THE BLEYZER FOUNDATION

SigmaBleyzer

April 25, 2014

Public Private Equity Partnership (PPEP) as an Instrument to Attract Investments into Ukraine

Dr. E. Segura and V. Povroznyuk

After two decades of insufficient economic reforms and widespread corruption, the Ukrainian economy remains underdeveloped, undiversified and dependent of a few commodities for its exports and economic growth. In fact, Ukraine's economy is at the mercy of international developments in the metallurgy, chemicals and agricultural sectors for its wellbeing. It is also dependent on a few countries for the bulk of its foreign trade. Only major investments, both foreign and domestic, may be able to convert Ukraine into a prosperous and diversified country, both geographically and product-wise.

Unfortunately, the current political crisis and hostility with one of its major trading partners have added business uncertainties to the already poor business investment climate of the country. Even before the current political crisis, Ukraine's business climate was ranked 145 out of 186 countries analyzed by the World Bank's 2013 Doing Business Survey. Ukraine's business climate's ranking was the lowest in all Europe, and similar to such backward countries as Tanzania, Lesotho, Sierra Leone, Madagascar and Tajikistan. In areas such as Dealing with Construction Permits, Paying Taxes, Resolving Insolvency, and Trading Across Borders, Ukraine was ranked 183, 165, 157 and 145, respectively. Under these conditions, attracting necessary investments will be a challenge.

The realization of Ukraine's growth potential requires large investments into many sectors. For example, agriculture alone needs more than US$50 billion of investments during the next 10 years. The energy sector may also require large investments to diversify sources of supply and achieve energy efficiency. The overall economy may require no less than US$200 billion of investments in revenue-generating projects over the next 10 years, or about US$20 billion per year, to achieve its potential. It is evident that domestic sources of investment will not be enough to meet the country's needs. Large amounts of foreign investments will need to be attracted.

Given Ukraine's poor investment climate, in order to attract required amounts of foreign investments, it is essential that Ukraine undertake major economic reforms to improve its investment climate to bring its Doing Business ranking below 70. This would allow the country to be competitive with countries such as Georgia (9), Slovak Republic (46), Poland (55), or Bulgaria (66). But given the current political risks and the likelihood that hostilities with Russia will not be totally alleviated in the near future, improving Ukraine's investment climate would not be enough to attract large foreign investment. Ukraine must devise an additional mechanism to attract financing.

We believe that Public Private Equity Partnership (PPEP) could be a mechanism that could be used to address the investments needs of Ukraine. PPEPs combine the advantages of both Public Private Partnerships (PPP- join ventures between governments and private investors normally used for large infrastructure and social projects) and Private Equity funds (PE- private equity funds normally used for diversified revenue-generating projects). A PPEP involves the creation of an investment fund (as a limited liability company) that would be financially supported by equity contributions of both the

Ukrainian government and private equity investors. In addition, multilateral or bilateral financial institutions could be involved in providing financing, either in the form of equity or debt. These investors would be the Limited Partners of the fund, and would not be involved in the direct management and operations of the fund. The PPEP fund would be managed by a private Fund Manager, who would be a General Partner of the Fund. The Fund Manager will be responsible for identifying, appraising and investing in large revenue-generating projects. It will decide on the merits of the investments and ultimately operates the projects until their exits. These projects could be in any revenue-generating sector, or could be limited to specific sectors agreed upon with the government, such as agriculture, energy, etc.

To sum up, in this joint ownership PPEP model, the government and private-sector investors agree to unite in order to provide funding for projects to be selected and managed by an independent private sector manager. The main advantage of a PPEP Fund is that the direct equity participation of the government in the fund would alleviate many of the risks that foreign investors may experience in Ukraine. This risk attenuation would be a significant factor to leverage and attract the large amounts of investments necessary in Ukraine to modernize and diversify its economy. The government may provide its funding in kind or in money. For example, in an agricultural project, the government may provide the agricultural land for the project. The government may also provide any needed concession rights to its private partner and will also handle the political and legal roadblocks faced by the new company.

