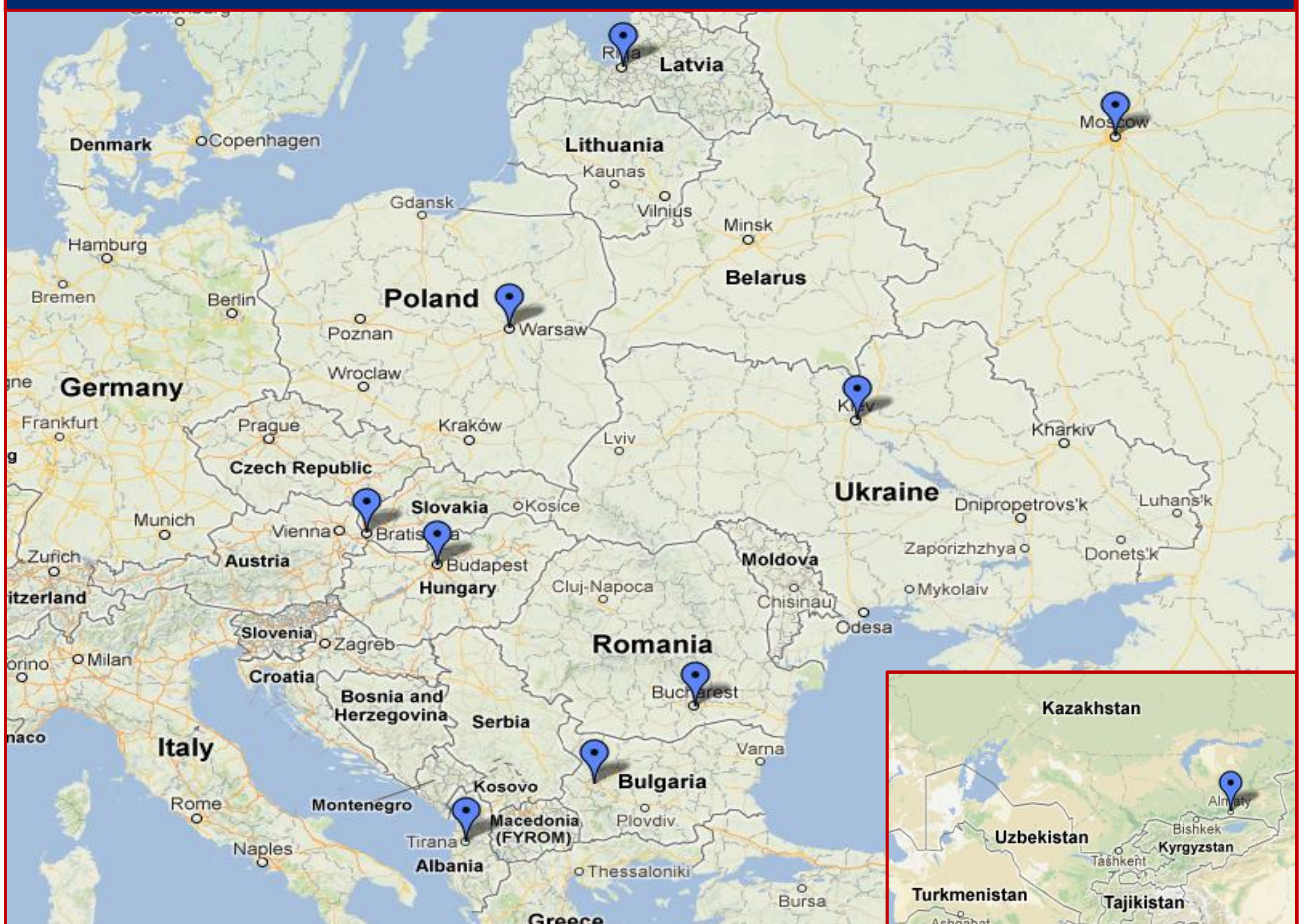
USAID
FROM THE AMERICAN PEOPLE

THE ENTERPRISE FUNDS IN EUROPE AND EURASIA:

Successes and Lessons Learned



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PREFACE

This paper is an effort to reflect on and document the successes and challenges of a group of ten (10) investment funds in Eastern Europe and Eurasia, designated as the "E&E Enterprise Funds," established by USAID following the collapse of the Berlin Wall in 1989 and the break-up of the Former Soviet Union in December, 1991. At the time of this report, nine of the 10 Enterprise Funds have now reached the point in their life cycle where they have ceased making new investments and have either completely exited their investment portfolio or are in the process of doing so. The proceeds of their investments, which in some cases significantly exceeded the amount of the original USAID grant, have been utilized to i) form Legacy Foundations in their host countries which will continue to support private sector development objectives, and ii) return a portion of the original Grant amount to the U.S Treasury.

Until recently, the Enterprise Fund model has not been replicated within USAID as an economic development tool. However, in early 2011, the events characterized as the "Arab Spring," led to a renewed interest in the potential use of this model in the Middle East region as well as in other countries undergoing economic and political transition. Following these events, there has been a significant interest within the USG in obtaining more information on the results of the Enterprise Funds in the Europe & Eurasia (E&E) region, and how the model can be adopted as one element of a broader, long-term economic assistance effort by USAID and other donors.

There has not been an independent evaluation of the Enterprise Funds for many years. Some of the more extensive reviews were completed in 1999 or earlier and do not take into account the significant accomplishments, both developmental and financial, that many of the Funds have achieved in later years, as well as the lessons learned from USAID's experience in overseeing such Funds during their 20 plus years of operations.

It is important to recognize that this document is not a formal evaluation. It is an internal review and was written with the intent of serving as a learning tool and a starting point, to assist USAID and other donors who are in the process of establishing similar investment funds.[1] It is important to understand that this report represents the lessons learned and challenges encountered, from the standpoint of the oversight role of the USAID/USG, which would not necessarily be the same as that experienced from the perspective of the Boards of Directors of the Enterprise Funds and their management staff.

This document is not intended to be a road map, or "how to" guide for all matters related to Enterprise Funds. The E&E Enterprise Funds were designed and have been operating for over 20 years. At the time they were established they were considered to be an innovative attempt to utilize a public private partnership model to address an historic opportunity to assist countries

[1] NOTE: At the time of this report, pursuant to legislation enacted by Congress, USAID is in the process of establishing new Enterprise Funds in the Middle East region, and similar investment funds are also being considered for other countries undergoing political and economic transition. In order to provide some timely input on the Enterprise Fund experience in the E&E region, the E&E Bureau's Enterprise Fund team at USAID/Washington has attempted to summarize the lessons learned from interacting with and monitoring these ten Enterprise Funds during their more than 20 years of operations in the E&E region.

transitioning from communist structures to democratic societies and competitive market economies. The lessons learned in the E&E region based on the circumstances existing there in 1989, may not be directly applicable to the circumstances on the ground in the Middle East or other countries today. For example, in the former Soviet Union commercial banking was non-existent, presenting a tremendous need to establish banks and basic financial products. This is not necessarily the case in many of the Middle East countries where there is a more developed financial sector.

This is intended to be a living document, as the lessons learned from the E&E Enterprise Funds are still evolving and will continue to do so for many years. Because several of the Funds will continue to operate for a number of years as they sell off their portfolio investments, and further develop their legacy foundations, it would be useful to conduct a final evaluation of the overall impact and success of the E&E Enterprise Funds once they complete that process. However, we believe that the experience of the Enterprise Funds over the last 20 years has provided a rich and informative body of experience that is worth capturing at this time, to provide relevant information and insights to USAID and other donors as they contemplate the formation of similar investment fund activities.

In 1989, the Enterprise Fund model was a new and unproven development tool. Over time, the performance and objectives for the Enterprise Funds evolved to include pursuit of a "double bottom line" (sometimes referred to as a "dual mandate"): i) contributing broadly to economic development in the countries where they operate and, ii) achieving financial profitability as a demonstration to others that it is possible to invest profitably and transparently in these transitional environments. In considering their impact it is important to remember that the Enterprise Funds were created primarily as economic development tools to help "jump-start" these economies and to assist, more broadly, in private sector development within their host countries.

Despite their overall success, there have been many challenges, and there have been important lessons learned that should be carefully considered in establishing similar investment funds in the future. Initially, USAID was directed to provide only very limited oversight of the Funds, in the belief that the private sector Boards of Directors and management staff had unique investment experience and would not require USAID oversight, unlike with other grants. After a few years, USAID was directed to implement a more active oversight program to insure compliance with the terms of the grant and adherence to appropriate financial and corporate governance standards. Also, when Funds were financially successful they often generated significant incentive compensation for their managers, similar to what would occur in private sector investment funds. (See "Lessons Learned" section herein)

This paper is primarily a work product of Steve Eastham, David Cowles and Richard Johnson (now retired), and would not have been possible without their effort. Any shortcomings or inaccuracies herein are solely attributable to them. Others who have contributed significantly to the completion of this review are as follows: Jerry Bisson, Neal Nathanson, Sharon Valentine, Sandra Goshgarian, Elizabeth Jones, and Matt Hutcherson.

This is not a formal, independent evaluation, but rather represents an assessment by the Bureau charged with design, implementation and oversight of the E&E Enterprise Fund and does not represent an official Agency finding.

