FMO EVALUATION REPORT 2010 /2011

Development in times of crisis

NOTE TO THE READER:

FMO's 2010/11 Annual Evaluation Review, the ninth of its kind, is a concise presentation of the findings from project evaluations carried out by FMO's internal Evaluation Unit in the course of 2010. Any opinions and conclusions contained in this report are those of FMO's Evaluation Unit, and are based on evaluation findings. They do not necessarily coincide with the views of FMO's Management Board. Management's position on the Review's findings and conclusions is expressed in the Management Response, which is reproduced on page 16.

Interested readers may obtain further background information and documentation from FMO's Evaluation Unit: evaluation@fmo.nl

TABLE OF CONTENTS

HIGHLIGHTS

- Development outcome remains strongly correlated to FMO's investment outcome; among FMO-A investments no less than 84% had either a win-win (positive development and investment outcome) or a lose-lose outcome. Once again, this proves that realizing sustainable impact goes hand in hand with good returns.

- The global economic crisis did have a visible effect on the business of several FMO projects evaluated in 2010. However, the actual effects on project success have been moderate, considering the 67% development outcome and 81% investment outcome success rate.

- Past evaluation results have shown that FMO-A manages to realize higher success rates in its focus sectors, being financial institutions and infrastructure, than in other sectors. Although the gap is becoming smaller each year, the difference in outcomes is still evident. The latest three year moving average development outcome success rate (covering the period 2008-2010), was 78% for focus sector investments, compared to 65% for non-focus. For investment outcome, the difference is there as well, although to a lesser extent (94% vs 83%).

- The Massif projects, focusing on MSME financial intermediaries in developing countries, are by far the best performing projects in terms of development outcome amongst government funds.
  The success rate of 76% for Massif projects evaluated in the past three years, is in line with the success rate for FMO-A investments in financial institutions.

- Based on the findings of a consumer finance policy research, FMO has adopted a more cautious and restrained approach to consumer finance. With regard to lending aimed at more vulnerable low income groups, FMO will in principle no longer support retail store credit and general purpose consumer lending. FMO will continue to support institutions that are primarily engaged in credit card lending (supporting such institutions' other business lines) and in specific purpose (motorcycle) finance. Such institutions compliance with responsible lending practices will be checked and assured.

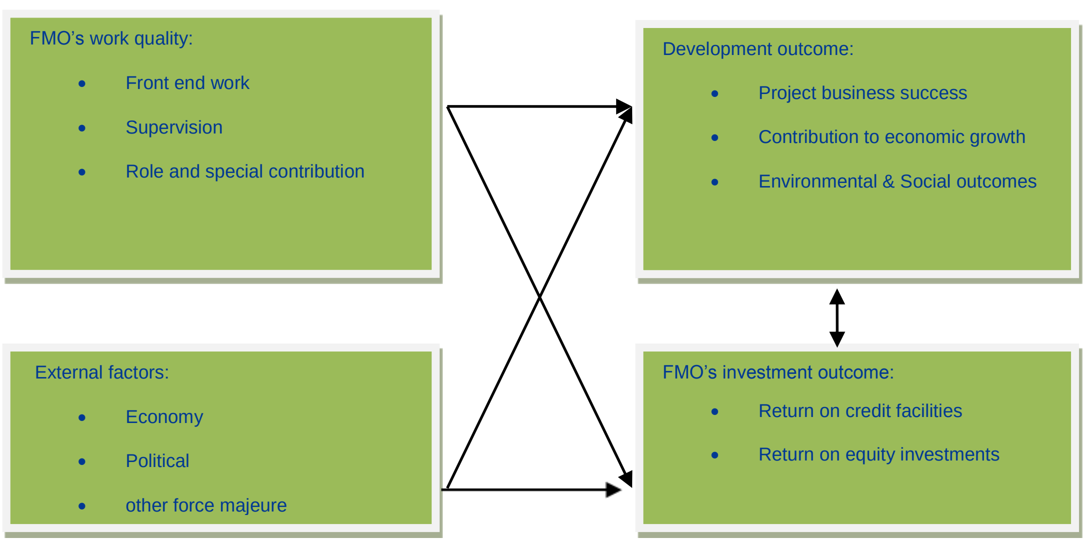
- Starting in 2011, FMO will change to a sector-based annual evaluation program. We expect to be able to realize major gains in relevance and (internal) learning, as specific policy questions within sectors may be researched and more purposeful sampling and on-site evaluations become possible. As the sector-based evaluation approach is considered less suited for accountability purposes, the approach will be supplemented by an evaluation tool that specifically serves portfolio-wide accountability.