As noted earlier, the role of the government in stimulating private investments would start with creation of an appropriate business policy framework. But equally important, the government's participation in the financing plan for the PPEP fund would help alleviate other major risks facing investors in today's uncertain economic and political situation. These risk categories are: (1) general political risks; (2) currency risks; (3) regulatory and policy risk; and (4) execution risk. The first category contains risks related to political stability and security of property rights in the country, which is particularly topical under the current political situation in Ukraine. The second category reflects concerns about administrative decisions that may lead to devaluations of the local currency affecting the value of the investment. The third category of risks related to stability and certainty of the regulatory and policy environment affecting the projects in the Fund. Finally, the fourth category contains risks reflecting concerns that authorities may not enforce contracts requiring local firms or institutions involved in the execution of an investment project.

The major benefit of state participation in the Fund's projects is that it can act to reduce or mitigate the above mentioned risks. This risk mitigation role would help leverage private finance needed for investments. Over time, as the political and regulatory situation in the country becomes more certain, the national currency strengthens and local developers becomes more experienced, some of these risks should be reduced or eliminated. The PPEP fund would have served as a "bridge" between the current business and political conditions and a more favorable situation later on. In fact, joint ownership under a PPEP fund must be seen as a temporary solution that can be used to overcome current constraints quickly. In the long run, the government should look to spin off its stake in the projects. It is vital for the government to look for ways to address the legal, regulatory, and institutional problems that initially prevented the investments from being launched by the private sector alone.

There are several equity structures that could be used in such PPEP funds. One possibility is that the equity provided both by the government and private sector limited partners are pari-passu of equal status. A second possibility (for example, for riskier projects with greater social content) is to subordinate the government equity funds. This means that repayment of the equity to the government is of lower priority compared to repayment of equity to other investors. This second scheme increases the risk-adjusted returns of private equity investors and gives them greater incentives to participate in the fund. A variation of the subordinated equity fund is a fund in which the state applies the so-called waterfall principle. The waterfall principle means that the state either protects investors from losses by way of taking greater than proportionate share of losses to reduce those of the private sector ("dampening downside") or grants investors with additional profits by way of taking smaller than proportionate profits to increase return of the private sector ("leveraging upside"). The exact equity arrangements for the fund would need to be agreed upon depending on the likelihood of attracting sufficient financing.

In terms of leverage, under the PPEP mechanism, government participation in its various forms sends a signal to private equity firms to invest in Ukraine, thus overcoming the current market failures and uncertainties. Some distinctive features of private equity make it one of the most suitable options to finance risky, innovative and both small and large investments. In short, private equity funds can provide both international expertise and capital which otherwise may not be available.

Overall, the PPEP mechanism utilizes all the advantages of the private equity funds but within the PPP framework benefiting both public and private sectors. The state ensures inflow of investments in particular sectors of its economy investing limited amounts of resources which can be significantly lower than investments of the private sector. At the same time, private sector obtains protection from major investment risks.

Today there are good examples of the use of PPEPs in developed and emerging economies. In fact, the United Kingdom in December 2012 launched a new approach to its PPP projects under which the government will act as a minority co-investor in future PPP projects, promoting more private sector investments with a better partnerships with industry, a stronger public voice on projects and greater transparency. A UK review of previous PPP projects concluded that the provision of government equity financing along with private equity financing would address many of the weaknesses of funds with only private equity. In each case the UK government will invest alongside the private sector into a 'joint venture company'. Each company will be majority owned by the private sector and the government will invest on the same terms as the private sector.

Other cases where the government and the private sector have joined their equity funds to finance projects of national importance are discussed in Annex I and listed below:

1. The Texas Emergency Technology Fund
2. The New Zealand Venture Investment Fund
3. The Morrison & Co. Public Infrastructure Partnership Fund
4. The UK Lloyds Banking Group Infrastructure Fund
5. The European Investment Fund
6. The Marguerite Fund
7. The Joint Ownership Company for E-Payments in Egypt.
8. Global Energy Efficiency and Renewable Energy Fund (GEEREF)
9. Israel's Yozma Venture Capital Fund.

