' experience across a very broad spectrum of sectors will aid the Brunei economy in its efforts to diversify away from its heavy focus on the hydrocarbon industry. The Fund expects to invest across a broad range of sectors within Brunei such as downstream processing and support services for oil and gas; support services to oil and gas; logistics centre for the BIMPEAGA region as well as the island of Borneo; aquaculture; production of organic food products; ecotourism; halal processing hub including food, pharmaceuticals and cosmetics; and Islamic financial services. It will focus on expansions, regional rollouts, management buy-outs (MBOs) and acquisition type transactions. Given that Brunei has a relatively small economy, and that some Bruneian businesses are already looking at regional rollouts, there is potential for cross-border transactions. In fact a number of businesses have already been involved in some form of regional expansion. Investments will be in the range of B$0.4–6 mn.

18. Aureos has had a first closing of its ten-year **Africa Fund** (AAF) at $227.5 mn. AAF's objective is to target SME businesses throughout Africa to promote their growth and development. The target capitalisation of the full fund is $400 mn (with a maximum cap of $500mn) and the target net IRR is 20 per cent in US dollars net of carry and expenses. The AAF is the successor to three prior regional Africa funds: namely, the $40 mn Aureos East Africa Fund (investing in Kenya, Uganda and Tanzania); the $50mn Aureos West Africa Fund (investing in Nigeria, Ghana, Sierra Leone and Senegal) and the $40 mn Aureos Southern Africa Fund (investing in SADC countries except Zimbabwe). These funds are fully invested and have an expected net IRR of between 25-28 per cent. An Interim Facility ($30mn) was established earlier this year (provided by CDC, Norfund and FMO) to avoid being "out of the money" and allow for continued investment, which was transferred to the new fund (AAF) after the first close.

19. Aureos' operating experience in these markets (and long presence on the ground including as part of CDC) has confirmed that there is a vibrant market for large volumes of private equity in Sub-Saharan Africa. This has also been reiterated by an earlier feasibility and due diligence study supported by the Commonwealth Secretariat. In parallel with fundraising for AAF, Aureos has developed a healthy pipeline of deals almost equalling the target investment capital. A related point is that although there are several other players operating/fund raising in Africa, most of the funds are sector/country or region focused on either start-ups or mature companies. Aureos is uniquely positioned as probably the only private equity fund manager that is exclusively focused on providing risk capital to SMEs on a Pan-Africa basis.

20. Some key features of AAF are:

Structure and management – a limited liability company, incorporated in Mauritius and managed by a single Africa team divided into 3 regional hubs (Nairobi, Accra and Johannesburg) plus Aureos offices in Port Louis, Lusaka, Lagos, Dar es Salaam and Dakar. Aureos is currently in the process of setting up offices in Casablanca and possibly Angola.

Average deal size - $2-10mn; 8-10 investments per annum over a 5 year investment period. No more than 25 per cent invested in any one country and 30 per cent in any one sector. A final portfolio of approximately 40-50 investee companies.

Advisory Committee – of investors contributing at least $25mn, meeting at least bi-annually.

Advisory Panel – of local business leaders meeting bi-annually.

Profile of investors – in addition to the 3 cornerstone investors and shareholders of Aureos, CDC ($75mn), Norfund ($40mn) and FMO ($30mn), the European Investment Bank ($40mn), IFC ($40mn) local Nigerian institution ($2.5mn) came into the first close. There will be rolling closings up until 12 months post first close. For later closings, the following types of investors are expected: other DFIs, African pension funds and insurance companies, regional banks, high net worth individuals and European pension funds, large North American endowments and US-based hedge funds.

21. Aureos believes that it is important to tap into local sources of funds within the countries where investments are to be made. Often, there are sizeable sources of institutional savings which can be channelled into investments of this sort, both to demonstrate to external investors a strong degree of local support signalling confidence in the economy and to create a new class of long term assets for the investment community and for pension funds in particular•. A related point is that it would also provide local investors the opportunity to get exposure to private equity as an asset class, which has demonstrated high profitability globally and increasingly in Africa as well. Through participation, these institutions would also become exposed to investment opportunities in other parts of the continent for purposes of their asset diversification. Unfortunately, in many cases, existing regulations prevent local institutions from being able to invest in offshore private equity funds. Aureos is planning to launch second generation funds in South and East Asia in 2009 and as the strategic partner of the Commonwealth, would be seeking to enlist investment from local pension funds and insurance companies. **We hope that Commonwealth governments will facilitate their local savings institutions to invest in these funds in Africa and Asia.**

• Local pension funds remain stymied by asset allocation regulations and are conservative in their investment approach. Perhaps more inhibiting than portfolio limits is the short-term bias inherent among domestic institutional investors after decades of investing in fixed income securities. They look for predictability in returns and are uneasy with a ten-year commitment to a private equity fund. The regulatory scheme for pensions in some markets also does not reward outperformance but penalises for underperformance. Pension funds are required to cover the shortfall whereas excess returns accrue to beneficiaries. Notwithstanding, pension fund assets are growing rapidly and have outpaced the growth of securities markets and is testing the limits of the conservative policy. The forces compelling some governments to reexamine their public pension fund schemes have intensified in the last few years. The impending demographic shift is placing tremendous pressure on governments to maximize public pension funds to sustain ageing populations.

