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The Venture Capital Mirage

Assessing USAID Experience With Equity Investment

by

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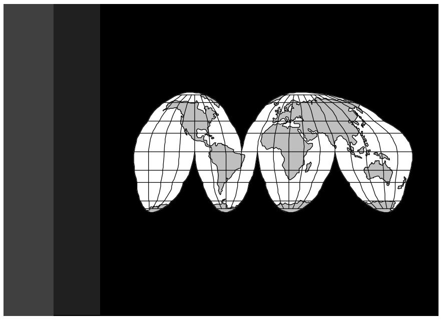

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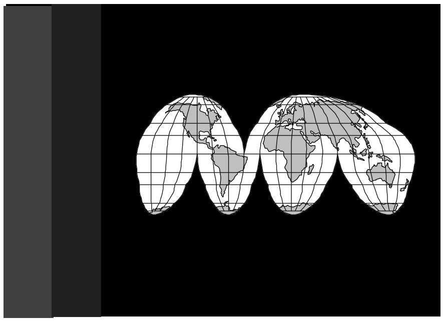

Introduction

IS USAID FUNDING for equity investment in business enterprises a useful way to reduce poverty and stimulate development? This study looks broadly at previous experience with equity investment to answer that question. It examines 13 USAID venture capital projects. It also reviews USAID's recent experience with enterprise funds in Eastern Europe and surveys related experience of others.

USAID *venture capital projects* have almost uniformly failed, the study finds. At the project level, USAID's approach clearly appears flawed. Two problems are evident. First, USAID often promoted venture capital projects in unpromising country environments where the business climate was uncertain or the prospects for expanding firms were poor.

Second, the Agency usually treated an activity requiring great flexibility and initiative as if it were straightforward and simple. Projects were overdesigned: they set too many goals or specified the approach to be used. A variant concept, *enterprise funds*, developed in Eastern Europe, improves substantially on USAID's traditional approach, because it delegates most decision-making to the implementing entity. Some enterprise funds have performed relatively well, but others have incurred significant losses. None has yet shown promise of substantial profitability.

Beyond the design issues, some aspects of the experience of USAID and other donors and enlightened private efforts suggest a more fundamental reason for failure. The allure of equity investment in emerging companies in developing countries is a mirage. Conceptually, it appears likely to pay high returns. In practice, it does poorly.[1] *Because donor programs are unable to produce results, venture capital should be left to private organizations willing to accept the risks.*

This report is organized as follows. Chapter 1 lays out the traditional rationale for venture capital activity. Chapter 2 describes the structure of the industry in the developed countries where it is most advanced. Chapter 3 summarizes USAID's experience with venture capital projects, and chapter 4 discusses enterprise

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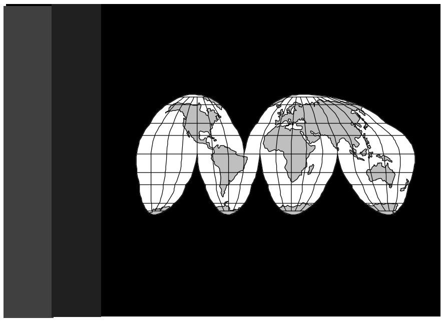
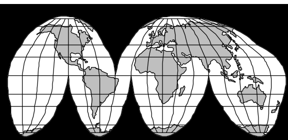
1 Hope springs eternal, however, and the poor track record of venture capital in developing countries has done little to dissuade people from seeing it as a magical remedy. See for example "Venture Abroad," by Larry Schwartz in the November 1994 *Foreign Affairs* for evidence that transplanting the U.S. venture capital industry to developing countries continues its allure.

funds, used by USAID in Eastern Europe. Chapter 5 examines the experience of private enterprises and multilateral agencies that have promoted venture capital in developing countries. Chapter 6 responds to the question of why venture capital projects usually fail, and chapter 7 provides conclusions.



Glossary

ADELA	Atlantic Community Development Group for Latin America
ATI	Appropriate Technology Incorporated (Asia)
AVT	Agricultural Venture Trust (eastern Caribbean)
BVP	Business Venture Promotion (Thailand)
CDC	Commonwealth Development Corporation
DFC	Development Finance Corporation (Haiti)
HIAMP	High Impact Agribusiness Marketing and Production (eastern Caribbean)
HPAEs	high-performing Asian economies
IBEC	International Basic Economy Corporation
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
JADF	Jamaica Agricultural Development Foundation
LAAD	Latin American Agribusiness Development Corporation
PED	Private Enterprise Development (Kenya)
PIC	Private Investment Corporation (Costa Rica)
PICA	Private Investment Company of Asia
SIFIDA	Société Internationale Financière pour les Investissements et de Development en Afrique



1 The Rationale for Equity Finance

PEOPLE IN DEVELOPING countries are poor in part because they have far less capital than people in industrial countries. Because of this shortage, workers have little in the way of specialized machinery and equipment, and firms lack money to obtain more equipment. As a result, productivity of workers in developing countries is low compared with that of workers in industrial countries.

Financial-resource flows from industrial to developing countries are an obvious means to overcome this inequality. But financial resources are not enough. Some developing countries have natural resources such as oil or minerals that, when sold on world markets, have provided large amounts of money. In many cases (such as Ecuador, Iran, Nigeria, and Zaire) the money has failed to stimulate sustained economic growth or increased productivity and income for the average person.

In part, failure to use capital productively results from the way these resources flow. In some countries the government gets the money, which it uses to perpetuate itself through military spending or through increased consumption spending (''bread and circuses''). In other cases, resources flow to wealthy individuals who use them to maintain high levels of conspicuous consumption or to travel to the watering places of Europe.

Donors and development strategists have proposed various approaches to channel financial resources to ''the right places'' to alleviate the shortage of capital in poor countries. In part, this is the role of the banking system in any country. It performs an intermediary function, hiring money from those who need money later rather than now and renting it to people who can use it productively now. In most developing countries, the banking system plays this role only imperfectly. Governments are partly responsible, because they use the financial system to transfer resources from the private to the public sector, or they establish policies (setting low interest rates, for example) that interfere with banks' intermediary function.

Even in the best of circumstances, however, banks have limitations. Banks lend money they themselves have borrowed, and they seek assurance that funds they lend will be repaid, so that the bank in turn can repay its lenders at the proper time. The borrower from the bank must repay whether the project is a failure or a moderate or smashing success. The bank's primary concern is security. It cares less about the use of the money than about the assurance of repayment. Conservative practices, such as reliance on collateral and lending only to large established businesses, are manifestations of this quest for assurance.

Banking systems are inherently conservative and status quo oriented. But conservative approaches are not enough if developing countries are to reduce poverty quickly. Mechanisms are needed to channel resources to the highest potential payoff, even though the risk may be higher than for traditional uses. Small businesses with no credit history need funding for expansion so they can grow into large businesses. New, generally small businesses need initial infusions of capital so the owner's idea can be turned into sales, jobs, and profits. Even where medium-term prospects are favorable, the near term may be difficult to predict. It is consequently risky for such businesses to borrow money and incur fixed obligations to repay because the near-term repayments may exceed their cash-flow capabilities and prevent the firm from achieving sustainability.

There is, therefore, a need for *risk capital* for people with ideas and capabilities but without money. Historically, much risk capital has come from wealthier people who know personally the potential user. Extended families play this role in many cases. Among religious or ethnic minorities, group solidarity is often helpful. Indeed, the great economic success of some groups (Jews, Lebanese, overseas Chinese) results in part from the ability to mobilize resources within the community for promising enterprises. Larger firms in an industry also may provide capital to new, smaller firms—often suppliers—when they know the new firms' capabilities or promise.