Annex I. Examples of PPEPs

1. The Texas Emergency Technology Fund

The Texas Emerging Technology Fund (ETF) was created in 2005 by the State of Texas to provide the State with an unparalleled advantage in the research, development, and commercialization of emerging technologies. The initial government investment amounted to US$200 million and was expanded later on to $500 million. The program has given a total of about $200 million to 140 companies as well as $160 million to educational institutions. The fund estimates that portfolio companies and awardees have risen close to $1.0 billion in follow-on investment and private funding following ETF investment.

The fund focuses on three main investment areas:

- *Commercialization Investments*: early-stage technology investment funds designed to assist companies in transforming ideas, concepts, and prototypes into commercial viable products. Approximately half of the commercialization investments have been made within the biotechnology and life sciences industry.
- *Research Matching Awards*: funds create public-private partnerships which leverage the unique strengths of universities, federal government grant programs, and industry.
- *Research Superiority Awards*: funds for Texas higher education institutions to recruit the best research talent in the world.

The ETF established seven **Regional Centers of Innovation and Commercialization** (RCICs) to foster technology commercialization throughout the entire state of Texas and act as an efficient deal sourcing mechanism. The RCICs act as the regional agent to identify, evaluate, and submit promising proposals from their respective regions to the ETF Advisory Committee, which makes the final decisions on awards. The Advisory Committee is composed of individuals who are industry leaders in Texas and or who are nationally recognized researchers from public or private institutions of higher education in Texas. The Advisory Committee and RCICs work closely with applicants in assisting with proposal development, post-proposal debriefings, and commercialization activities. In addition, RCICs are a strong focal point to increasing cooperation and spurring collaboration between industrial, financial, and academic entities.

The ETF is housed within the Economic Development and Tourism division of the Texas State Government. But all investment decisions are made by the representative of the private sector in the fund's Advisory Committee.

2. New Zealand Venture Investment Fund

The New Zealand Venture Investment Fund (NZVIF) was established by the New Zealand government in 2002 to accelerate the development of the Venture Capital industry and increase the commercialization of research. The government felt that information asymmetries and lack of skilled people had led to underdevelopment of the VC industry. NZVIF has invested $80 million NZD matched by $400 million NZD from the private sector. Since NZVIF was established six venture funds have been created. Before this there were no funds exclusively operating as VC funds.

NZVIF is a "fund of funds" owned by the government and invests into private sector venture capital funds and partners with angel investor groups to drive investment into young New Zealand companies with high-growth potential. Therefore it makes direct co-investments with the private sector. Its major goal is to help build a vibrant venture capital market in New Zealand. The major field of interest of NZVIF is the high tech sector (more than 75% of made investments). The Fund consists of two independent facilities (Venture Capital Fund of Funds and Seed Co-investment Fund) and is governed by a private sector board of directors.

All NZVIF government investments are made either through privately managed venture capital funds, or alongside experienced angel investors who are investing into New Zealand-originated, high-growth potential companies. NZVIF conducts extensive due diligence on all prospective fund managers and co-investment partners before making an investment commitment. It only invests with those fund managers and co-investors which it has assessed as having the strong potential for investment success. Furthermore, NZVIF only invests in private funds which have been successful in raising matching capital from private investors. The amount that NZVIF invests in a fund is dependent on the overall fund size as well as the investment stage and focus of the fund.

As of now the NZVIF has USD 200 million available for investments. The Venture Capital Fund of Funds has USD 160 million and the rest is under management of the Seed Co-Investment Fund. In its operation the NZVIF usually partners with some institutional and individual investments to make a joint investment into a venture capital fund. Then, the venture capital fund manager assesses the investment opportunities and makes equity investments into high growth companies. The Fund also makes angel investments into young companies. In this case NZVIF acts like a passive investor – it invests alongside accredited angel funds or angel networks and only after those funds or networks makes the decision to invest. In 2010/11, the NZVIF made USD 157 million of total capital commitments of different projects and attracted USD 293 million from private sector.