EXECUTIVE SUMMARY

BACKGROUND

With the fall of the Berlin Wall in November 1989, and the collapse of the Soviet Union on December 25, 1991, 29 countries in the former Eastern bloc began the transition process from centrally-planned to market-based economies. Realizing that these new states lacked the financial sector capacity necessary to support this historic transition, the United States Congress authorized nearly $1.2 billion through the U.S. Agency for International Development to establish ten (10) new investment funds, collectively known as the "Enterprise Funds" (or the "Funds"), covering 19 of those countries in Central and Eastern Europe and the Former Soviet Union. For each fund, USAID identified and the White House designated an independent Board of Directors, to serve on a pro bono basis, to guide the Fund's strategy and provide supervisory oversight. Although many challenges were encountered, including slow starts and organizational difficulties, after 20 years of operations throughout the Europe and Eurasia region (E&E), it is clear that, collectively, these ten (10) Enterprise Funds have been successful both in accomplishing their original economic development objectives, as well as achieving substantial financial returns, although there has been significant variation in the performance in individual funds.

IMPACT OF THE ENTERPRISE FUNDS

The Enterprise Funds are one of the very few development programs to ***achieve sustainable economic development impacts while leveraging additional investment resources, generating significant program income to endow long-term host country Legacy Foundations, and ultimately returning a significant portion of their original grant funds to the U.S. Treasury.***

The following is a summary of the substantial economic and development impacts provided by the Funds as of September 30, 2012:

- **$1.2 billion of USAID/USG funding has been invested into enterprise development in 19 countries**
- $**1.7 billion** of net proceeds realized from successful investments have been reinvested by the Funds allowing them to leverage the use of their initial funding
- $**6.9 billion** of private capital was raised from outside the USG, based on the convincing value proposition of the Funds

  A total of **$9.8 billion** in capital was raised from all sources over the life of the Funds

- Significant development capital was provided to SMEs and entrepreneurs operating in early-stage transition countries where private investment capital was limited or non-existent, which helped create an environment where the culture of private enterprise could flourish
- Over 300,000 jobs were created or sustained through investment and development activities

- The Funds provided **$77.7 million** in technical assistance for skill-building and technical training in finance and management to assist SMEs and to strengthen the private sector
- To date, the Funds have returned **$225.5** million to the USG and are on track to return over **$400 million** of the original USAID funding
- Remaining proceeds of **$1.3 billion** will endow ten (10) long-term philanthropic "legacy" institutions, which will continue to promote private sector and civil society development, and continue to build goodwill between the US and their host countries after USAID has exited the country
- The E&E Enterprise Funds were modeled after western style venture capital funds and created an important cadre of local financial sector professionals and introduced western financial concepts
- As a result of their investment activities, the Enterprise Funds have had a catalytic affect and transformational impact on the economies of the E&E region

DESCRIPTION OF ACTIVITIES

In addition to making direct equity investments and loans to a wide range of private enterprises, the Enterprise Funds played a key role in introducing new financial products into the region, such as home mortgage lending, mortgage securitization, credit cards, mezzanine financing, equipment leasing, and investment banking. In cooperation with other USAID-funded development programs, the Enterprise Funds played a pivotal role in removing institutional and regulatory roadblocks to market-driven private investment. Enterprise Funds have been instrumental in the transformation of renters into home owners and small business owners into citizen-stakeholders, who are vested in creating sustained economic growth in their countries.

As might be expected, the effectiveness of the ten E&E Funds varied greatly by country, based on the economic and political conditions on the ground, as well as the overall investment strategy and specific investment decisions made by each Fund's Board and management team. In the early years of operations, the financial performance of certain Funds was less than anticipated. However, as the Funds gained experience in the region, the long-term results have been significant.

In the E&E region, the Enterprise Funds were created before traditional venture capital funds were willing to invest. Thus, the Funds were pioneers in demonstrating that private sector investment in this region was feasible and could be profitable. Over time, this demonstration effect helped attract substantial foreign direct investment capital to further promote private sector development in the E&E region.

As the Enterprise Funds complete their active investment phase, investment proceeds are liquidated and a portion of those proceeds is used to establish long-term philanthropic or "legacy" institutions ("Legacy Foundations") that will continue to strengthen and promote private sector and civil society development in their host countries. These new Legacy Foundations will continue to advance USAID, USG and host country economic development objectives without additional USG funding. In addition to providing economic and development assistance on a sustained basis, they will also continue to generate goodwill between the U.S. and these countries for many years to come.

Legacy Foundations now operate in: Poland, Hungary, Central Asia, Bulgaria, Romania, Slovakia, Albania, Russia, and the Baltics. The Western NIS Enterprise Fund will complete its investment phase in 2013 and is expected to return additional funds to the US Treasury and use the balance of their assets to establish a Legacy Foundation that will operate in Ukraine, Moldova, and Belarus. This ensures that there will be a continuing flow of USG support for economic development in these countries long after the Enterprise Funds have completed their active investment phase.

This paper broadly examines the USG/USAID-funded Enterprise Funds operating in the Europe and Eurasia Region (E&E) 20+ years after their creation. The ***Introduction*** *section lays out the background and historical context for the Enterprise Funds. The paper then discusses the Enterprise Fund experience in terms of* ***Measuring Success, Lessons Learned and Recommendations*** *for implementation.* ***Annex A*** *provides more detailed financial data and summarizes the successes and accomplishments of the ten (10) E&E Enterprise Funds.*

INTRODUCTION

A REGION IN TRANSITION

In 1989, President George H.W. Bush introduced a bold, new concept in development assistance during speeches given in Poland and Hungary, two former Soviet satellite states, which were about to begin the difficult transition from centrally managed economies to free market economies. While many were shocked by the rapid decline of Soviet power, others realized there was a tremendous opportunity to help former communist countries transition to functioning market-based economies with democratic political systems. The Enterprise Fund model was envisioned to create Western style non-profit investment corporations managed by a combination of American and locally hired private sector investment professionals. The Funds would then make equity investments and loans and provide technical assistance to investee companies and introduce new financial products in the market.

These investment activities would be funded by USG grants, would have a Board of Directors composed of experienced American business leaders serving on a pro-bono basis, and would be monitored by USAID on behalf of the USG. This **public-private partnership model** was based on a "dual mandate" approach that has proved very successful as a means of promoting private sector development in the former Soviet bloc, through a combination of investment and development activities. The Enterprise Fund model was also unique in that the Funds' Boards of Directors served on a pro bono basis throughout the life of the Funds, thereby harnessing senior U.S. private sector expertise and advancing the concept of service and volunteerism in the region.

The basic premise for these "Enterprise Funds" was that, in parallel with the work of USAID and other donors to improve the overall business enabling environment and establishing the regulatory mechanisms to support macroeconomic stability, financing the creation and expansion of the private business sector was the most direct way to promote private enterprise growth in these former centrally planned economies. At the time the Funds were established, these nations were all severely lacking private investment capital, a functioning commercial banking system, and most of the institutional and regulatory structures that comprise a modern well-functioning financial system. The Enterprise Fund concept was designed to be implemented through these new investment funds, led by experienced private sector business professionals who could act outside of local government influence. This approach would allow them to effectively and efficiently respond to the evolving challenges in these economies, which were undergoing an historic economic and political transformation process.

Challenges in the Investment Environment

- Lack of well-functioning capital markets
- Lack of private investment capital
- Lack of a functioning commercial banking system
- Lack of institutional and market regulatory structures
- Lack of legal protection for investors
- Lack of company credit-worthiness information and financial disclosure
- Difficulty in legally enforcing contracts
- High business start-up costs and time consuming registration procedures
- Lack of an adequately skilled labor force

In 1989, the United States Congress authorized $300 million in the Support for Eastern European Democracy Act (SEED) to form the first two Enterprise Funds in Poland and Hungary. Congress later expanded SEED Act funding to include five additional funds and added similar authorizing language to the FREEDOM Support Act of 1992 (FSA), allowing for inclusion of the former Soviet states. Following the Congressional mandate, USAID established a total of ten investment funds throughout Central and Eastern Europe and the Former Soviet Union with total authorized funding of nearly $1.2 billion, collectively known as the Enterprise Funds.

The Enterprise Funds, in conjunction with a wide range of additional economic and technical assistance projects funded by USAID and other donors, were intended to promote free market economies in the Former Soviet Union and satellite states over a 10 to 15 year transition period. The objectives of the Enterprise Funds were broadly stated in the legislative language of the SEED and FSA acts to include:

- Development of the private sector, including small businesses and the agricultural sector, and joint ventures between the United States and host country participants, and
- Policies and practices conducive to private sector development.

Countries or Regions	USAID Authorized (millions)
Russia	$329
Poland	$255
Ukraine, Moldova & Belarus	$150
Central Asia	$106
Hungary	$ 73
Czech & Slovak Rep.	$ 64
Romania	$ 61
Bulgaria	$ 58
Baltics	$ 50
Albania	$ 30

During the life of the Funds, the global economy has seen significant volatility. The Enterprise Funds in E&E had a front-row seat for the 1998 Russian financial crisis and more recently, the 2008-2009 global economic crises – during which the E&E region was particularly affected. In this difficult environment, the Enterprise Funds have filled a significant and fundamental gap by providing: 1) direct investment capital at a time when conditions would not have attracted outside investors; and 2) liquidity and development finance in these fragile capital markets. When taken in context of the economic and political struggles the region was facing, the significance of the Enterprise Funds' overall development impact and investment performance is particularly noteworthy.