For the most part, however, budding entrepreneurs lack access to capital from these sources. If they are to obtain capital, it must come from a source with whom they have no personal acquaintance. This is where *venture capital* enters the development business. A venture capital financier looks for promising enterprises to back with funding and limited technical advice, perhaps for a considerable period of time. If the enterprise fails, the financier simply loses his stake. If it succeeds, the financier has acquired an equity stake in the company that allows him to benefit in proportion to the success—and sometimes far out of proportion to his initial investment.

This need for venture capital is not limited to developing countries; the United States has the most developed venture capital industry in the world. The U.S. industry is particularly critical to growth of new firms in high-technology industries such as computers and biotechnology. A typical venture capitalist expects to sell off the equity after a five- to seven-year period, during which the firm has had time to develop its market niche and mature financially.

The case for equity financing is, on the surface, a compelling one. The rationale for USAID involvement in venture capital projects has typically been to demonstrate the existence of a profitable market for such financing, thus catalyzing private flows for this purpose.

Venture capital activity is aimed primarily at small and medium enterprises. Large enterprises are a different matter, as they have the capital base and visibility that make them candidates for conventional lending, as well as bond sales and equity sales on a broad scale. There is some confusion about the relationship of venture capital to stock market development, and some USAID projects used stock market development as part of the rationale for venture capital activity. This approach is not borne out by experience. The universal experience seems to be development of public ownership and stock markets in a gradually broadening process, with securities of large and stable enterprises providing the backbone of stock market expansion.

2 What Does the 'Real' Venture Capital Industry Look Like?

THE VENTURE CAPITAL industry is well developed only in Canada, Great Britain, the United States, and a handful of other industrial economies. Venture capital can be furnished by an entrepreneur's family, an informal lender, a pension fund, an insurance company, a development finance institution, a small bank, a commercial or investment bank, a formal venture capital company, or any other funder willing to provide financing without collateral in return for an equity stake in the enterprise. Although the industry continues to evolve around the world as entrepreneurs vary its implementation to suit their specific financial needs, some characteristics remain the same.[2]

The venture capital industry evolves through a combination of a) demand for alternate, unconventional forms of financing and b) a financial sector mature enough to absorb a higher level of risk and uncertainty in investment decision-making.

Profile of the Venture Capitalist

Venture capitalists are usually specialists in one or a few industries. They make their investment decisions solely on the basis of the profit potential they see in business proposals. The only objective of managers of venture capital companies is capital appreciation. Thus they channel all their energies into choosing investments that, with technical and financial oversight, can grow in sales and profits to the point that the equity stake increases in value and can be converted into cash or liquid assets. Although venture capitalists may appreciate the need for economic development in third world countries, their sole motivation is to seek out and invest in high value-added companies, to influence as much profitable growth as possible in the shortest amount of time,[3] and to profit from that investment through stock market divestiture or any other viable exit strategy.

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2 This description of the characteristics of the venture capital industry is drawn mainly from Frustace (1994a), who reviewed academic literature (such as Wellons et al. 1986), USAID project documentation, and interviewed venture capitalists in the United States.

3 Typically, venture capitalists look to make investments in countries or industries that can yield an expected return of 30 percent a year by permitting divestment after five to seven years for three to five times the original value of the investment.

The high risk–high reward nature of venture capital often steers fund managers toward high-margin industries that can benefit from value-added management and technical and financial assistance. High margin and profit potential usually come in the form of a company with new technology but little knowledge of how to finance, produce, market, or distribute it. Accordingly, venture capitalists often play a major role in moving newly developed technologies into the commercial sector. A fund manager sees the commercial potential of a new product and can translate that potential into a viable and highly profitable business undertaking.

Investments with high growth potential are often specialized windows of opportunity, visible only to the trained eye; venture capitalists typically choose 3 percent or fewer of the business plans submitted to them for financing. To pass the rigorous standards set by venture capitalists, business proposals must provide evidence of how a company can, with specialized assistance from the venture capital company, earn returns well above the market rate. Even so, venture capitalists expect to make most of their profits from a minority of their investments. One rule of thumb is that a fourth of the investments will fail, half will break even or yield a modest profit, and a fourth will be big winners.

Most USAID projects were designed under the assumption they could implement and influence the growth of venture capital companies and industries without meeting the rigorous standards venture capitalists set for themselves. Those standards include hiring experienced and specialized fund managers who have 1) the knowledge and expertise to choose portfolio companies with convincing and viable business proposals, 2) the ability to manage those investments with the attention and care needed to nurture potential into reality, and 3) some of their own money at risk.

How Venture Capital Companies Are Established

Traditionally four steps are involved in putting together a venture capital fund in the U.S. private sector:

1. Assemble a group of professionals with proven track records and both domestic and international connections. These connections are needed to raise capital initially and to assist in disposition of fund assets later.

2. Have each of the fund's managers legitimize his participation in the company by contributing personally significant capitalization. Acceptable levels of internal fundraising signal to both commercial investors and potential investee companies that the venture capital company has a dedicated management staff. Investment funds are generally capitalized at $8–10 million per professional. Normally a minimum of $25 million[4] under management is needed to generate adequate management fees.

3. After assembling a dedicated and well-capitalized management team, the venture capital company must raise a predetermined external minimum amount and have a first closing.

4. The company can now pursue proposals from companies seeking investment capital, otherwise known as developing a transactions flow.

4 Well-established venture capital companies in the United States have pools of capital ranging from $5 million to $30 million and have grown as large as $200 million in recent years.

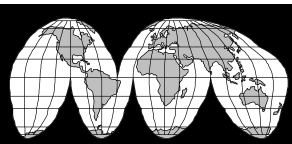
Relevance of the Venture Capital Model for USAID

Wide differences exist between financial market conditions in the industrial countries where venture capital companies have thrived and those in developing countries. USAID has most commonly made two major assumptions: 1) the U.S. experience can be transferred directly to developing countries by professionals using techniques learned in the United States and 2) venture capital development is a vehicle for stock-market development. Both assumptions are open to question.

Conditions in developing countries are sufficiently different from those in industrial countries to call into question the first assumption. Information—about the company's finances, about market conditions, about relevant government policies—is likely to be much scarcer in developing countries. Legal systems are frequently less transparent, and government policy may change more quickly and dramatically than in industrial countries, making the prospects for any company less predictable. Developing countries are far smaller economies—a typical developing country has a gross national product the size of that of one U.S. city. Prospects for profits from individual transactions are therefore likely to be much smaller. In sum, risks are likely to be much larger, and profit prospects much smaller, than in the United States.

Venture capital was not a vehicle for stock-market development in the United States. Vibrant equities markets long preceded development of the venture capital industry here. Moreover, emerging companies are unlikely to be an important part of any country's stock market. The backbone of such markets has to be equity and debt of very large and stable companies with long track records and a need for additional capital.

Every country has such blue-chip enterprises, ranging from banks, breweries, and cement plants to public utilities. Public utility debt would seem an important factor even if such enterprises are government owned. Given efforts to privatize utilities in many developing countries in recent years, these enterprises would also seem a more promising means for stock market development than unknown small companies. Overall, a well-established market for equity and debt in large enterprises would seem to indicate the possibility of developing trading in smaller companies. Where no such market exits, it seems unlikely that promotion of equities in small companies would produce one.