INTRODUCTION

Being a development finance institution, creating development impact in emerging markets is part of FMO's mission. When selecting new investments, FMO uses the Economic Development Impact Score (EDIS) to determine the expected economic impact per euro invested. Furthermore, environmental and social (E&S) policy is critically examined and possible areas for improvement are identified and included as a condition in the contract. It is of major importance, not only to assess these issues ex-ante, but also to establish ex-post whether impact and improvement has actually been realized. For this purpose, FMO uses an evaluation program executed by its own Evaluation Unit, which operates independently from FMO's front-office.

The individual project evaluations, which take place five years after commitment, can provide valuable lessons learned. These lessons learned are stored in a central database and actively used to improve new deals. In addition, all project evaluations taken together reveal patterns and trends that provide data for accountability and strategic choices. They generate insight into what works and what is less effective towards achieving FMO's goals.

FMO evaluates its investments in line with the Multilateral Development Banks Good Practice Standards for Private Sector Investment Operations. As illustrated below, FMO's project evaluations assess (1) development outcome, (2) FMO's investment outcome, (3) FMO's work quality.



For establishing **development outcome**, three indicators are used; the business success measures the financial impact on the projects' shareholders and lenders. A financially sustainable project will more likely create long term effects for its stakeholders. These stakeholder effects are captured by the indicator 'Contribution to economic growth'; the more stakeholders (i.e. employees, suppliers, government) profit from the project, the higher the rating. Finally, environmental and social policy is viewed, to see whether compliance with (inter)national law has been achieved. An overall rating for development outcome is given, based on the separate scores for the three indicators.

The **investment outcome** indicates whether FMO has been able to realize the projected returns on the loan and equity products provided.

FMO's work quality is also part of the evaluation. The overall score for work quality is based on three separate items: (1) ex-ante front-end work (screening, appraisal and structuring), (2) monitoring and supervision of the project and (3) the role of FMO in terms of additionality and catalyzing other investors.

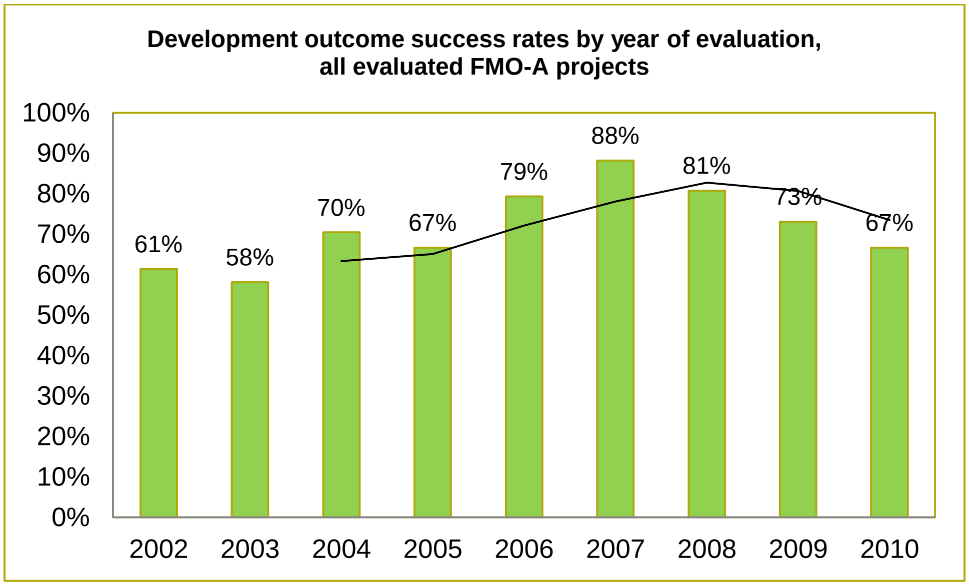
This report describes the evaluation outcome of projects committed in 2005. In that year a total amount of EUR 699 million (involving 93 projects) was committed, a record amount for FMO at the time. A representative sample[1] of 28 projects was taken to be evaluated. The relatively low number of projects in the sample and their strong diversity in terms of sector and country, makes it difficult to perform in-depth analyses. However, it does allow for more general conclusions on the overall development of outcomes of FMO's projects over the past few years.