MEASURING SUCCESS

Over the life of the Enterprise Funds, USAID has provided a total of $1.2 billion in funding to the ten Funds. Through a combination of re-investment of profits and capital reflows, lines of credit, co-investments by third parties and raising additional equity capital, the **$1.2 billion in USAID funding has leveraged total investments of nearly $10 billion** for the Europe and Eurasia region. Further, the use of liquidation proceeds from the investments of the Enterprise Funds has resulted in the creation to-date of nine (9) Legacy Foundations with over $1 billion in assets, and the Funds are on-track to return over $400 million to the American taxpayers. A 10th Legacy Foundation is expected to be added in 2013 with the winding down of the Western NIS Enterprise Fund.

Nine of the ten Enterprise Funds have completed their active investment phase and have either fully liquidated or are in the process of liquidating their assets. As previously agreed with Congress and USAID, the Enterprise Funds are using their liquidated assets to: (1) establish charitable Legacy Foundations in their host countries to continue supporting and funding private sector development; and (2) in most cases, return a portion of such assets to the U.S. Treasury[2].

The long-term collective success of the Enterprise Funds does not belie the degree of uncertainty and numerous obstacles that existed at the beginning of the conversion to free market economies in Eastern Europe and the Former Soviet Union. These countries lacked transparency, private property rights, modern banking and financial institutions, and consistent laws and regulations. From the very beginning, the Funds faced undeveloped markets and serious problems with corruption, which lowered profit expectations and raised the level of perceived investment risk. The extremely difficult financial and economic environment faced by the Funds' investment managers, and a lack of sound investment opportunities, led many of the Funds to be appropriately cautious in the first several years of their investment activity. Even after the first 5-7 years of operations, some of the Funds had not yet achieved a significant impact, leading some to conclude that the Enterprise Fund model was not a viable economic development tool. However, at the end of the Funds' active investment phase, collectively, the Funds have been successful in:

A story of success:

Enterprise Fund Accomplishments

- Broaden the range of goods and services offered in host countries
- Introduce modern technologies
- Attract new foreign investors to local markets
- Develop capital markets in host countries
- Support and train local managerial groups
- Improve social responsibility of business and legacy activities

- Promoting the establishment of key financial institutions in their host countries;
- Contributing to policy, legislation, and regulatory reform which strengthened the enabling environment for business and deepened the financial and capital markets in each country;
- Attracting substantial foreign direct investment (FDI) to the region;
- Creating numerous legacy institutions, greatly increasing the longevity of USG impact; and
- Achieving financial profitability and returning substantial investment reflows to the U.S.

Thus, by any objective measure, the aggregate impact of the E&E Enterprise Funds has demonstrated their ability to accomplish the dual-mandates of promoting economic growth and

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[2] USAID with approval of Congress, determined that a portion of the total assets available at the termination of the Enterprise Funds would be returned to the US Treasury and the American people, and the balance would remain in the host country to establish ongoing 501(c)(3) Legacy Foundations, which would make grants to local NGOs and other organizations, to promote private sector development.

development, while demonstrating profitable and transparent investment practices. Since inception, the Enterprise Funds have collectively:

- Invested **$2.97 billion** in host countries (includes recycling of original investment capital)
- Financed **$77.7 million** in technical assistance
- Leveraged **$6.9 billion** in debt, equity capital and co-investment, which together with USAID's grants funds, and reinvested funds, resulted in a total of **$9.8 billion** total capital
- Expected to return over **$400 million** of the original grant funds to American taxpayers
- Resulted in approximately **$1.3 billion** in available funding for follow-on legacy institutions
- Created over **300,000 jobs** through investment and development activities

As noted above, the results for the ten E&E Funds varied greatly by country, based on the economic and political conditions on the ground, as well as the overall investment strategy and specific investment decisions made by each Fund's Board and management team. In the early years of operations, the financial performance of certain Funds was less than anticipated. However, as the Funds gained experience in the region, the long-term results have been significant. Many of the Funds were able to significantly increase their original capital and net asset values in their later years, as the economic environment in host countries improved and their portfolio companies matured. In the E&E region, the Enterprise Funds were created before traditional venture capital funds were willing to invest. Thus, the Funds served as true investment 'trailblazers', demonstrating that private sector investment in this region was feasible. Over time, this demonstration effect helped attract substantial foreign direct investment capital to further promote private sector development in the E&E region.

Enterprise Funds were able to fill an important void in the nascent capital markets of transition economies, leveraging USG grant funds to act as a catalyst for economic activity, and resulting in additional financing alternatives for private sector businesses. The Enterprise Funds in the E&E region collectively created over 30 financial intermediary entities and have facilitated the availability of:

→ **Home mortgage lending**
→ **Mortgage securitization**
→ **Credit cards**
→ **Pension funds**
→ **Mezzanine financing**
→ **Equipment leasing**
→ **Investment banking**
→ **Loan syndication**

In addition, the Funds have cooperated with USAID and other donors in providing technical assistance to companies, helping them conduct strategic and financial planning, updating key financial reporting, leading business training, and identifying strategic partners. In many countries, the Funds created the first modern financial service institutions, which made sophisticated lending and investment activities possible. To accomplish this, the Funds were involved in activities such as transforming state-owned banks into internationally viable, privatelyowned lending entities and acting as a catalyst for host country governments to enact necessary legislative reforms.

The Funds have also been instrumental in developing nonprofit organizations like the US-Russia Center for Entrepreneurship, whose mission is to advance entrepreneurship by providing highly practical, short-term financial and management training to meet the immediate growth needs of entrepreneurs and business managers. After more than 20 years of active investment and engagement in reform efforts in their host countries, we have seen that that the Enterprise Funds' role in systemic economic development has often been as important as its role in private sector finance and investment.

The Enterprise Funds have been instrumental in the promotion of free market economies, the development of private sector businesses and financial markets, contributing to transformation of the economies of Central and Eastern Europe and the Former Soviet Union, and in providing increased stability and economic advancement for citizens in the region. Additionally, the willingness and commitment of over 100 senior level U.S. investment and business professionals to serve as Board members of the 10 E&E Enterprise Funds on a pro bono basis throughout the life of the Funds, demonstrated the American people's commitment to service and volunteerism within their host countries.

LESSONS LEARNED AND RECOMMENDATIONS

The following section sets forth the 'lessons learned', from the perspective of USAID, in the creation and implementation of the Enterprise Funds, and incorporates recommendations to inform further discussion regarding any potential new Funds utilizing the Enterprise Fund structure. Given the unique and historic challenges in the E&E region when the Enterprise Funds were being formed, the Enterprise Fund model has proven itself as a viable economic development tool, when used in appropriate circumstances where it can contribute to providing a significant positive impact. Collectively, the funds have proven themselves successful from the dual mandate, or double bottom line of achieving economic development impact as well as overall positive financial returns. Nevertheless, with the benefit of hindsight, there are certain important lessons that can be taken from this experience, which could assist in designing, implementing and overseeing any similar such funds in the future.

GOVERNING IDEOLOGY

1. ***In order to be successful, Funds need to be implemented in parallel with the work of USAID, other donors and host country leaders, to provide a wide range of traditional economic and technical assistance tools to create a supportive business enabling environment.***

The work of USAID missions and other donor organizations, along with the committed efforts of host country citizens and counterparts, in providing long-term, in depth technical assistance, training, judicial, legal, and regulatory reform, has been the cornerstone for building well-functioning economies in the transition countries within the E&E region. Without this broad range of assistance to reform the overall business enabling environment, as well as capacity building assistance for economic regulators, entrepreneurs, and business owners, the work of the Enterprise Funds would have been a much greater challenge and likely could not have been as successful. The Enterprise Funds can also work to directly support the goal of improving the business enabling environment, functioning as an effective voice of the private sector in lobbying and advocating for reform.

2. *Successful Fund and management performance should be based upon a demonstration of profitable investing as well as the support of targeted development objectives – the "dual mandate" or "double bottom line."*

When the SEED Act and the FSA were drafted, Congress and development experts were not primarily concerned with the level of profits that the Enterprise Funds might generate. They were focused on how the former Soviet countries and satellite states could transition from centrally planned economies to free market economies without pre-existing modern banking and financial sectors, legal regulations, and property rights. The grants given through the Enterprise Fund program were designed to "jumpstart" the newly emerging market economies and financial sectors. For example, while the profitable sale of Delta Credit Bank by the Russian Fund was important, the fact that this Fund promoted the introduction of mortgage legislation was equally important, as the latter financial tool is now in place to help individuals and companies in the future.

When evaluating the performance of a Fund or the Fund's management, the USG (i.e. State, USAID, and Congress) should take into account the "dual mandate" to: (1) support targeted development objectives and (2) provide a demonstration of profitable private sector investing. However, even without significant financial returns, many believe that the significant developmental accomplishments of the Funds justify the grant investments made by the USG. Similarly, Board Members of the Funds have observed that, to the extent USAID or others encourage the Funds to focus more on financial profitability, the Boards would be reluctant to pursue potentially higher risk projects which could have a greater development benefit. Profit maximization should not be the sole goal or objective of the Funds.

3. *Effective oversight and maintaining close working relationships between USAID and the Funds' Board of Directors and managers are critical to the long-term success of the Funds.*

In the early years of the E&E Enterprise Funds, USG oversight roles and responsibilities for the Funds were not clearly defined. In cooperation with the Funds, Congress and USAID developed a reporting structure and format to satisfy necessary requirements for USG oversight. This structure included regular meetings between USAID and the Board, the creation of individual Fund oversight teams, semi-annual reviews to ensure compliance with the terms of the grant agreement, the right for USAID to conduct site visits and independent evaluations, as well as independent audits to verify financial reporting.