3 USAID's Experience With Venture Capital Projects

USAID HAS HAD a modest interest in venture capital over the past few years. There has been a steady flow of project activity, but not enough for the Agency to develop a cadre of experienced specialists. USAID has approved at least 13 projects since 1970 (see table 1) that included at least one component aimed at venture capital or equity investment.

For this study, the author reviewed available documentation in USAID's central documents center to learn the projects' outcome. Where gaps existed in documentation, the author attempted to clarify the record by contacting individuals knowledgeable about a project.[5] Venture capital projects, however, are generally slow to mature. USAID disbursements typically end after all funds are committed, usually four to five years after inception. At this point the final evaluation report is written, and the written record (as well as USAID staff involvement) ends. Another five years or so are likely to elapse before a sound determination can be made of the value of the investments. Given this difficulty, as well as gaps in documentation, conclusions reached on available data must be tentative.

Project papers generally used justification in accord with the theory above—the activity would stimulate flows of funds to high-payoff investments, which would stimulate development by creating jobs and raising output. The USAID project would be a catalyst, leading other private organizations to begin providing venture capital. Often there was also the expectation the increased supply of equities resulting from the project would help develop the capital market, or the stock market, in the country.

In three projects, the venture capital component was not implemented. For the remaining projects, the result as compared with the venture capital expectation was uniformly disappointing. In none of the cases did the generic venture capital scenario proceed according to plan—that is, the firm acquires shares in a set of firms, sells them for a profit, and invests the proceeds in new firms. The specific cases vary.

1. *Latin American Agribusiness Development Corporation (LAAD)* and its subsidiaries received six USAID loans totaling $44 million from 1971 through 1989. LAAD was established by 12 U.S. agribusiness firms in 1970 with an initial capital of $2.4 million to invest

[5] Teri Frustace of DAI, Inc. prepared detailed case studies of the AID projects (Frustace 1994b), which provided the basic data for this section.

in Central American agribusiness enterprises. The initial USAID loan was intended to increase LAAD's involvement as a lender and equity investor in agribusiness enterprises in Central America. The corporation was to make equity investments wherever possible, as a means for capital market development.

LAAD was to use at least two thirds of the $6 million in its first USAID loan for equity or for loans convertible into equity. LAAD's eq-

Table 1. USAID Approved Venture Capital Projects

Year	Country	Amount* ($million)	Purpose	Implemented?
1971	Latin America	20.0	Latin American Agribusiness Dev. (LAAD)	yes
1979	Egypt	1.0	Private Investment Encouragement Fund	no
1982	Haiti	12.0	Establish development finance corporation for lending and venture capital	no
1984	Jamaica	21.2	Grant for Jamaica Agricultural Development Foundation for loans, equity investments	yes
1985	Costa Rica	26.0	Private Investment Corporation for lending, equity	yes
1985	Asia	na	Appropriate Technology, Inc.	yes
1986	Eastern Caribbean	40.0	High-impact agribusiness promotion	yes
1986	Ireland	50.0†	Part of cash transfer for venture capital lending	yes
1987	Thailand	3.0	USAID Private Enterprise Bureau loan to a new venture capital firm	yes
1987	Jordan	0.7	Establish a venture capital fund and other activities	no
1987	Kenya	9.6	Fund two equity capital companies	yes
1988	Sri Lanka	2.4	To launch a venture capital company and other activities	yes
1989	Africa	2.4	Africa Growth Fund for equity investment	yes

*Project amounts are not necessarily for venture capital; in some cases, the USAID funds are used for lending by firms using other funds for venture capital activities.

†Total project; documentation unclear on amount for venture capital activity.

uity investments, however, were not particularly successful, and LAAD saw little prospect for sales of equity holdings that would permit it to avoid the risk of illiquidity. In a second loan in 1976, USAID agreed to eliminate the equity requirement and sought instead to have LAAD put greater efforts into promoting agribusiness investments that benefited small farmers.

After that, LAAD established itself as an efficient financial intermediary for private agribusiness investment in Central America. It maintained a low administrative cost structure and closely managed its portfolio. Commercial losses averaged less than 1 percent of the portfolio, according to a 1989 evaluation. Nevertheless, LAAD experienced serious financial problems in the early 1980s, when political and economic turmoil enveloped most of Central America. Most of its Nicaragua portfolio had to be written off, and the imposition of debt-service restrictions by other governments in the region undercut its financial position.

In 1993, 91 percent of LAAD's assets were in loans, only 9 percent in equity. Its capital base had risen to $20 million, and its loans and equity holdings to $62 million. Of all the institutions USAID promoted in the venture capital field, LAAD is the only one that is a sustainable, profit-making enterprise. USAID's substantial support played a key role. Nevertheless, the return earned by LAAD on its USAID resources was modest. Had LAAD invested the Agency's resources in six-month U.S. Treasury bills rather than in development projects, the corporation's capitalization would have risen to more than $40 million.

2. *The Egyptian Private Investment Encouragement Fund* was designed in 1979 to provide financial assistance in the form of loans and equity investment to large private sector companies. USAID authorized up to $1 million in equity investments, but no investments were actually made. The venture capital component of the project had not been carefully designed. The entire project had serious implementation problems, with four chiefs of party during its relatively short life. Part of the funds were later deobligated.

3. *Appropriate Technology Incorporated (ATI) venture capital initiatives.* ATI receives USAID grant assistance, which it has used to fund several venture capital initiatives in Asia. During the early 1980s, ATI developed venture capital funds in Indonesia, the Philippines, Sri Lanka, and Thailand. All four funds were managed by nonprofit organizations headquartered in the host country. All ended poorly. Each fell far below design objectives in number of investments, capitalization rate, and financial self-sufficiency. ATI concluded that nonprofit organizations cannot successfully manage funds that have the sole purpose of making money. ATI established a second generation of venture capital funds in Indonesia and Thailand in the late 1980s with more experienced venture capitalists. Neither fund had begun divestiture by 1993, but ATI considers the investments to be satisfactory and potentially marketable.

4. *The Jamaica Agricultural Development Foundation (JADF)* was a venture capital activity initiated in 1984. The foundation received PL 480 Title II surplus U.S. dairy commodities, which it processed and sold to capitalize an investment and loan fund. Problems came in the form of a lack of clear understanding regarding sustainability. Although USAID identified sustainability as one of the primary project goals, JADF relied continually on granted surplus commodities as its sole source of investment funds.

After experiencing bottlenecks in processing and marketing cheese and butter, the foundation met with cash-flow problems and relied on a USAID grant facility to subsidize operating costs. Although the project took steps to improve its operating procedure and cash flow, the USAID project assistance completion report indicated that JADF had not been able to build a capital base and was still dependent on USAID-granted dairy commodities as the sole source of operating income and investment capital.

5. *The Private Investment Corporation (PIC).* This entity was established in 1984 to promote private investment in export-related enterprises. PIC was owned by a consortium of Costa Rican banks, private companies, and the Coalition for Economic Development Initiatives, a private sector export promotion agency heavily funded by USAID. The purpose was to provide credit, equity investment, and other services for investors in the export sector. PIC was to emphasize risky ''nonbankable'' projects in this sector, including start-ups. USAID provided $26 million in funding—$20 million for relending, $1 million for technical assistance, and $5 million in USAID-managed local currency for equity investment.

PIC's early lending and equity investment experience was disastrous. Many of the projects it financed failed completely, and others were not making interest payments. The institution flirted with bankruptcy. Management was replaced, and operations shifted away from high-risk efforts. PIC ended its equity investment activities and concentrated on lending and other financial services. The corporation's financial viability was subsequently restored, and it has become a respectable provider of medium-term lending.