REPORT ON KULA FUND II LIMITED

Capital

Kula Fund II Limited was launched during 2006 with a target committed capital of US$25 million.

At 30 June 2008 Kula II has committed capital of US$16 million from the following investors:-

	US$	%
➢ International Investors		
- CDC	5.0	31.25%
- Asian Development Bank	4.0	25.00%
- European Investment Bank	4.0	25.00%
Sub-total	**13.0m**	**81.25%**
➢ Local Investors		
- Australia and New Zealand Banking Group Ltd (Pan Pacific)	2.0	12.50%
- Fiji National Provident Fund (Fiji)	1.0	6.25%
Sub-total	**3.0m**	**18.75%**
TOTAL	**16.0m**	**100%**

The International Finance Corporation is currently undertaking due diligence to assess a possible investment in the Fund. The final close of the Fund for capital raising purposes is 31 December 2008. To date local superannuation funds in the region (with the exception of Fiji National Provident Fund) have declined to invest in the Fund.

Investment Enquiries

Since inception Kula II has received the following enquiries:-

BY COUNTRY	No	%
Papua New Guinea	138	53
Fiji	48	17
Vanuatu	10	4
Solomon Islands	11	4
Cook Islands	11	4
Tonga	17	6
Samoa	19	7
New Caledonia	1	1
Wallis Islands	1	1
Tuvalu	1	1
Kiribati	1	1
Not disclosed	1	1
	259	100%

The status of these enquiries is shown in the following table:-

PRIORITY	No	%
Completed	4	2
Due diligence (A)	2	1
Under Review (B)	9	3
Casual Enquiry (C)	24	9
Fallout or Decline (D)	220	85
	259	100%

Investments

Kula has completed 4 transactions in the region as of 30 June 2008 with a further 2 transactions expected to disbursed by the end of July. Kula expects to hold investments totalling US$7.1 million in Papua New Guinea, Fiji, Vanuatu, Tonga and Samoa by the end of July.

Kula's investee company in Tonga was recently announced as the successful bidder for the first asset to be privatised by the Government of Tonga. Kula is committed to assisting local businesses participate in the acquisition of assets marked for privatisation by regional Governments.

Regional Representation

Pacific Capital Partners Limited maintains offices in Port Moresby and Brisbane and has representatives in Tonga, Samoa, Papua New Guinea, Fiji and Vanuatu. Discussions are currently underway to appoint representatives in Cook Islands and Solomon Islands.

Other

During the year representatives of Pacific Capital Partners Limited have conducted seminars on the role of Private Equity in Samoa, Tonga, Vanuatu, Solomon Islands and Cook Islands and have regularly met with business groups and stakeholders in Fiji and Papua New Guinea.

Annex II

REPORT ON AUREOS SOUTH ASIA FUND L.L.C

Capital

Aureos South Asia Fund (ASAF) was launched during 2006 with a target committed capital of US$ 70 million.

Targeted Countries – India, Sri Lanka and Bangladesh

On 28 February 2007, ASAF achieved final close with a committed capital of US$ 85 million from the following investors:-

➢ International Investors	US$m	%
- CDC	35.0	41.18
- Norfund	20.0	23.53
- Asian Development Bank	17.5	20.59
- FMO	10.0	11.76
- Trans-century Limited	2.5	2.94
	85.0	**100.00**

In addition, ASAF will co-invest in India with India Opportunities Fund (IOF) and Aureos Offshore India Opportunities Fund (AOIOF) both being India-specific special purpose vehicles sponsored by Aureos Capital.

IOF had its final close in May 2006 with the following commitments:

➢ Indian Investors	US$m
- High Net Worth Individuals (HNW)	4.0
- Bank of India	5.8
	9.8

AOIOF had its final close in November 2007 with the following commitments:

➢ International Investors	US$m
- PPM Capital Partners	15.0
- Purse Finance	5.0
- High Net Worth Individuals (HNW)	8.0
	28.0

Investment Enquiries

As at 31 March 2008 Aureos South Asia Fund has received the following enquiries:-

BY COUNTRY	No	%
India	258	65.65
Sri Lanka	124	31.55
Bangladesh	11	2.80
	393	100%

The status of these enquiries is shown in the following table:-

PRIORITY	No	%
Completed	6	1. 53
Pre/Post screening (A)	1	0.26
Active discussion (B)	9	2.29
Initial discussion (C)	14	3.56
Rejects (D)	363	92.36
	393	100%

Investments

Investee Company	Date	Amount (US$m)	Deal Type	Country	Sector
Dutch Lanka Trailers	08/06	1.3	Expansion	Sri Lanka	Export Manufacturing
Accutest Research Labs	06/06	4.0	Growth	India	Clinical Research
Hind High Vacuum Co	10/06	6.7	Growth	India	Engineering
Ordyn Technologies	04/07	9.7	Expansion	India	Telecom Equipment
STS Holdings	08/07	5.0	Expansion	Bangladesh	Healthcare
Paras Pharmaceuticals	11/07	6.2	Buyout	India	Pharmaceuticals

Regional Representation

ASAF regional hub office is located in Colombo, Sri Lanka. Two offices in Bangalore and Mumbai manage the investment process in India. The hub office in Colombo currently manages investment sourcing in Bangladesh.