The E&E Bureau maintains a team of professionals that actively reviews submissions from the Funds and independent auditors and meets regularly with the Funds' Boards and management teams. Based on early experience, it was understood that USAID should not take an entirely "hands-off approach" to its role, as was originally directed. Rather, it is necessary for USAID and the Coordinator's Office within the Department of State, to maintain a close working relationships with the Boards of Directors and Fund managers, similar to other USAID grants, while not participating directly in the Funds' investment and programmatic decisions.

4. ***Funds should be given maximum flexibility to use a variety of investment tools to meet development objectives.***

Initially, it was anticipated that the Enterprise Funds would take equity stakes in companies being privatized and sell those stakes at an appropriate point in time. In practice, the Enterprise Funds used a variety of investment approaches. For example, in some countries, poor corporate governance and weak legal structures and financial environments made direct loans to companies a much more effective means of managing investment risk than a straight equity investment.

In other situations, Funds took majority equity stakes in order to effectively manage the risk and return of their investments and to protect their rights as outside investors. In other cases, Funds have been very successful in developing new financial instruments and markets, such as residential mortgage programs and small business finance, by establishing new banks, leasing companies, insurance companies, and other financial institutions, as well as investing in new greenfield projects offering new goods and services that were not adequately developed in the region. The clear lesson is that the Fund Boards and managers need to have sufficient flexibility to develop a suitable investment strategy based on local conditions. In addition, Funds need to be free to choose which businesses and economic sectors to target rather than being influenced by political or other outside interests.

5. ***The pace of investments made by the Funds should parallel the ability of management to find good investments within the host country environment. Expenditure of grant funding will likely be slower than traditional USAID grants.***

Funds should be encouraged to undertake research and form an understanding of their host country investment environment, while being given wide discretion regarding specific investment decisions. For example, while the Polish-American Enterprise Fund (PAEF) initially planned to make equity investments, it quickly discovered that it did not have enough information about the Polish investing environment for its investments to ultimately become profitable. Pulling back, it shifted its strategy toward making direct loans to businesses rather than acquiring an equity interest, while gaining knowledge and expertise in Poland's investment environment. As conditions improved, PAEF began making equity investments as well. Future funds should be encouraged to pursue attractive investments in viable enterprises and development projects based on the business judgment and experience of Fund managers and the strategic guidance of their Boards of Directors.

Early on, many of the Funds were not considered successful by traditional development aid grant standards wherein the success of a development program is partially associated with the relatively fast expenditure of grant funds along with the achievement of demonstrable results. Policy makers should have tolerance with these types of funds during the early years, especially where the host country is undergoing significant political and economic change.

6. ***The investment time horizon for each individual Fund should be carefully established based on the overall state of a country's economy, the respective legal and regulatory environment and the country's development priorities.***

In order to operate efficiently, the Funds' Board of Directors must select a strong management team, which is able to explore the investment opportunities in local markets, and conduct due diligence, among other required start-up tasks. In many cases, this start-up period took up to 24 months before the Funds were ready to make their first investments. Even after the Funds were operational, many exercised great caution in their investment strategy, due to uncertainty in local markets and the lack of attractive investment opportunities in their host countries.

The Enterprise Funds, however, represent a unique economic development concept, and their success is difficult to fully judge using traditional development measures. Ironically, in later years, after some of the Funds achieved significant financial success with their investments, there was a tendency by some to analyze and judge the Funds based solely on their financial rate of return, rather than the original economic development objectives. The Funds were operating in extremely fragile, transitioning markets with high investment risk and minimal protections for investors.

The long-term investment horizon of the Funds allowed the markets to develop sufficiently, investments to mature, and in many cases, for the Funds' investments to ultimately generate attractive financial returns while also contributing to broader economic development goals. Based on the experience of the Enterprise Funds, similar programs should be given an operating and investment timeline commensurate with the investment environments expected within the host countries; this may require a long term view. However, Funds should have a finite period of operations, generally 10-15 years.

It is important to provide legal authority for USAID to impose a reasonable time frame for each Fund to make an orderly exit from its portfolio, so that the need for USG oversight and the expense of winding down the Fund is minimized. At times this may conflict with the desire of Fund management to generate incentive compensation. However USAID must have the authority to determine the point at which desired developmental objectives have been achieved and to balance such goals against the desire to maximize financial returns.

7. ***The amount of USAID financial support for Enterprise Funds within a country should be determined based on the specific needs and development objectives existing in each country. It is also necessary that a Fund be established with a sufficient base of capital that it can attract a skilled Board and management team, and that the Fund is seen as having sufficient resources to significantly benefit the host country and its financial markets.***

Population size and geographic distribution are not the only factors to consider when appropriating funding for specific countries. A country's economic progression, diversity in employment opportunities, financial sector maturity, transparency, private property rights and enforceability of laws and regulations must be carefully evaluated to determine the appropriate level of capitalization necessary to allow each Fund to operate successfully and to provide the desired development and financial impact within their host country environment. The Funds must have enough capital to cover operating costs for the life of the Fund, and to attract a professional, qualified staff, capable of achieving the desired development impacts. However, there does not have to be a strict proportionality between a country's region or population size and the size of the fund, as was initially assumed. Critics of the Enterprise Fund model have often argued that, for Funds to be truly successful, they require a substantial amount of investment capital and funding—i.e. hundreds of millions of dollars. The Enterprise Funds, however, have demonstrated that this is not necessarily the case.

The smallest Enterprise Fund was the Albanian-American Enterprise Fund (AAEF) with an initial investment capital of $30 million. The Fund has taken its original $30 million appropriation and, through reinvestment of profits, has directly invested $111 million in 77 investments in 40 companies. Over five thousand new jobs have been created and $1.2 billion has been contributed to Albania's GDP by current and former portfolio companies. During the time that the Fund was the owner of the American Bank of Albania, now Intesa Sanpaolo Albania, the Bank provided $977 million in financing to companies in Albania that contributed $2.2 billion to the Albanian GDP. More than $300 million in additional foreign direct investment was attracted to Albania by AAEF investments. Starting from this modest capital base, the Fund was able to profitably finance infrastructure and banking projects, including the creation of the following:

- The Mother Theresa International Airport
- The first biometric identification card for all citizens and the first biometric passports
- The American Bank of Albania

The Fund took the U.S. Government grant of $30 million and turned it into an investment portfolio worth approximately $208 million and which is still growing. After returning half of the original capital to the USG, more than $150 million was used to create the Albanian-American Development Foundation. As the remaining assets are liquidated, the additional capital will be added to the Foundation. The current estimated value of the Fund and the Foundation equals **700%** of the original USG grant amount. Similarly, working with an initial $50 million grant, the Baltic-American Enterprise Fund (BalEF) was able to raise over $300 million in multilateral and commercial bank funding and ultimately invested $749 million in the Baltic region.

At the other end of the spectrum, the U.S. Russia Investment Fund (TUSRIF) was the largest of the Enterprise Funds, with an original grant funding level of $329 million for economic development activities in Russia. Due to the vast geographical and political challenges facing Russia when the Funds were founded, it was assumed that TUSRIF needed a large amount of funding in order to achieve the desired development impacts, and that smaller levels of funding would be insufficient to achieve these goals. However, the Fund has greatly benefited from effective management oversight and has successfully invested its grant funding realizing investment reflows in excess of $300 million, and attracting an additional $1.2 billion in equity, debt, and co-investments. TUSRIF has achieved its development impact goals by establishing Delta Credit Bank, a mortgage bank designed to develop best practices for the home mortgage market, funding Delta Bank, which introduced western-style credit cards to Russia, and founding the U.S. Russia Center for Entrepreneurship, which provides short-term practical training and networking events targeting the growth needs of entrepreneurs and business owners.

The successful experience of the AAEF, BalEF, and TUSRIF provides additional evidence that the success of an Enterprise Fund is not directly tied to the size of the Fund. Rather, successful Funds should be tailored to the specific needs and existing conditions of the host country. It may be that $30 million represents the lower range for a viable fund able to cover overhead and start-up costs and achieve a positive economic return on the overall portfolio.

8. ***Regional or multi-country Funds pose significant logistical, operational, and political challenges and are often considerably more expensive to operate than Funds based in a single country.***

The investment needs of a region should be closely examined before deciding whether one large fund or several smaller, independent funds would be best suited to the stated development objectives. Countries often have major cultural, legal, political, and linguistic differences, making management of investments in multiple countries difficult and expensive. For example, while standardization of products and services has been possible across all three Baltic countries involved in the Baltic-American Enterprise Fund, the other two multi-country Funds (the Western NIS Enterprise Fund, and the Central Asian-American Enterprise Fund) determined that they would need to establish an office in each country within their sub-region, in order to provide a sufficient level of "hands-on" involvement, thus making it somewhat redundant and more expensive to have a multi-country Fund.

In the case of the Western NIS Enterprise Fund, an office was opened in Belarus for diplomatic reasons and at the request of the USG, even though the environment was not particularly conducive to profitable investment at that time. Correspondingly, if a Fund is tasked with investing in a geographic region composed of many different states, Fund managers should be permitted to choose investments based on objective economic criteria, and not based on political influence or mandates to allocate capital in various countries or investment sectors.

9. ***Fund managers should balance cost efficiency with the need to cultivate a professional business work environment and supportive organizational structure.***

The unique structure of the Enterprise Funds allowed individual Fund management teams to develop and implement strategies that specifically targeted individual country needs based on their varying economic and political environments. A few Fund managers attempted to minimize operating costs in the management offices so that more funds were available for direct investment in the capital and financial markets of host countries, which may have compromised the ability of the Fund to attract experienced investment staff as well as its visibility within the business community. A professional and orderly atmosphere encourages professionalism amongst the staff and emphasizes the business aspect and private sector approach of the investment funds.