6. *The International Fund for Ireland* was established in 1986 for $50 million and was appropriated by the Reagan administration in response to the Anglo–Irish Terrorism Reduction Agreement. The fund aimed to promote economic and social development by stimulating private investment in troubled areas in Northern Ireland and the adjoining provinces of the Irish Free State.

One of several project components involved establishing an equity investment fund in the Republic of Ireland and another in Northern Ireland, for ''providing venture capital on normal commercial criteria to both start-up projects and existing businesses'' (International Fund for Ireland 1992, 43). The equity investment activity started slowly, and a U.S. Government Accounting Office audit in 1989 criticized the fund for receiving disbursements of several million dollars for venture capital activities while actually committing or disbursing only a small fraction of the allocations.

Investment activity began to pick up in 1990 and 1991. By 1994 the two funds had invested $14 million in 34 enterprises in the two countries. Annual reports of the International Fund for Ireland give no indication that any equity has been sold, nor do they give any indication of performance of the portfolio. The funds themselves had not achieved profitability. Together, their operating deficit accumulated to about $800,000 during 1990–94.

7. *High Impact Agribusiness Marketing and Production (HIAMP)* was authorized in June 1986, for $40 million, for the eastern Caribbean region. Centerpiece of the USAID strategy, the project was based on a belief that entrepreneurship was critical to growth in the region and that venture capital funding and related activities would stimulate entrepreneurship. Of the total, $12.8 million was for equity investment in small agribusiness-related projects.

Because of technical and legal issues, including a prohibition on use of Agency funds for purchase of equity, considerable time and effort were required to establish an intermediary to manage the funds intended for equity investment. By 1988 a nonprofit Agricultural Venture Trust (AVT) had been created to receive the USAID grant funds and to invest them in promising agribusiness enterprises in the islands of the eastern Caribbean. AVT was to establish a buy-back arrangement with each enterprise.

By the time of the close-out evaluation of the project in June 1993, AVT had invested in 28 subprojects, mainly in private agribusiness firms. But the trust had not sold its shares in any of the firms, nor did there appear to be early prospects for doing so. The evaluation narratives suggest that none of the firms had become profitable, and a half dozen had ceased operations. A notional estimate, based on the evaluation narratives, puts the value of AVT investments in 1993 at 51 percent of its original cost in nominal terms.

8. *The Haiti Development Finance Corporation (DFC)* was designed in 1986 to provide loans and equity to investors for industrial projects in Haiti. A small equity component was designed into the project, although it was given little definition. During implementation, the DFC concluded that it lacked the capability to manage equity investments, and the equity component of the project was never implemented.

9. *The Jordan Private Services Sector Development Project* was designed in 1986 to provide several forms of financial and technical assistance to the Jordanian private services sector. A $700,000 equity component was to be used to assist in capitalizing a venture capital fund.[6] The project ran into problems at the outset and was prematurely closed by USAID without any venture capital activities having taken place.

10. *Thailand Business Venture Promotion, Ltd. (BVP)* was established in 1987 for slightly more than $6 million, including $3 million in equity provided by Thai financiers, $3 million in USAID loans, and $50,000 in a USAID grant for start-up costs. Over its lifetime BVP drew down on only 30 percent of the total loan and grant facilities, for a total of 10 investments. Of those, all but two registered substantial losses or went bankrupt.

The main problem for BVP was its unwieldy management style. The board of directors, made up of representatives of six commercial banks, became involved in the fund's everyday management decisions. Conflicts among board members resulted, and BVP had great difficulties closing on investment decisions. Additionally, investments that were funded were chosen without any specialized industry knowledge.

11. *The Sri Lanka Private Sector Policy Support project* was begun in 1988 as a multipart initiative. One part was to provide financing for the start-up costs of a venture capital company. By completion of project activity in 1993, the company had not yet attempted to divest any of its holdings. The evaluators did identify several problems with portfolio quality. The main problem had to do with investment conservatism and the links of the venture fund manager to the commercial banking sector. Many fund shareholders were commercial banks, which saw the equity fund simply as a tool for improving the borrowing capacity of their portfolio companies: a larger capital base made them able to lend more. The evaluation also concluded that the fund manager lacked experience or outside connections that could help fund portfolio companies develop export markets.

12. *The Kenya Private Enterprise Development (PED) project* was a serious effort that failed to achieve its intended result. From prefeasibility and design through implementation, USAID made a number of inappropriate decisions. Problems started with faulty assumptions about the existence in Kenya of a demand for venture capital and an enabling environment to support venture capital investments. Owners of small and medium-size companies targeted by the project had no perception it would be desirable to reduce their debt in exchange for part ownership in the companies. Moreover, many companies refused to disclose real financial statements, making it impossible for venture capitalists to accurately assess investment potential.

The second problem was inadequate capitalization. Under the project, USAID provided

[6] Although the design document spoke about "capitalizing" the investment fund, it is likely that the $700,000 would have been used to cover operating costs and technical assistance associated with venture capital industry development.

money for two investment funds: Kenya Equity Management (a USAID-formed company) and Industrial Promotion Services of Kenya. But the Agency provided insufficient financing to support even one venture capitalist. Insufficient funding is perhaps why 17 of the 18 firms asked to submit proposals for the project showed no interest.

Because of the lack of interest by potential fund managers, the project contracted as fund managers firms inexperienced in venture capital. Two companies were hired. One was the project designer, and the other was a holding company based in Kenya. By the end of the project, neither company was engaged in mainstream venture capital activities. Each redesigned its mandate to provide financial services more in demand—one as a merchant bank and the other as a holding company. Although the fund managers of both companies were smart and hardworking, and although both realized and fulfilled an unmet demand for assistance in financial services, the project strayed widely from its intended purpose of *equity* investing.

13. *The Africa Growth Fund* was incorporated in 1985 with a planned $10 million in equity participation from institutional investors (to be raised by First Boston Corporation), buttressed by $20 million in credit guaranteed by the Overseas Private Investment Corporation, and a USAID grant of $150,000 to cover start-up costs. The start-up process took much longer than anticipated, and First Boston withdrew from participation. A merchant banking company known as Equator Holdings Ltd. took over management, agreeing to make at least 12 investments a year for 2.5 years, or a total of 30 investments. (Equator Holdings was parent company of the same merchant bank that unsuccessfully managed the Kenya Private Enterprise Development project described above.)

But the fund was able to raise only half the intended $10 million in capital. The shortfall jeopardized the company's cash flow, and its ability to meet its original investment schedule was put into serious doubt. A 1993 evaluation concluded that although the fund had made good investments, its high costs relative to its portfolio size made its ability to be profitable questionable. It seemed likely the fund would have to divest early from its holdings to meet immediate cash needs.

Analysis and Interpretation

The USAID projects reflect differing degrees of sophistication about the venture capital industry, ranging from vague aspirations to detailed analyses. Many projects made poor investments; nearly all had cost structures that made them unsustainable. Only one institution—the Latin American Agribusiness Development Corporation—has proven over time to be clearly sustainable. It did so, however, by shifting from equity funding to more conventional agribusiness lending, combined with substantial subsequent USAID funding.

For the nine USAID projects that were implemented, table 2 provides some summary judgments based on available evaluations. These reports were reviewed for evidence of the quality of the implementation structure, speed of implementation compared with expectations, quality of investments, and whether the company made any profitable divestments.

Implementation structure. Most projects encountered difficulties because the structure conceived in the project paper was not feasible in practice. In some cases (e.g., High Impact Agribusiness Marketing and Production project), the proposed structure was found to be legally impermissible under USAID competition guidelines. In other cases, the management structure of the implementing institution prevented effective decision-making.