3. The Morrison & CO Public Infrastructure Partnership (PIP) Fund

In 2009, Morrison & Co launched the New Zealand Public Infrastructure Partnership Fund (PIP Fund). The Fund was established to contribute to the development of social infrastructure, namely educational, healthcare, student accommodations, and penitentiary facilities. The core seed capital was provided by the government-owned New Zealand Superannuation Fund (i.e, Government Pension Fund). The New Zealand Superannuation Fund is the sovereign wealth fund which was created to provide the universal pensions to people above 65 years of age. The New Zealand Government had contributed US$ 15 billion to the pension fund as of the end of 2012. The government seed capital into the PIP fund was able to attract large investments from institutional investors from New Zealand and Australia. In order to allow private investors to participate in the Public Infrastructure Partnership (PIP) Fund, a new private sector fund was created in 2010: the New Zealand Social Infrastructure Fund.

The contribution of the New Zealand Superannuation Fund in the PIP Fund was equal to NZD 100 million. The New Zealand Social Infrastructure Fund contributed NZD 125 million. The total initial investment limit was equal to NZD 500 million in July 2009. At the same time, the total investment capacity of the Fund was set at NZD 1-1.5 billion. In August 2010, the PIP Fund entered a joint venture agreement with Plenary Group through which it is investing in the Melbourne Convention & Exhibition

Centre Public-Private Partnership. In May 2013, the PIP Fund started an investment project aimed at the development of 120 residential apartments required by key health workers at the Bendigo Hospital (Victoria, Australia).

4. Lloyds Banking Group Infrastructure Funds in the UK

Lloyds Banking Group established two infrastructure funds in 2012. Both funds invest in energy projects, social infrastructure, and transport sector projects, with around 50% of their funds allocated to energy and 50% to social and transport infrastructure. Within the energy sector the funds provide financial resources to traditional and renewable energy projects. As for social infrastructure, the funds are interested in the waste management projects, education and health.

The first fund is called Lloyds Bank European Infrastructure Partners LP (LBEIP LP) and was established in February 2012. The second fund is called Lloyds Bank UK Infrastructure Partners LP (LBUKIP LP) and was established in September 2012. The bulk of the funding came to the funds from institutional investors, including the UK corporate pension plans. The state is present in the funding through Lloyds Bank itself, approximately 43% of shares of which are in ownership of UK government. Furthermore, the European Investment Bank, which is the bank owned by European Union Member States, committed EUR 25 million to LBUKIP LP. The time horizon of the funds is 25 years.

As of September 13, 2012, the two funds raised approximately GBP 750 million, GBP 150 million of which were raised by LBUKIP LP. Both funds invest into primary/greenfield social and economic infrastructure projects but with different geographic coverage. The LBEIP LP was expected to invest in infrastructure projects in Europe but in reality around GBP 350 million of GBP 500 million raised are being invested in the UK. At the same time, the LBUKIP LP is designed to invest solely in UK infrastructure projects. The LBEIP LP invested EUR 63 million into public buildings and transport in Spain and France over the last 18 months.

5. European Investment Fund

The European Investment Fund (EIF) was established in 1994 as a public private partnership in order to promote economic recovery in Europe. Its initial goal was to finance the Trans-European Network Infrastructure and guarantee operations in support of SMEs. Initially European Investment Bank and the European Commission were the two owners of the EIF. Later on, private companies were allowed to become shareholders. As of now around 20 private financial institutions from the European Union Member States and Turkey control approximately 8% of shares of the Fund. As of December 31st, 2013, the Fund had almost EUR 7 billion of private equity assets under management.

EIF evolved from a fund with a narrow specialization and with ECU 515 million of commitments for its first year of operations, to a broader multipurpose fund with EUR 3.4 billion in overall commitments for the year 2013, for a total of 163 transactions, benefiting 140,000 SMEs across Europe. In the European private equity market, the Fund is a leading financial institution in Europe now. It plays a crucial role in the creation and development of high-growth and innovative SMEs by facilitating access to equity for these companies across the entire life cycle of corporate innovation. EIF invests in venture or growth capital projects from the very earliest stages of intellectual property development into technology transfer, to more mature phases of development. Having a strong track record and good reputation in the industry, the Fund takes significant minority stakes in funds which provide a catalytic effect on commitments from a wide range of investors, particularly in the private sector.