10. ***The institutional capacity-building legacy of the Enterprise Fund process should include the development of a cadre of seasoned host country investment professionals who can continue to use their skills to promote private sector development and attract additional foreign direct investment to the region.***

One of the major contributions of the Enterprise Funds is the transfer of knowledge and expertise to local financial professionals, businesses and investors. In the countries where the Enterprise Funds have been active, there has been a recognizable contribution to creating a professional investment network in host countries (an "alumni effect") among the individuals who have worked for or with the Enterprise Funds. The Hungarian-American Enterprise Fund (HAEF) did just that with the establishment of a subsidiary called the Hungarian Innovative Technologies Fund (HITF), an investment team focused on cutting-edge technology firms; a new management company, MAVA Capital; and a private fund called Hungarian Equity Partners (HEP). These new investment teams raised additional private capital and used the skills they gained as investment professionals over the 15-year lifecycle of the Fund.

In Poland, to attract private capital, the investment team formed the Polish Enterprise Investors (EI), which is now considered to be one of the largest private equity funds in Eastern Europe. Funds are encouraged to leverage their grant resources to attract investments from other international donors and private sector investors. This strategy has been highly successful for both Enterprise Fund investments and in raising capital for the private equity funds that have been "spun-off" as the Enterprise Funds mature and approach the end of their active investment phase.

11. *USAID should encourage regular cross-border communication between Enterprise Funds and similar development investment funds and Legacy Foundations operating in other countries and regions.*

At their inception, the Funds did not generally communicate with one another at a high level. Each Fund developed and implemented its own unique investing and development strategy and reported directly back to USAID. As time progressed, Funds realized the inherent benefits of sharing experiences and thus began communicating their investment strategy and individual lessons learned. An informal association of active board members and management teams was formed. This Enterprise Fund Association met regularly for several years, once its members saw the value of sharing their experiences.

As they have evolved, the Funds' Legacy Foundations have expressed an interest in sharing experiences with other Legacy Foundations. This information sharing among Funds and Foundations contributes to a comprehensive understanding of the investment and development alternatives in the region, and their ability to identify and implement Legacy Foundation projects, which continue to contribute to private sector development in their beneficiary countries.

12. *USAID should work with the Boards of Directors and managers of Enterprise Funds to establish appropriate internal policies and practices to ensure that the Funds operate at all times on an ethical and transparent basis.*

In conducting semi-annual reviews with the Funds (at least one in the U.S. and one in the host country) the E&E Economic Growth staff monitored the Funds' overall investment practice along with organizational policies, meeting regularly with the Funds' Boards of Directors as well as each Fund's professional investment staff. The face to face meetings, including at least one annual review in the field, and visits to the Funds' offices and investee clients, is critical to allowing USAID to fulfill its monitoring and oversight role.

In almost all instances, the Boards of Directors and managers of the E&E Enterprise Funds were composed of individuals who cared deeply about and performed with the highest level of ethical integrity and transparency. However, with the high level of USG resources involved and the high visibility of the Enterprise Funds within Congress and the development community, it is critical that USAID and State work closely with the Fund's Board of Directors to provide a high level of oversight, to insure they operate with the highest standards of ethical performance. In addition, having clear practices and procedures in place is critical when the Board faces a challenging personnel or other management issue.

13. *USAID and the USG must have the specific legal authority and bureaucratic willingness to make changes, if necessary, in the composition of the Funds' Boards of Directors, to ensure each Fund is continuing to address the mandated financial and developmental goals, or any other issue requiring a change.*

During the course of the Funds' operating history, we have been fortunate to be able to identify an exceptional group of senior level financial and business professionals from the U.S. private sector, who have provided their strategic guidance and oversight of their respective Funds, on a pro bono basis, involving substantial commitments of time throughout the 15-20 year life of a Fund. One of the fundamental lessons learned during this period is that—if you get the Board right—everything else will likely fall in place. That fact cannot be over-emphasized.

Occasionally, the make-up of a Board may evolve to where it is not functioning in a way that is most effective in terms of meeting the dual mandate objectives of an Enterprise Fund. In some cases, it is possible for a strong-willed Chairman or President/CEO to dominate a Board, and for individual Board members to become less willing to challenge and confront such individuals on important issues.

In such cases, it is critical that USAID, State, and other parts of the USG exercise its legal authority and take the necessary steps to re-constitute the Board so as to best meet its stated objectives. In the E&E experience, the great majority of the Funds' Directors have contributed their investment, business and strategic experience over many years with an exceptional level of commitment and professional skill. In the few cases when changes in Board make-up was considered necessary, all effort was made to do so in a respectful manner, seeking input and collaboration with the existing Board. USAID's willingness to exert its rights to make changes in Board composition should be done sparingly, so as not to interfere with normal Board decision-making, but pursued actively when deemed to be in the best interests of the Fund, and the development and foreign policy goals of the USG and the American people.

INITIAL FUND STRUCTURE AND SETUP

1. *Alternative approaches to the Enterprise Fund model should be considered, based on existing conditions in the host country and availability of funding.*

Private Equity Model – Request for Proposals (RFP)

In certain circumstances, where a country's size or economic conditions were not considered appropriate for an Enterprise Fund, USAID has elected to establish investment funds in countries using alternative approaches. As an alternative to the Enterprise Fund structure, an RFP may be issued to solicit proposals from existing international investment managers, with experience in managing private equity investments in developing countries. In such cases organizations such as Small Enterprise Assistance Fund (SEAF), with extensive experience managing international investment funds, were able to leverage an initial grant from USAID to attract investment capital for a new fund from other donor groups such as the EBRD, SIDA, Norvest, and others.

In June, 2013, USAID launched the Pakistan Private Investment Initiative (PPII) a new private equity fund using an RFP approach. The PPII fund leverages private sector funding by requiring fund managers to provide matching funds and is a hybrid model using certain characteristics of the E&E Enterprise Fund model as well as the RFP model, and should be considered for replication when conditions in the host country are likely to allow for leveraging additional private investment capital.

USAID Development Credit Authority (DCA)

Another alternative to be considered in certain circumstances is the expanded use of USAID's DCA program, which provides a partial guarantee for loans made by existing financial institutions to small and medium business enterprises. In countries where there are existing financial institutions with available liquidity, it may be preferable to consider a combination of loan guarantees along with technical assistance on both the demand side (existing businesses) and the supply side (financial institutions) to serve as a catalyst for increasing lending activity and building on the capacity of the existing financial institutions.

There are pros and cons to each of these approaches and they should be carefully analyzed and considered, based on the conditions existing in the host country, before choosing the most appropriate structure. Prior to proceeding, a thorough study of the current historical socio-economic and political environment is critical.

2. ***An appropriate compensation plan, including consideration of incentive compensation, should be established from the outset to incentivize fund management and reduce personnel turnover. Likewise, to avoid the potential for excessive compensation, setting a maximum cap on annual and overall compensation should be strongly considered.***

"Small enterprises are the backbone of the European economy. They are a key source of jobs and a breeding ground for business ideas. Europe's efforts to usher in the new economy will succeed only if small business is brought to the top of the agenda."

European Charter for Small Enterprises

Investment professionals are typically well compensated for their skills, and the Funds need to compensate their managers accordingly in order to retain talent and maintain the highest professional standards. Many funds reported difficulties obtaining qualified management staff, due to the Congressionally mandated salary cap of $150,000 which was established in the early 1990s, and has not been adjusted over the 20 years of Enterprise Fund activity. Several Funds also experienced difficulty maintaining a qualified and committed staff of investment professionals, where no incentive compensation plan was in place. Thus, to attract and maintain high quality staff, several Funds proposed to USAID that they be allowed to design incentive programs for their management staff.

It is important to consider this issue at the outset of establishing a Fund, in order to avoid unintended consequences, loss of momentum and complications in designing incentive compensation after the Fund has actively commenced its investment program. It is also critical to consider some reasonable "cap," or maximum overall compensation, for Fund management to avoid potential criticism regarding excessive compensation received from USG funded projects. It is possible for a Fund established in countries undergoing economic transition, to reap substantial profits on investments made during the early years of the transition process.

Care must be taken to consider and evaluate the appropriate level of incentive compensation based on the degree of risk assumed by Fund managers (generally they have no personal capital investment in an Enterprise Fund) and other relevant factors, when compared to a private equity model in the U.S. private sector. Thus, it may not be appropriate for a USG funded investment activity such as the Enterprise Funds to provide "industry standard" incentive compensation (20% carried interest) to Fund managers who did not have the burden of raising the Fund's equity capital and who do not personally share in the Fund's investment risks. Without a similar risk/reward profile, incentive compensation should be designed to reflect the Fund's legitimate need to retain qualified professional staff, balanced against the fact that they do not share in the risk associated with each of the Fund's investments.

Also, rather than basing incentive compensation on the financial profitability of individual investment transactions of the Fund, more of a hybrid approach should be utilized. Including a provision in incentive compensation plans so that losses in portfolio investments are offset against gains on profitable investments should be strongly considered. Incentive compensation schemes should be carefully aligned with the broader development objectives of the Funds and not based solely on financial returns.