Implementation speed. Most projects were far slower disbursing than anticipated. This usually reflected a scarcity of investment opportunities of the desired quality. In turn, that reflected a poor country climate. Project papers were usually optimistic about the demand for funding, but such optimism seldom proved justified in practice.

Average investment quality. The information base for this variable is limited, and judgments are often based on qualitative statements in evaluation reports. Nevertheless, the evaluation reports contain no evidence of big winners, nor do they document any improvements in national capital markets as having resulted from the project.

Profitable divestments. The ultimate test of the venture capital concept is in the *sale of equity investments in the marketplace for a profit*. This enables the venture capital company to reinvest in new companies. Although information is incomplete for several projects, no record of profitable divestments exists for any company. (If such divestments had been made, it is reasonable to assume they would have been publicized as evidencing success of the project.)

Four characteristics of USAID projects seem responsible for the poor performance:

1. *Choosing the wrong implementer.* In most projects, the implementing institution had little or no previous venture capital experience. As discussed above, private sector venture capital operations start with the management team, which then finds the money and the investments. USAID projects typically skip this step and go straight to capitalizing the investment fund. In fact, the Agency's procurement process is predicated on allocating and obligating funds before a management team is even identified. Characteristically, a request for proposals is released. The request contains the fund's financial and administrative management provisions but lacks any input from the

Table 2. Characteristics of USAID Venture Capital Projects

Project	Implementation		Average Investment Quality	Profitable Divestments?
	Structure	Speed		
LAAD	eventually sound	OK	insufficient	no?
ATI	?	slow	poor	?
JADF	poor	?	poor	no
PIC	poor	good	poor	no
IFI	?	slow	?	no?
HIAMP	poor	slow	poor	no
BVP	weak	slow	poor	?
Sri Lanka	weak	?	weak?	no
PED	weak	good	OK	no
Africa Growth Fund	weak	slow	OK	?

Source: Author's judgments based on case studies.

implementors-to-be—who are at this stage unknown.

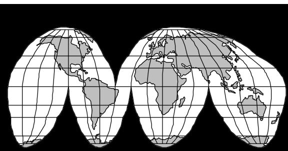
This approach works on USAID projects in other industries but does not work with venture capital initiatives. That is because venture capital companies can be successful only if their managers have a sense of ownership and vested interest in the fund's success. By following the standard bureaucratic approach to procuring the services of a fund manager, USAID supports creation and perpetuation of venture capital companies administered by groups of inexperienced individuals who a) lack the skills and experience required to choose or manage the profitable growth of investments, b) are unable to provide adequate internal capitalization, and c) are incapable of raising funds from financial sector institutions and typically fall seriously behind USAID's project design capitalization projections. The model followed in USAID projects for creating a venture capital company was so different from the typical fund manager's way of operating that USAID has not been able to interest mainstream venture capitalists in managing USAID projects.

2. *Excessive constraints on the implementer*. Venture capital projects tried to target too narrowly. Particular USAID concerns (very small businesses, the agricultural sector, women-owned businesses) were written into projects. Finding good investment opportunities in developing countries is difficult enough. Further limiting the ability of the implementer to select investments can make sustainable operation impossible. The HIAMP project aimed to provide up to $20 million in equity and quasi-equity to firms in the small islands of the eastern Caribbean, with a population of less than one million. This already difficult task was compounded by limiting activity to agribusiness.

3. *Rigid design.* In some projects, actual conditions during implementation differed sharply from those anticipated in the design. Adaptation to such problems was slow. USAID project designs are based on the supposition that the problem is understood and that a specific remedy is the appropriate one. In developing-country capital markets, this assumption of knowledge is simply unwarranted.

4. *Inadequate demand.* In most countries, entrepreneurs were extremely reluctant to sell a share of their equity. USAID's tendency is to target development of small and medium-size enterprises and of capital markets as two primary purposes of venture capital activity. However, a strong small and medium-size enterprise sector and an operating capital market are better understood as the elementary building blocks on which a venture capital industry must grow. *Stock markets* do not develop because a handful of venture capitalists are ready to divest their holdings in small and medium-size enterprises. Rather, established investment bankers making public equity investments in high-value stocks expand the securities market, gradually creating a market for such less-than-blue-chip companies. They thus partly set the stage for development of a venture capital industry for small and medium-size enterprises. In short, USAID is putting the venture capital cart before the equity market horse.

The first three problems are closely linked to the ways USAID plans and implements projects. The fourth is more generic.



4 The Enterprise Fund Model

IN 1989 PRESIDENT George Bush proposed creation of ‘‘enterprise funds’’ for Hungary and Poland. Later that year, Congress passed the Support for Eastern European Democracies Act, which defines a broad structure and goals for enterprise funds in Hungary and Poland. The funds were to speed the transition to market economies by supporting establishment and expansion of private business firms. They were to be established as nonprofit U.S. corporations operating under the guidance of a board of directors made up of a combination of U.S. and host-country members.

A wide range of activities was permitted by the legislation and subsequent grant agreements between USAID and the enterprise funds, including debt and equity investments, leasing, grants, and technical assistance. The expectation was that they would be ‘‘venture capital’’ funds, providing a mix of equity and debt financing to emerging businesses in recipient countries. The enterprise funds were to operate for a limited period (expected to be 10–15 years, though this was vague), after which assets of the funds were to be sold off and the proceeds redeployed for other purposes.

To ensure rapid implementation of the enterprise fund concept, management of the funds was to be largely independent of the U.S. government, which was to grant the resources to each fund. Board members were to be the best minds in the U.S. private sector and were to be appointed by the President. As shown in table 3, enterprise funds for Hungary and Poland were organized in 1990, and funds for Bulgaria and the Czech Republic began operations in 1991. Seven more funds were added in 1994–95, but these are only beginning to have significant operational activity.

The relationship of the funds to the U.S. government was initially confused. The government provided the resources but had no membership on the boards of directors nor any voice in disposition of funds. No clear reporting or monitoring relationship with USAID or other U.S. agencies was established, and fund managers initially resisted such oversight.

But use of public funds without public oversight proved unfeasible. Unfavorable press reports in 1993 about one of the funds led to a requirement for semiannual reports to USAID and an agreement on audits by U.S. government agencies. The funds agreed formally or informally to a variety of other procedures, such as a ceiling on salaries of fund officials and safeguards against export of U.S. jobs—procedures that already applied to direct U.S. government assistance programs.

Each enterprise fund took a different approach to its mandate. The Hungarian and

Table 3. USAID Established Enterprise Funds					
Fund	**Start up**	**Authorized Amount ($millions)**	**Disbursed Amount ($millions)**	**Percent Invested in Equity**	**Average Equity Investment ($millions)**
Albanian	1995	30	0		
Baltic	1994	50	5		
Bulgarian	1991	55	19	73	0.6
Central Asian	1994	150	22		
Czech–Slovak	1991	65	43	88	0.4
Hungarian	1990	70	54	84	1.2
Polish	1990	264	179	67	3.1
Romanian	1994	50	5		
Russian	1993	440	53		
Southern Africa	1995	100	0		
Western NIS	1994	150	7		
	Total	1,424	386		

Source: Authorization and disbursement amounts are as of September 30, 1995, and are from USAID internal reports. Equity investment data are from Development Alternatives, Inc., (1995).