6. The Marguerite Fund

The Marguerite Fund (or The 2020 European Fund for Energy, Climate Change and Infrastructure) was established by six major European financial institutions to make capital intensive infrastructure investments. One of the mentioned six institutions is European Investment Bank which is the only bank owned by and representing the interests of the European Union Member States. Other core sponsors are: Caisse des dépôts et consignations (France), Cassa Depositi e Prestiti (Italy), Instituto de Crédito Oficial (Spain), KfW (Germany), and PKO Bank Polski SA (Poland). All these banks are in state ownership. Each of the six core sponsor has committed EUR 100 million to the Fund. In addition, three further investors (including the European Commission) have committed an incremental EUR 110 million to the Fund, bringing current commitments to EUR 710 million.

The Fund is a pan-European equity fund that acts as a catalyst for key investments in renewables, energy, and transport. It is the first fund of its kind. Marguerite is managed by and independent management team. The available financial resources are more or less equally distributed across three core sectors with selective targeting of opportunities in both Western Europe and the CEE region. As of now, the Fund has several ongoing projects in the energy sector in Poland, Germany, and Romania. Polish projects are realized within the PPP framework. In particular, Poznań Energy-from-Waste Project foresee financing, design, construction, and operation of a municipal waste incineration plant with a capacity of 210000 tons per year. Total cost of the project is estimated around EUR 175 million.

7. Joint Ownership for E-Payments in Egypt.

In 2007, the Egyptian government formed a joint venture with private sector companies to set up an e-payment system that would automate government payments, including pension disbursements and the salaries of its workers. The Egyptian government took a 60 percent stake in the new company through three public banks; the two private partners had a combined 40 percent stake. The investors in the company all served on the board of directors and had voting rights that reflected the capital they had committed. The president of the company and two outside experts also became members of the board, providing input even though they did not have voting rights. Six permanent committees worked with the board, providing advice in the areas of governance and nomination, strategic planning, performance monitoring, auditing, public relations, and service delivery.

Egypt gave concession rights to the newly formed company—specifically, the right to be the sole entity allowed to operate an electronic payments platform for the Ministry of Finance. The Egyptian government was also able to ensure the buy-in of the banks, pension fund managers, and others that needed to be part of the system. The private partners, meanwhile, provided know-how in the areas of software development, banking, automation, and e-services; and designed, installed, managed, and maintained the e-payment system. The private partners also contributed 40 percent of the required capital.

Three risks endemic to this kind of partnership—that of the new company being a monopoly, of the government having conflicts of interest, and of demand falling short of expectations—all had to be addressed. Egypt addressed the monopoly risk by setting pricing in advance and by including service-level agreements that penalized the jointly owned company if it failed to deliver specified levels of customer satisfaction, processing time, operating hours, and network robustness. It addressed the risk of conflict of interest by separating its investment interests from its monitoring efforts. And it mitigated demand risk—the private sector's concern that the 10-year revenue forecast might prove overly optimistic—by agreeing to minimum yearly payments and by allowing for flexibility in pricing in response to inflation and the level of financial return targeted by the private sector.

8. Global Energy Efficiency and Renewable Energy Fund (GEEREF)

The EC, Germany, Denmark, and Norway established this fund in 2009. GEEREF aimed to cut greenhouse gas emissions, increase access to energy services, and support financial sustainability.

These governments felt that the externality caused by greenhouse gas emissions and financial market imperfections lead to too little private investment into this area. The fund was expected to catalyze private and public capital.

The target funding size for GEEREF was €200-250 million, of which €108 million was secured initially. The funds is totally invested.

9. Israel's Yozma Venture Capital Ltd.

Yozma is a fund fully owned by the Israeli government to support the growth and development of new technology companies in Israel. The rationale for the fund was that financial markets has failed to provide capital to new technology companies, due to uncertainties.

The initial investment was $100 million. New Yozma funds are still on-going.

The Yozma group has contributed to the development of a $10 billion Venture Capital industry in Israel (the largest in the world as a ratio of GDP).