3. *Clear expectations and guidance for the wind-down and termination of Fund investment activities should be considered and defined at the outset.*

As previously stated, the flexible and long term investment time horizon of the Enterprise Funds was central to their success. Giving the Funds complete control over the timing of asset sales and allowing the Funds a sufficient investment period (i.e. a 10-15 year window of operation) allows them to respond appropriately to market changes. Within this timeframe it is important to have a well-defined plan that encompasses the investment lifespan of a Fund. It is very important for USAID, in cooperation with the Board of Directors and the Fund's management teams, to establish expectations and guidance concerning the use of investment reflows following the end of their active investment phase.

In the case of the Enterprise Funds in the E&E region, there was no clear determination at the outset which defined the use of the assets remaining at the end of the Funds' investment phase. Resolving this issue several years after the Funds were established was extremely difficult and time consuming.

It should be noted that current legislation authorizing Enterprise Funds in Egypt and Tunisia require that all investment reflows shall be returned to the U.S. Treasury. Enterprise Fund Board members have expressed concern that this may lead to the Fund's Board of Directors having less motivation to push for the highest financial return, while Fund managers who have incentive compensation arrangements may continue to do so.

4. ***Determining the appropriate use of investment reflows and the amount of assets to be transferred to a Legacy Foundation should be based on objective criteria, rather than any pre-determined formula.***

Due to the varying economic environments in the host countries and the differing degrees of success experienced by the Funds, decisions concerning the use of investment reflows should be determined individually for each Fund. For the E&E Funds, common practice has been for a portion of the reflows to be returned to the U.S. Treasury and the remainder used to establish legacy institutions (Legacy Foundations) in the host countries. Legacy Foundations allow the host countries to continue to receive economic development benefits from USG funding, and allows the U.S. to maintain meaningful partnerships in these countries after the Enterprise Fund's active investment phase is completed, and USAID is no longer present in the country. Maintaining this Legacy Foundation continues to strengthen ties between the US government and the host country, fosters goodwill between participant nations, and helps to continually improve economic opportunities and stability in the region.

In the event that all or a portion of a Fund's investment proceeds are allowed to remain in the host country to establish a Legacy Foundation, care should be taken to provide an adequate level of resources to provide meaningful grant activity, which continues to support private sector development. In certain cases within the E&E region where a specific Fund has achieved an exceptional degree of financial success, consideration should be given to capping the total assets transferred to a Legacy Foundation when the level of assets may be excessive or disproportionate to the needs of the country. Alternatively, allowing the Legacy Foundations to utilize their resources on a broader regional basis, outside their host country, would allow them to assist less developed neighboring countries and promote stronger regional trade and stability.

5. ***Funds should actively promote and publicize their investment and related development activities within the host country.***

The Funds should actively work to promote a solid public image in their communities by developing and distributing educational and promotional material detailing the Fund's activities. The creation of a "brand name" and platform provided by the marketing materials can generate public support and interest in the Enterprise Funds, and maintain a high level of credibility for their investments and legacy activities. The material disseminated should recognize the differing interests and technical knowledge of the targeted audience such as policy-makers, international fund managers, high-value investors as well as the general business and foreign investment community seeking opportunities in the host country.

It is also important to avoid creating expectations within a host country that cannot be met. Providing relevant information on a Fund's specific areas of interest and its procedures for evaluating investment decisions may help avoid the Fund from receiving numerous requests for investment from organizations that are not appropriate for investment by the Fund.

INVESTMENT CHOICES

1. *Investment decisions must be made within the local context.*

Funds should analyze existing banking and financial sectors, look for opportunities in existing markets, and base their investment decisions on what best fits the local environment. Western-style investments and strategies may not be appropriate in the early stages of transitioning economies. It should be left up to the Fund's Board and management teams to determine whether equity investing, loans, mezzanine financing structures, or other investments best fit the local environment. Central to the Enterprise Fund model and their success is the idea that the Funds themselves should identify existing gaps in capital markets and seek innovative ways to provide profitable solutions and development impact within their countries, while taking into account the inherent risks of investing in the target country.

2. *In making investment decisions, funds should balance anticipated financial reward and potential for overall development impact.*

The core programs could include loan programs for SMEs, a micro-lending program, direct equity investments, mortgage financing, and technical assistance. As with any investment fund, Fund managers in the E&E region attempted to minimize their investment risk by diversifying their investment portfolios over a broad range of investments. While some investments were extremely profitable, generating a high cash return, others did not recoup the original investment. The careful balancing of risk and return allows Funds to compensate for investments which achieve important development objectives, but are not as likely to achieve a strong financial return on their investment. In some cases trying to maximize financial returns on a specific investment may compromise development goals.

3. *Funds should assess the optimum level of shareholding ownership to minimize the risk of being a minority shareholder.*

The original USG grant encouraged the Funds to initially acquire a minority ownership position in the investee companies. It was thought that by making a significant number of smaller investments, the Funds would achieve greater economic impact and spread their risk over a larger number of businesses. In some cases, the Funds' management teams and Boards did not anticipate the difficulty they would experience with this approach, due to insufficient legal frameworks and regulations protecting the rights of minority shareholders. Fund management teams were often frustrated by their inability to influence a company's business decisions and realize profitable investment returns, due to corporate management's disinterest in paying dividends to shareholders, selling assets, and/or registering shares on public stock exchanges. If taking an equity position, Funds should acquire the appropriate ownership interest in portfolio companies that will allow them to sufficiently influence key management decisions and protect their investment in the business.

4. *Where appropriate and necessary, Funds should consider investing in the host country's financial infrastructure.*

Many of the Funds operated in countries severely lacking a well-functioning banking and financial infrastructure. The creation of financial institutions and improvements to financial sectors not only increased the ability of Fund managers to negotiate business transactions, but these improvements also directly impacted the lives of countless individuals by opening a window of investment opportunities that may not have otherwise been possible. The strengthened financial sectors and availability of functioning commercial banking systems can provide necessary support for the introduction of home mortgages, credit cards, small loans, ATMs, and other types of financial tools by maintaining a level of macroeconomic stabilization in the region. A strong level of economic stability and financial infrastructure are important to securing sound investments, profitable returns, and sustained development activities.

5. ***A significant day-to-day management presence on the ground and input from locally hired staff and advisors can contribute greatly to Fund performance.***

Managers/ CEOs from the earlier E&E Enterprise Funds initially conducted their operations from a base within the United States, rather than in the country or region where the investments were being made. In some cases, this hindered the early performance of the Funds. One key reason the Russia Fund was slow to develop was that early-on, senior managers were not located in-country and were not involved on a daily basis with Fund operations. This, alongside knowledge of the local markets and opportunities that come from in-country presence, are critical ingredients for long-term success. Over time the Funds generally based their day-to-day management on the ground in the host countries. In certain cases, a Fund's President/CEO was able to effectively manage Fund operations by spending approximately 50% of the time in country and 50% from at a U.S. location, although such Funds usually had significant in country staff as well.

6. The Funds, in conjunction with USAID and other donors, may wish to identify and address specific concerns related to the investment climate prior to initiating intensive investment activities.

At the inception of the Funds, many countries in the Europe and Eurasia region were experiencing varying degrees of economic and democratic instability, which influenced the Funds' ability to engage in an aggressive investment and development campaign. The Board members and management team of an Enterprise Fund can be an important resource for technical assistance in the host country. Likewise, the economic and political teams within the U.S. Embassy and USAID have insights into the local business environment and can be very helpful in providing information and understanding the realities of operating in the host country.

If existing laws or policies inhibit the ability of a Fund to invest prudently and profitably, that Fund should take advantage of opportunities to affect policy, legal reforms, and regulatory changes. Examples of this can be seen in the Baltics, Bulgaria, Poland, and Russia, where the Funds worked extensively to promote changes in regulations and legislation, to enable the development of innovative investment programs such as mortgage lending, equipment leasing, and syndication of loans.

If a Fund desires to allocate a portion of its resources to provide "technical assistance" to address policy constraints or to assist portfolio companies, special care must be taken to insure that such funds are not utilized to "augment" the profitability by subsidizing the expenses of such investee companies. Technical assistance can be a very appropriate activity of a Fund, however Board and USAID oversight are need to insure it is not used improperly.

7. Based on the availability of long-term, patient investment capital, the Funds are well suited to initiate systemic economic reform that is related, directly and indirectly, to their investment activities.

Overall, the Funds have worked to improve legal and policy environments, corporate governance, and contract and judicial decision enforcement, particularly when existing conditions had the potential to impact the success of their own investments. While important, the regulatory changes the Funds influenced have been piecemeal. Systemic changes in the business enabling environment are best addressed by donor activities that target necessary changes to the existing policy, legal and regulatory framework. Funds initiated change directly related to their activities by financing mortgage lending programs and learning from their own difficulties in the lending environment. Through this process, several Funds were able to identify and influence substantial reforms to existing laws and regulations.

TRANSPARENCY AND CONFLICTS OF INTEREST

1) Constant vigilance is needed to avoid actual or perceived conflicts of interest.

The Funds are a unique form of public-private partnerships that have developed a high level of visibility within the US and the donor community. The substantial level of resources committed to the Funds and the nature of the public-private partnership existing between the USG/USAID and the Funds makes it critical that great care be taken at all times to avoid actual or perceived conflicts of interest. The Board of Directors, management teams, and USAID staff must be vigilant in raising potential issues or conflicts in order to ensure continued adherence to the highest standards of professional and financial conduct. Special care is required to avoid perceived conflicts of interest, particularly with regard to investment in related funds or transactions, as well as transfers of portfolio investments, and selling, and valuation of "in kind" assets.