Czech[7] funds invested almost exclusively in equities, whereas the Polish fund implemented a substantial lending program. The Polish and Hungarian funds sought larger enterprises and made investments averaging $1--3 million, while the Czech and Bulgarian funds sought smaller companies. The funds also varied substantially in their approach to staffing, in economic sectors emphasized, in geographical diversification, and in the extent to which joint ventures with U.S. firms were emphasized.

The funds were established for the broad foreign policy purpose of speeding the transition of Eastern Europe to a market economy. The mere act of creating the funds was itself a factor in achieving this purpose. It provided a clear statement of U.S. government support that probably encouraged private investment in the region. An assessment of the success of the funds in this broader perspective is beyond the scope of this report, though an overview of the operations and impact of the four operating funds is contained in a recent (1995) report by Development Alternatives, Inc. The present report is concerned only with the venture capital aspect of their operations.

7 This fund subsequently created Czech and Slovak funds as separate operations. The general approach is the same, though, so they will be treated as one entity.

Quality of the Equity Portfolio

It is still too early to measure the success or failure of the European enterprise funds. Though they have been formally in operation for four to five years, many of their investments were made only in the last two years. Another five years of experience is needed before we can arrive at definitive conclusions. Moreover, the ultimate performance of a fund can be affected dramatically by one or two investments (e.g., a Microsoft of the future) that can compensate for many poor investments. Despite this imperfect state of knowledge, the experience so far appears to provide some reasonable expectations about the success of the individual funds.

In principle, Eastern Europe should be an ideal setting for venture capital activities. Since the funds were launched in 1990–91, the private sector in each country has grown dramatically, with governments divesting themselves of assets, and opportunities for new businesses appearing everywhere. Labor forces are much more educated than in developing countries, and the policy climate for private business has improved rapidly. Overall economic activity has begun to recover in most countries—though private economic activity was rising rapidly even in the early 1990s. Moreover, the Eastern European countries lacked a banking sector either experienced or interested in lending to small and medium-size private enterprises. Therefore, venture capital providers faced less competition from banks than in other countries.

All these considerations would make one expect funds in Eastern Europe to perform extremely well in comparison with venture capital funds launched in developing countries.

It is still too soon to judge with any precision the performance of fund portfolios, but available evidence suggests it has not been particularly favorable. Two of the four funds (in Czechoslovakia and Bulgaria) have suffered large losses unlikely to be offset by gains elsewhere in the portfolio. The value of the portfolios of the other two funds appears so far to have increased only slightly, if at all. (Both have, however, sold a small number of equity holdings for a profit—an achievement not documented for any of the USAID funds discussed earlier.) None of the funds has achieved operational sustainability. All have had difficulty finding equity investments that offer high payoffs—calling into question the basic hypothesis of a severe shortage of equity capital. The Development Alternatives study concludes, ''It is clear that the market for conventional venture capital is narrower and less profitable than might have been originally anticipated.''[8]

Operational Issues

The funds did avoid some of the problems with USAID projects described in chapter 3. Boards of directors selected by the President were largely financial-market professionals, emphasizing private sector profitability and sustainability. Nevertheless, board members with investment banking experience predominated over venture capitalists. Some have argued that this biased the funds' operations toward conservatism. USAID gave fund staffs total freedom of action, imposing none of the constraints or rigid approaches characteristic of Agency-designed venture capital projects.

The new institutions did begin operations quickly. In comparison with the European Bank for Reconstruction and Development—the major governmental institution with the same general mandate—the enterprise funds

8 DAI 1995, p. v.

took one year less to achieve normal operations. Almost certainly, they got off to a faster start than would have been the case had they been designed as USAID projects.

Enterprise funds also adapted flexibly to changing investment opportunities and country conditions. The Polish fund shifted substantial resources to its small-lending program in response to its initial favorable experience, and created a major niche in the marketplace. The other funds each did useful experimentation. A typical USAID project would have limited the scope for such experimentation. Since uncertainties in these countries substantially outweighed certainties, the usual USAID project, with its rigid design, would have been less successful.

Despite these operational advantages, the experience with enterprise funds so far is mixed. Freedom from constraints appears to have produced innovation and flexibility, but it also produced mistakes and errors in judgment in some funds. With strong internal management, some funds avoided such problems. In other cases, greater USAID oversight might have prevented them.

5 Experiences of Other Approaches, Other Places

USAID IS ONLY ONE OF A number of actors promoting venture capital in developing countries. Both private entities with a development goal and multilateral agencies have been active in this field. These other experiences provide a perspective for assessing the failure of USAID to identify a successful approach.

Private Ventures

1. *International Basic Economy Corporation.* IBEC was established in 1947 by the Rockefeller Foundation. Its creator, Nelson Rockefeller, saw it as a model of enlightened American capitalism, to demonstrate that fostering profitable business activities would contribute to economic and social development of poor countries.

Originally involved in Latin America, by 1968 IBEC operated in 33 countries through 119 subsidiaries and principal affiliates. Emphasizing enterprises that contributed to a nation's food and housing supply, IBEC funded such ventures as mutual funds, agricultural services, home building, poultry breeding, and manufacturing.

IBEC had some notable successes. It pioneered supermarket chains in Latin America that generally helped reduce retail prices. It helped to improve egg output through scientific poultry breeding in several countries. In Brazil, IBEC developed a hybrid seed plant that has increased corn crop yields. More often, though, IBEC acquired unproductive and marginal facilities that cost millions of dollars. It got into ventures in which it had no expertise, and it failed to make consistently good profits.

During its first two decades, IBEC experienced steady, if only marginally profitable, growth. Stockholders' equity grew steadily to $16 million, and assets totaled $30 million after the first decade. By 1966 equity amounted to $42 million, and total assets had grown to $157 million.

The company decided in the mid-1950s to invest in the United States to provide a steadier cash flow than it was getting from developing countries. In 1955–57, IBEC purchased two successful U.S. manufacturing companies, V.D. Anderson Co. and Bellows Co.

These companies provided a continuing cash flow to finance IBEC's foreign investments (Broehl 1968, 260). IBEC's merger with the U.S.–based Arbor Acres chicken company in 1964 also contributed to the company's profitability. The merger significantly increased the company's size, with gross sales for 1965 climbing to $197 million.

By the early 1970s, however, IBEC faced serious financial troubles. In 1973 a group of banks led by Chase Manhattan extended IBEC a $45 million line of credit. But by 1975, the company was unable to meet its financial obligations to some financial institutions. IBEC again turned to Chase Manhattan for help. This led to later charges of conflict of interest with respect to Rockefeller family involvement in both institutions. IBEC's revenues peaked in

1974 at $300 million, but management aggressively reduced both the work force and IBEC's affiliations from that time on. By 1979 revenues had fallen to $66 million, and the Rockefeller family decided to dissolve IBEC.

Dismantling IBEC was undertaken for a variety of reasons, not all of which had to do with lackluster performance in developing countries. Its investments in U.S. manufacturing companies were also weakening by this time. Also, in the early 1970s as a result of actions by the Organization of Petroleum Exporting Countries, IBEC found itself operating in increasingly hostile political environments—in Venezuela because of the rise of nationalism and suspicion of multinationals, and in Brazil because of hyperinflation due to balance-of-payments problems.

IBEC's problems continued to mount. By 1979, when Nelson Rockefeller died, IBEC faced increasing losses and a string of lawsuits. In 1980 the enterprise was sold to a British conglomerate, Booker McConnell, Ltd. There it existed for several years as a subsidiary before disappearing entirely.