[1] For efficiency purposes, FOM investments were excluded from the sample. FOM was chosen due to the fact that an independent external evaluation was already planned for 2010.

1. EVALUATION RESULTS: OUTCOME TRENDS AND PATTERNS

FMO-A investments: development outcome

Nearly 75% of projects financed by FMO-A and evaluated over the past three years (see trend line in graph below) generated good (i.e. satisfactory or excellent) development outcome success rates. Although a good result, this implies that the downward trend in development outcome success rates, which started in 2008, is continued, leading to a 67% development outcome success rate in 2010. The economic climate has been of influence on this development.



The global economic crisis erupted at the end of 2008. As reported last year, this did not have a real effect on the project evaluation outcomes of 2009. Now, in 2010, we noticed that almost 2 out of 5 evaluated projects were more or less affected by the crisis due to for example lower sales and limited access to liquidity. Fortunately, in half of these cases, the development outcome was still positive. The companies concerned fared well through the economic crisis through proper management.

An example of how management saved the company during the crisis

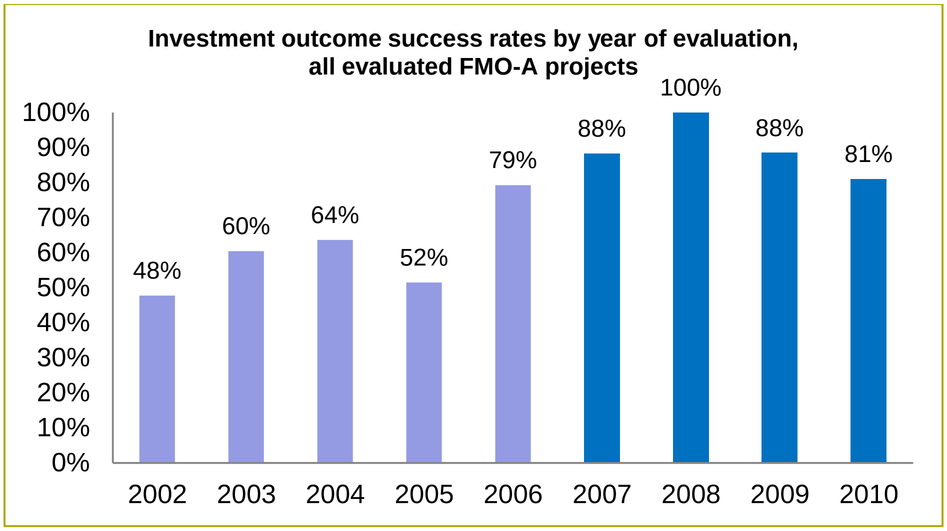
One of our clients, a Brazilian production company for the car industry, had to deal with a credit crunch due to the crisis. Fortunately, the CEO had learned from experience with an earlier credit crunch in 2000. Since then the company kept a considerable amount of cash available for times of low liquidity. Furthermore, it was able to profit from dropping steel prices and tax incentives provided by the government for buying cars.