- **Separation of Roles and Responsibility—"Wearing too Many Hats"**
  In certain cases, the Enterprise Fund's Board and management structures evolved such that one or more persons occupied positions with the Fund and/or its outside management firm, which created either actual or perceived conflicts of interest.
  In retrospect, the conflicts of interest which occurred in certain of the Enterprise Funds were fairly obvious and should have been circumvented by identifying and dealing with them when the situation first arose. However, there are many subtleties and situations which led the Boards to allow them to continue and which USAID did not effectively address as part of its oversight role.

  One example is where the Fund's President/CEO who is responsible for its day to day operations, also has an ownership interest and/or executive position in the Fund's outside management firm. In some cases, such conflicts, while not "best practice" can be resolved with special rules and procedures to recuse such individuals from voting or being involved in decisions where there is a personal conflict. In other cases, the only resolution may be to require the individual to resign from one or more of the positions which create the conflict. The grant agreement should include a provision for potential conflicts of interest to be disclosed in writing to the Board and for the Board to take steps to resolve or mitigate such conflicts. USAID, as well as the Fund's Board of Directors, must be especially attuned to avoiding such actual or perceived conflicts of interest.

- **Investment in Related Funds or Transactions**

  Generally speaking, members of the Funds' Board of Directors and management teams should not personally co-invest in transactions with the Fund. In certain cases, in order to stimulate parallel private funds, Board members desired to personally invest in newly-created private funds formed by an Enterprise Fund's existing management team. In such cases, extreme care must be taken to avoid perceived or actual conflicts of interest. When USG funds are being invested by an Enterprise Fund, in all instances, any circumstances giving rise to potential conflict of interest should be brought to the attention of both the Board and USAID, including USAID's General Counsel Office. If necessary, Board members should recuse themselves and avoid participation in any such personal investments.

- **Pricing and Transfer, of "In Kind" Assets**

  In some cases it becomes necessary to establish a market value for all or a portion of a Fund's investment portfolio This can arise when, for example, a Fund is establishing an incentive compensation programs or when a Fund is transferring certain assets to a new parallel investment fund created by the Fund's outside management firm, in exchange for an ownership interest in such new fund. In such cases, there is a significant potential for conflict of interest or the perception thereof. The nature of transition economies makes it extremely difficult to price assets accurately.

  Valuation of an illiquid asset in such situations creates a high risk of less than accurate pricing. When those assets are eventually sold, the "mispricing" of the asset can lead to perceptions of self-dealing, particularly when the asset is later sold for a high profit. Experience indicates that it is best to avoid valuation of illiquid assets in these economic environments, including transfers to related investment funds. Likewise, because of the difficulty of valuing private equity investments in transition economies, every effort should be made to avoid creating incentive compensation structures, which would require a valuation of assets held by the Fund.

  When valuations of portfolio assets are required they should be made by an independent party not linked to the Fund or its Board in any way. However, even with such steps being taken, it is inherently difficult to value private businesses and assets, particularly in emerging markets where there is not an active market for the sale of such assets.

USAID/USG BRANDING

In all cases where promotional or informational material is being developed concerning the activities and successes of the Enterprise Funds, as well as the Legacy Foundations, the role of the

USG and USAID in creating and funding the Enterprise Funds must be appropriately recognized in accordance with all USAID standards concerning branding.

USAID MONITORING AND OVERSIGHT

In the event USAID creates additional investment funds using the Enterprise Fund model, it is strongly recommended that USAID should consider establishing a Central Oversight Group to provide appropriate oversight and monitoring of these types of private-sector led investment funds which should include properly trained, long-term career staff. Such a mechanism would allow for the sharing of best practices and increase the level of professionalism and quality of oversight provided.

1) It is important to ensure that any such oversight unit includes senior level professional staff with the necessary business and development background to be able to interact on a regular basis with the Board of Directors and management of the funds. Within the E&E region there were times when individuals without adequate knowledge of investment funds generally, were assigned oversight responsibility to interact with the Funds' management and Board of Directors. On occasion this resulted in a loss of credibility for USAID from the perspective of the Funds' Board members and management professionals, as well as with others with whom they communicated, including Congressional representatives and the White House.

   Because oversight of the Enterprise Funds requires a significant degree of financial sector background and experience, they have been managed from USAID/W versus from USAID's field missions. With the significant levels of grant funding allocated for Enterprise Funds, USAID Missions have at times felt that they were not sufficiently involved in the operations and oversight of the Funds, creating tension and inefficiency within USAID over the appropriate role and responsibility for overseeing the Funds.

   It is important that the need for the centralized oversight process be communicated and understood by USAID/W and field Missions, and that the USAID office providing such oversight provide necessary information to the USAID Missions to foster a positive relationship between the Funds and USAID and Embassy staff in the host country. As key individuals in each country rotate, it is important to brief them on the operations of each Fund and the existing oversight process.

   Equally important is allocating sufficient funds for travel and administration, over the anticipated 15-20 years lifetime of such Enterprise Funds. Within USAID, when an activity is no longer receiving current year obligated funding, there is a tendency to assume there is no longer a need to allocate and retain staff to oversee the activity. Based on the significant level of grant funds allocated to a typical Enterprise Fund (ranging from $30 million to $300 million), it is critical that the responsible bureau within USAID retain sufficient senior level staff, as well as funding for travel and administration, to adequately monitor and oversee the Funds' activities. This has been a recurring issue, particularly as funding for the E&E region is declining, and can lead to a lack of appropriate oversight of these large and high visibility grants.

   The Enterprise Funds, because of their high visibility within Congress, USAID and host countries, often encounter unique and sensitive issues which, if not handled appropriately, can substantially harm the Agency. Similar to USAID's Development Credit Authority (DCA), which has a central management team, the Enterprise Funds have unique characteristics and oversight responsibilities that would benefit from a more centralized staffing and capability.

2) Strong consideration should be given to establishing an external and independent private sector Advisory Board to provide advice and guidance on issues relating to the technical and investment practices of the Funds. Such Advisory Board could meet quarterly throughout the year and would be very useful for USAID and its technical staff in carrying out their oversight responsibilities for these Funds. .

BOARD OF DIRECTORS

1) The quality and long-term commitment of the Board of Directors has been critical in the success or failure of past Enterprise Funds. Identifying and recruiting the most experienced individuals to serve as a Fund's Board of Directors is the single most important element in achieving the long-term development goals and financial profitability of an Enterprise Fund. Board of Director appointees should have a strong private sector background in such areas as venture capital, commercial banking, investment banking, and corporate management. Other areas of expertise that may be helpful include business skills such as legal, financial, supply chain management, manufacturing, human resources, and computer systems.

   It is strongly recommended that Enterprise Funds' Board members have investment experience and/or experience leading US corporations. Enterprise Funds' Board members have been typically selected based on their overall business and financial acumen, rather than based on their political credentials. One of the most critical roles of the Funds' Board of Directors is to select the day-to-day management team, keeping in mind that the most successful Funds hired a combination of U.S. private sector professionals augmented by highly qualified local professionals.

2) Prior experience indicates that it would be preferable for the initial Board to be comprised of American citizens only, especially during the early years of a Fund's operations. Board members from the ten (10) E&E Enterprise Funds have expressed their strong belief that the Boards should be comprised exclusively of US citizens. Their experience indicates, particularly in the early stages of economic and political transition, that it is very difficult to identify truly independent host country board members without some inherent conflict of interest.

   There is a strong need to have the Board achieve a consensus on major investment and operational decisions, rather than simply a majority vote. For instance, if the Board is made up of a majority of Americans, and those Board members outvote the local Board members on certain issues, it could create considerable ill will and potential diplomatic issues, which could inhibit the operational success of the Fund. Furthermore, the contribution of U.S. business financial and investment professionals who bring their important range of experience and expertise to the Board is a critical resource being provided in the Enterprise Fund structure. Additionally, the significant level of grant funding committed to an Enterprise Fund by the USG, on behalf of the American people, makes it highly desirable that the Board of Directors be primarily comprised of American citizens. As the Fund matures, it may be appropriate and beneficial to add carefully selected Board members from the host country.

3) If it is determined to be advisable to add one or more host country citizens to the Board, great care should be taken in selecting and appointing such members. While the desire to be inclusive is well-intentioned, any mandated involvement of local citizens to serve on the legal Board of Directors can in fact be a disservice to the overall mission of the Enterprise Fund. Host country individuals may have inherent family, business, political, ethnic or geographic conflicts which would affect their ability to evaluate proposed investments based solely on their financial and developmental merits.

   As an alternative, the input and knowledge of local businessmen and women, and the desire for inclusiveness and local human capacity building can be obtained by having local citizens serve on an Advisory Board for a fixed time period (2-3 years, renewable) — rather than on the legal Board of Directors. The make-up of that Advisory Board could change and be re-constituted periodically to get a broader range of experience and input.

4) Governing legal documents need to provide for the USG and USAID to affirmatively authorize the appointment of any new board members which are being considered by the Board to replace retiring Board members or to add additional Board members. Experience has indicated that this is an important requirement of the oversight process.

CONCLUSIONS

Original USG Grant Funds:
$1.176 billion

Leveraged an additional:
$8.781 billion

The establishment of the Enterprise Funds in the E&E region to assist in the historic economic transformation of Central & Eastern Europe and the Former Soviet Union was truly an innovative approach to economic development. As one of the earliest projects to utilize the structure of large-scale public-private partnerships for economic development, their success and contribution as part of USAID's broader assistance efforts, introduced the idea that development programs can profitably invest in a host county's financial, political, and social development sectors and **achieve significant development objectives while making a financial profit**.