2. The Atlantic Community Development Group for Latin America (ADELA) was established in 1964 with private American and European funding to promote venture capital funding in Latin America. The concept of a private venture fund for Latin America had been proposed by Senators Jacob Javits and Hubert Humphrey, who generated international support. Initial investors consisted of 54 major multinational manufacturing and financial firms, which provided $17 million in capital. ADELA later grew to have $61 million in capital, with 240 investors, none of whom held more than 1 percent of equity. With no dominant shareholder, ADELA's large board of directors provided little effective oversight over the company's management.

ADELA investments grew rapidly. By 1970 the corporation had invested $217 million in loans and equity in 100 companies and had offices in 11 Latin American countries. By 1977, investments had grown to $485 million in 600 companies in 18 countries, about two thirds of which were in loans. The rapid growth was financed by borrowing from commercial banks and by issuing Eurobonds, and ADELA became steadily more leveraged. It reached a debt–equity ratio of 5.3 in 1979.

The company was consistently profitable on paper through the 1970s, though its financial statements misrepresented its real condition, which was deteriorating. For example, stock dividends were treated as income, and nonperforming loans continued to accrue income. Lack of financial controls and a decentralized structure permitted deceptive practices by branch offices. In January 1980, the corporation declared itself unable to meet its debt obligations, and it suspended payments.

For the next decade, ADELA was, in effect, in receivership, as assets were liquidated to repay debt. Tessler & Cloherty (1985) estimate that ADELA's annualized rate of return on its capital over 1969–83 was minus 60 percent a year. It managed to reduce capitalization of $90 million to $14 million. The company was finally liquidated in 1992.

3. *Private Investment Company of Asia (PICA)*, like ADELA, had been promoted by Senator Javits as a vehicle for private sector development. Conceived in 1969, it was built on the same model as ADELA (as was SIFIDA later—see below), with ownership distributed among more than 100 corporations, each owning only a tiny share, and a mandate to engage in equity investment and lending to private business. With an initial capitalization of $40 million, it began operations in 1972 from a Tokyo office. It later moved to Singapore, establishing eight other offices and building its staff up to 65.

PICA provided a variety of financial services as well as loan and equity financing. Its equity portfolio grew to $40 million by 1984. But the combination of increasing competition from other financial entities, relatively high administrative costs, and the recession of the early 1980s created severe difficulties for the enterprise. In 1987 it was absorbed by Elders Finance and Investment Company of Australia.

4. *Société Internationale Financière pour les Investissements et le Development en Afrique* (SIFIDA) was established in 1970 to provide equity and long-term capital investment in Africa. SIFIDA's stockholders included more than a hundred private and public institutions from the industrial countries as well as multilateral agencies. As with ADELA, SIFIDA had a large (27-member) board of directors with no single dominant shareholder: the African Development Bank was the largest, with 6 percent of shares.

SIFIDA's approach was much more conservative than ADELA's. The company concentrated initially on constructing a headquarters building and staffing its Geneva, Switzerland, headquarters, from which all staff operated. Its investment portfolio grew only slowly during its first decade, from $6 million in 1974 to $38 million by 1981. It was only slightly leveraged, as paid-in capital was $21 million. SIFIDA's strategy emphasized equity investments, but this proved difficult in practice. The corporation had placed $5 million in equity (compared with $9 million in debt) by 1977, but equity holdings stagnated for the next five years, whereas debt grew to $37 million. During its first decade, SIFIDA had only one sizable capital gain—a profit of $1.5 million on the sale of its Geneva headquarters building.

SIFIDA's conservatism did protect it from illiquidity during the early 1980s. One estimate of its return on investment during 1975–82 puts the annualized rate at 2.6 percent. Had SIFIDA's capital been invested in U.S. Treasury bills, the rate of return would have been 9.3 percent (Tessler and Cloherty 1985, 19). Worse was to come, though. The economic difficulties of African countries during the 1980s led to a gradual deterioration of the company's financial position. In 1994 it became insolvent.

Thus, all four ''enlightened'' private sector efforts to promote venture capital in developing countries ultimately failed. All four can be considered ''benevolent,'' in the sense they intended to do well by doing good: their creators sought to promote economic development and to enjoy profits as a by-product. All four institutions had difficulties in making business decisions. IBEC was reluctant to contest breach of contract by partners because of the adverse publicity for the Rockefeller name. The other three institutions lacked a dominant shareholder to enforce a clear purpose or to control management.

Multilateral Agencies and Other Governments

1. *International Finance Corporation* (IFC). The International Finance Corporation was established in 1956 as an affiliate of the World Bank to directly fund private businesses in developing countries. The IFC operates in the venture capital field at two levels. First, it has provided direct lending and investment in emerging enterprises in developing countries. Second, it has invested in venture capital companies in developing countries, having taken an equity stake in eight such companies during 1975–85.

IFC as an equity investor. U.S. opposition initially prevented the IFC from investing in equity, but its mandate was broadened in 1961 to include both equity investment and lending. IFC equity investments rose rapidly after 1961, and the portfolio in 1970 was 60 percent in loans and 40 percent in equities.[9] After 1970, however, the IFC shifted sharply away from equity investments and toward lending. Equity investment continued to grow during

9 The IFC values its equity investment portfolio on a historic cost basis, so the market value of the equity share may be somewhat different.

this period, but only slowly, whereas lending increased rapidly. At the end of FY 1995, 81 percent of the IFC's total portfolio of $9.5 billion was in loans, only 19 percent in equities.

The average IFC operation is considerably larger than those typically pursued in USAID venture capital projects. The average new commitment in 1995 was $12 million, and many of the investments are in very large enterprises: steel mills, mining companies, public utilities. Such firms are visible, and their large capital requirements create the possibility for widespread public ownership. Consequently, the IFC operates in a segment of the market where prospects for public sale of equities are far more promising than they are for the smaller firms favored by USAID. Nevertheless, the IFC's equity portfolio has not seen rapid turnover. In 1995 the IFC sold equity with a cost basis of only $42 million, compared with a cost basis for its total equity portfolio of well over $1 billion. That implies an average holding period for equity substantially longer than the five to seven years of which venture capitalists typically speak.

No studies were found of the relative profitability of the IFC's equity portfolio in relation to its lending.[10] The IFC's gradual reduction in the equity share of its operations suggests that staff did not consider it favorable. (Alternatively, equity lending could on average be more profitable but hampered by lack of opportunities.)

One apparent benefit of the IFC's concentration on private sector lending is the opportunity to be selective about where it places its resources. Country conditions are generally considered important to the prospects of business enterprises, but the IFC portfolio does not appear to have been particularly successful in this regard. Its portfolio has historically emphasized Latin America over Asia. Even within Asia, its resources flowed more to India and Pakistan than to the fast-growing countries of East Asia. (In 1983 the IFC's portfolio in Yugoslavia was larger than that of the seven ''Asian Miracle'' countries combined. In that year, the 10 largest users of IFC resources were, in declining order, Brazil, Yugoslavia, Mexico, India, Turkey, Egypt, Argentina, the Philippines, Pakistan, and Zambia.) In the 12 years since then, most of these countries have been relatively poor performers.

IFC as investor in venture capital companies. The IFC has also provided resources for venture capital companies. A recent evaluation of eight such enterprises (IFC 1992) in which the IFC invested $40 million from 1976 through 1986 concluded that this indirect support had serious problems. The venture capital companies had difficulty persuading owners of promising businesses to sell part of their equity; managers of venture capital companies were usually inexperienced and had to learn by doing; and developing a management structure that created proper incentives was difficult.