The re-payment of $120 million by the Polish American Enterprise Fund to the USG marked an exceptional moment in the history of USAID's global foreign assistance programs. Subsequent repayment by the Hungarian-American Enterprise Fund ($13.0 million), the Bulgarian American Enterprise Fund ($27.5 million), the Albanian-American Enterprise Fund ($15 million), the Romanian-American Enterprise Fund ($25 million) and the Baltic-American Enterprise Fund ($25 million) followed, and additional repayments are still anticipated for a total of over $400 million being returned to the U.S. Treasury.

While not all of the ten (10) E&E Enterprise Funds were financially profitable, each of them made a contribution to the development needs of the countries where they operated and, through their Legacy Foundations, will continue to do so for many years in the future. Taken collectively, the Funds' repayment rates demonstrate the benefits of using U.S. private sector skills and resources in conjunction with USG funds to achieve public policy objectives.

This partnership is at the core of the Enterprise Funds' success. By donating their time and expertise to the Funds, Board members ensured the Funds' sustainability and contributed to the development of capital markets and sound business practices in countries attempting to establish market economies. The significant financial success and development impact achieved by the Funds serve as an important example for government officials and private sector professionals, while inspiring policy makers to tackle problems in transient economic markets with innovative programs in partnership with the U.S. private sector.

The Enterprise Funds are one of the very few development programs to ***achieve sustainable economic development impacts while leveraging additional investment resources, generating substantial program income to endow long-term host country Legacy Foundations, and ultimately returning a significant portion of their original grant funds to the U.S. taxpayers***. This differentiates the Enterprise Funds from all other traditional aid programs.

Liquidation proceeds:
$1.704 billion

Funds to be returned to the American taxpayer:
$400 million

Endowments to legacy institutions:
$1.278 billion

The Enterprise Funds and the development investment programs they helped establish should be considered a viable model for future economic stabilization and development initiatives. The Enterprise Funds overcame the challenges of investing in transitioning economies while achieving, collectively, positive overall returns on their investments. By focusing their efforts on projects and improvements in banking and financial markets, direct investment activities, institutional reforms, and capacity-building, the USAID funded Enterprise Funds paved the way for follow-on private sector investments and continued economic development within their host countries.

Similar future investment funds can benefit substantially from the experience of the E&E Enterprise Funds and utilize the lessons learned to evolve and improve upon this model. Their overall success in Eastern Europe and Eurasia can be attributed to their unique characteristics and design, which was tailored to meet specific regional needs. While the individual country environments were conducive to the development of capital markets, the countries lacked the infrastructure, investment funding, technical assistance, and government and legal reforms necessary to make the much needed improvements.

"The Enterprise Funds are a valuable instrument and should be applied more widely. Hopefully, one day our achievements will be recognized and emulated elsewhere."

~John Birkelund
PAEF Chairman
May 30th, 2006

The Europe and Eurasia Enterprise Funds, in conjunction with the broader macro-economic and political reforms facilitated by USAID, host country counterparts, and other donors provided critical private sector investment experience, and were vital players in the creation of a stable economic climate that encouraged entrepreneurship, financing activities, and trade liberalization.

In the right economic and political circumstances, and with the assistance of a committed Board of Directors and appropriate USG/USAID monitoring and oversight, the Enterprise Fund model can serve as a critical catalyst to: (i) transform weak economic environments; support and encourage democratization and economic policy reforms; (ii) establish well-functioning and transparent financial and banking institutions; and (iii) provide growth capital and technical assistance to a wide range of private sector enterprises within their host countries.

Many regions of the world are still struggling with economic instability, a lack of sound financial institutions, and insufficient access to private sector capital, much like the E&E region in 1989. The Enterprise Fund model has the potential to achieve substantial economic development, and make improvements to the business and macroeconomic environment of a country, while also achieving profitable investment returns.

It has always been the goal of USAID to promote US foreign policy interests by establishing democracies and providing economic assistance and aid to improve the lives of individuals and communities worldwide. The unique experiences of the Enterprise Funds have proven that private sector initiatives can be used to offset the staggering effects of economic and social instability and contribute to furthering global development. The Enterprise Funds, as one element of USAID's broad range of traditional economic and political development programs, should serve as a shining example of the strong commitment of the US Government and the American people to increasing global access to capital markets, and building the foundation for future partnerships that encourage economic and political stabilization in host countries.

ANNEX A: FINANCIAL & DEVELOPMENT ACHIEVEMENTS

Fund	Liquidation and Legacy
Albanian-American Enterprise Fund	• Returned $15 million of original $30 million USAID grant to the US Treasury • Endowed the **Albanian-American Development Foundation** with an estimated $190 million to continue to promote broad-based private sector development.
Bulgarian-American Enterprise Fund	• Returned $27.5 million of original $58 million USAID grant to the US Treasury • Has endowed the **America for Bulgaria Foundation** with approximately $422.5 million to promote broad-based private sector development.
Baltic-American Enterprise Fund	• Has returned $25 million of original $50 million USAID grant to the US Treasury • Has endowed the **Baltic-American Freedom Foundation** with $37.2 million to provide internships, research and scholarships.
Central Asian-American Enterprise Fund	• $17 million from an original grant of $106 million will benefit the **US-Central Asian Education Foundation** for business and economic education in Central Asia.
Hungarian-American Enterprise Fund	• $13 million from an original grant of $73 million has been returned to U.S. Treasury (An additional $2-5 million is expected) • Has endowed the **Hungarian-American Enterprise Scholarship Fund** with approximately $13 million to promote internships and scholarships; an additional $2-5 million is expected.
Polish-American Enterprise Fund	• Returned $120 million of original $255 million USAID grant to the US Treasury • Has endowed the **Polish-American Freedom Foundation** with $263 million to continue to promote private sector development.
Romanian-American Enterprise Fund	• Has returned $25 million of original $50 million USAID grant to the US Treasury • Has endowed the **Romanian-American Foundation** with $125 million to continue to promote private sector development.
Slovak-American Enterprise Fund	• Proceeds of approximately $4 million of the original grant of $64 million will benefit the **Slovak-American Foundation** for business and economic education and internships in Slovakia.
U.S.-Russia Investment Fund	• Is expected to return approximately $150 million of original $328.9 million USAID grant to the US Treasury • Has endowed the **US-Russia Foundation for Economic Advancement and the Rule of Law** with $150 million to continue to promote private sector development.
Western NIS Enterprise Fund	• Liquidation process is still pending.

SUMMARY OF KEY FINANCIAL DATA

Since their inception, **Enterprise Funds have collectively**:

- Invested **$2.97 billion** in host countries
- Financed **$77.7 million** in technical assistance
- Leveraged **$6.9 billion** in debt, equity capital and co-investment
    - Funds are on-track to return **$400 million** of original grant funds to American taxpayers
    - Successful Fund performance resulted in over **$1.2 billion** in available funding for follow-on legacy institutions

DIRECT INVESTMENT ACTIVITIES

- Invested in Hungary's EURONET, a start-up developer of ATM networks and back-office bank services in Europe
- Turned around failing Moldovan Glass Container Company, saving 267 jobs and returning the company to profitability
- Funded equipment leasing in Romania and Bulgaria, enabling businesses to expand
- Started two leasing companies in Russia that collectively lease well over a million dollars in equipment each month
- Assisted companies in Ukraine and Moldova in raising over $100 million of debt financing from third parties and successfully raised $132 million in new private equity capital
- Pioneered syndicated loans and acted as lead investor in building the new Mother Teresa International Airport in Albania and other public/private infrastructure projects

FINANCIAL MARKETS DEVELOPMENT

- Established the largest micro-finance institution in Poland, disbursing $183 million through 69,275 loans
- Pioneered investment banking in Romania to support privatization of state owned enterprises, including two banks and energy companies, attracting over $200 million in FDI
- Instituted a nation-wide bank in Bulgaria, making mortgages widely available
- Initiated mezzanine financing in the Baltics to broaden the range of non-bank financing available to finance SMEs
- Established a nation-wide bank in Albania, providing Western-style credit cards, ATMs, mortgages, commercial banking services, and $50 million in syndicated loans for public/private infrastructure projects
- Introduced Russia's first Western-style credit cards
- Launched private equity funds in Ukraine, Russia, Poland, Romania, and Bulgaria

INSTITUTIONAL REFORMS

- Developed the necessary legal structure in the Baltics to support an annual $100 million consumer mortgage industry and the first mortgage backed securities in Eastern Europe
- Initiated residential mortgages and business equipment leasing in Russia and helped encourage significant changes in the regulatory environment for these activities.
- Fostered policies and established institutions that contributed to the rapid transformation of the Polish economy
- Helped develop the necessary legal structures for mortgage backed securities and real estate investment trusts in Bulgaria
- Assisted the Albanian government in creating its anti-money laundering strategy and created the first Albanian financial institution outside Albania
- Helped launch the Ukrainian National Mortgage Association and Competitiveness Council

CAPACITY BUILDING

- Funded the $240 million endowment for the Polish-American Freedom Foundation to strengthen civil society, democracy and education
- The US Russia Investment Fund (TUSRIF) played a key role in the establishment of a venture capital association in Russia
- Started the Hungarian-American Enterprise Scholarship Fund to bring talented Hungarians to the US for further training
- Founded the US-Russia Center for Entrepreneurship to target specific growth needs of entrepreneurs in Russia