Overall, the IFC's venture capital portfolio performed poorly. Estimated real rate of return on its projects in venture capital companies was minus 5 percent, compared with +6 percent on its overall portfolio.[11] In other words, the IFC's investment in venture capital companies lost 5 percent of its value for each year it was invested.

Inter-American Investment Corporation (IIC). In 1987 the Inter-American Development

10 One IFC study (IFC 1989) examines the economic and financial rates of return to projects in which the corporation has invested. It includes breakdowns by sector of activity for such variables but, curiously, does not consider the question of whether equity or lending activities have yielded better results.

11 Even though the 1992 evaluation covered only investments made in 1986 or earlier, the slowness of many venture capital operations to mature makes valuation uncertain except after a long time lapse. The IFC evaluators considered their estimates to be conservative. Thus, a later evaluation might produce less unfavorable results.

Bank established an affiliate for investment in private sector projects, the Inter-American Investment Corporation, along the lines of the IFC. It is too early to make judgments of the effectiveness of the IIC's investment portfolio. Nevertheless, the IIC's early experience is similar to cases described earlier. Start-up took longer than expected, and administrative costs mounted before the corporation began to generate income. It encountered early difficulties finding suitable investments. By 1994 it had fully committed its resources, but inflows were inadequate to cover operational costs, and the IIC had to sharply reduce its staffing.

3. *Commonwealth Development Corporation (CDC)* was established by the British government in 1947 to promote development in present and former colonies. The corporation has operated as a financial intermediary, with a capital stock and borrowing authority, rather than as an aid agency. At least between 1955 and the early 1980s, the corporation was consistently profitable, though this may owe much to the fact that its debt is to the British government at concessional interest rates.

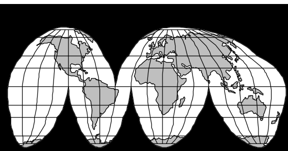
CDC financing has consisted primarily of loans, particularly for public utilities and housing. Equity investment has represented 10–20 percent of the corporation's portfolio. The corporation has maintained a relatively lean organization, with administrative costs held to about 2 percent of the portfolio. Moreover, its country portfolio mix appears to have generally been better than that of the IFC. Initially confined to the Commonwealth, it expanded after 1972 into other developing countries. This was done selectively, with initial investments in Costa Rica, Côte d'Ivoire, Indonesia, Liberia, and Thailand. Even within the Commonwealth, CDC made no investments in India or Pakistan until the 1980s.

CDC's early experience was unfavorable, and it apparently lost £11 million on the first £12 million of investments. Subsequent portfolio performance has apparently been reasonably satisfactory, though no specific information was available on the equity portion of the portfolio. It has had at least one big winner—a share of a Hong Kong container ship terminal. A 1972 loan of £2 million, later converted to equity, was sold in 1992 for £45 million. Analysis of CDC's total portfolio for 1972–81 (Tessler & Cloherty, 1985) showed that it substantially outperformed both ADELA and SIFIDA, producing an internal rate of return on its portfolio of 5.4 percent. (This return is not impressive for the period; it compares with an 8.2 percent return that CDC would have earned by investing in U.S. Treasury bills rather than its actual portfolio.)

Where Was Venture Capital in the 'Asian Miracle' Countries?

The most rapid economic growth in recent decades has occurred in East Asia, where the seven countries called high-performing Asian economies (HPAEs) by the World Bank have grown rapidly and have dramatically transformed the structure of their production to become manufacturing centers. In 1992 dollars, the value of industrial output from these economies grew tenfold to more than $200 billion from 1965 through 1990. What role did venture capital play in this transformation?

The answer seems to be—very little. The World Bank report *The East Asia Miracle* (World Bank 1993, p. 223) concludes that bond and equity markets "were not generally a key factor in mobilizing investment during the HPAEs' economic takeoffs." Stiglitz (1993) has calculated that only a small fraction of the growth in capitalization of enterprises in either the HPAEs or in industrial countries has come from outside equity. Retained earnings were the primary factor, usually accounting for more than half of financing requirements, but loans and bonds were each more important than equity financing in most cases. The study concludes (p. 226) that stock market activity, which has boomed in recent years in East Asia, is "a result rather than a cause of East Asia's rapid growth."



6 Why Is Venture Capital a Mirage?

CONCLUSIONS ABOUT the success or failure of USAID venture capital projects must generally be tentative, as the documentation trail in most cases ends with a final project evaluation report. Such reports are typically written after project activity has ended, perhaps five years after the project began. For venture capital projects—particularly since they often take several years to get up to speed—this time period may be too short. It is possible that a few winners will emerge that pay such handsome gains that all else can be forgotten. Although this is possible, the weight of available evidence suggests it is unlikely.

Moreover, the experience of IBEC, ADELA, PICA, and SIFIDA is not encouraging in this regard. All had a decade or two of experience that, in theory, allowed for the emergence of big winners. Some winners did emerge, but they were inadequate to compensate for the losers. Even working with enterprises far larger than those USAID has tried to encourage, the IFC's record leaves no indication that this area is one of high payoffs. The CDC's experience similarly suggests low payoffs. Quite simply, there is just no evidence that donor-supported equity financing activity is a desirable or sustainable use of scarce resources.

It is important to emphasize that this is quite different from concluding that venture capital is not an important source of developing-country growth. It is possible that private venture capital may be useful or important to future growth in developing countries. Experience simply suggests that donors cannot do it successfully, and that venture capital activity, at whatever level, should take place in the private sector.

The main characteristics of venture capital in the private sector seem to be

- Quick decision-making
- Investment officers with direct financial interest in results
- Relentless concern about profitability
- Relentless cost control

Donors are not particularly good at any of these. Although the first and fourth could conceivably be designed into donor projects, the second and third characteristics pose serious problems. Donors find it difficult to justify enriching a private individual or group through use of public funds. This is an almost insurmountable obstacle except in exceptional circumstances—such as the opening of Eastern Europe. The third characteristic is a serious challenge because donors usually are seeking multiple goals. They want profitability, of course, but they seek to achieve it while supporting particular activities (such as agribusiness or women's enterprise) and in particular places (the more remote or backward parts of a country). Inability to concentrate on the bottom line almost invariably leads to failure in this keenly competitive business.

7 Conclusions

SIX CONCLUSIONS FLOW from the analysis in this paper:

1. The Agency's experience with venture capital projects has been unsatisfactory. Poor project design, partly caused by USAID procedural requirements, has contributed to this failure.

2. The experience of other ''official'' and ''benevolent'' venture capital funds strongly reinforces the conclusion that this is a sector where donors, or socially oriented private institutions, are likely to perform poorly. Moreover, evidence from the rapidly growing Asian economies suggests that dynamic activity in the equity market is more likely an *effect* than a *cause* of rapid private-sector growth.

3. The enterprise fund concept avoids many problems associated with USAID venture capital projects, but the funds so far have had only mixed success. A fund's success depends heavily on the quality of its management and the clarity of its purpose.

4. Even successful enterprise funds have not demonstrated that lack of equity capital is a problem that donor funding can solve. There is no evidence so far suggesting their portfolios will yield as much as a 10 percent rate of return, and the return could well be much lower.

5. Enterprise funds do, however, provide a means for developing instruments adapted to a country's private sector financial needs. It is the flexibility of the enterprise funds' ability to innovate and to look for market niches that provides the likely payoff. Such niches are unlikely to be in equity financing.

6. In sum, there is no basis for believing that equity funding—either as venture capital or in some other form—is a high-payoff activity for donors. Experience suggests the opposite. Consequently, USAID should leave this activity to others.

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