And an example of how management failed

When FMO financed a fruit producer in Costa Rica, agreements were made to improve corporate governance. However, milestones were easily circumvented by the main shareholder without leading to a breach of contract. They got into trouble because of unauthorized capital expenses, which they were unable to finance due to the local liquidity crisis. They had to be saved by a financial injection from their main off-taker. The company is still financially weak. The development outcome was rated as poor as employment growth dropped far below what was expected. Contribution to economic growth was already likely to be low, due to the neutral impact on local consumers (all products are exported to the U.S.) and the fact that the company is located in a Free Trade Zone.

Investment outcome

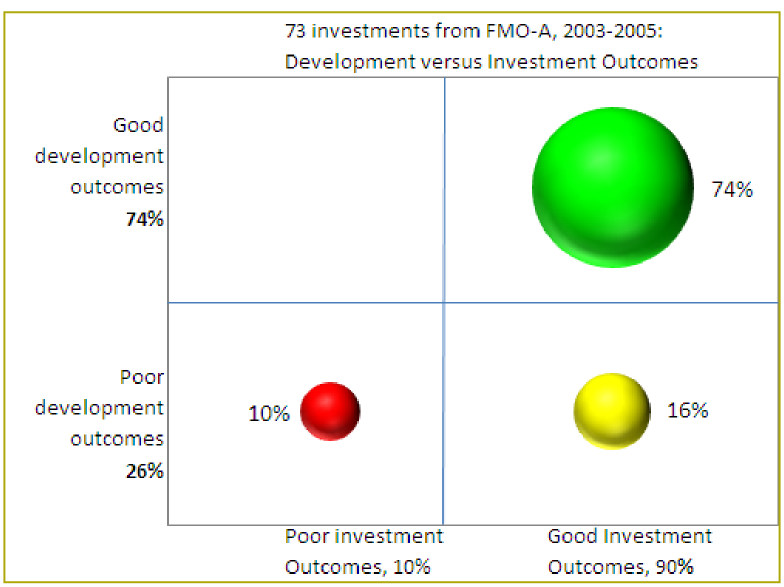
FMO's investment outcome success rate for this years' evaluated projects is 81%.



The difference between the 2010 development outcome (67%) and the investment outcome success rate (81%) is explained by the fact that most of the projects involved, only scored moderately unsuccessful in terms of development outcome; results were below expectations, but financially still sufficient to be able to serve the obligations towards financiers.

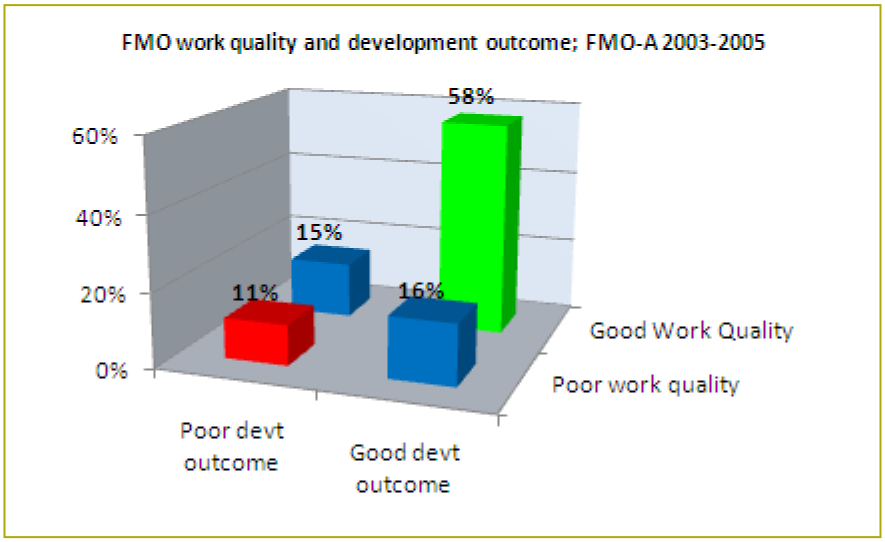
Interrelations and the influence of FMO's work quality

In line with earlier evaluation reports, development outcome remains strongly correlated with FMO's investment outcome; among FMO-A investments no less than 84% had either a win-win (positive development and investment outcome) or a lose-lose outcome. Once again, this proves that realizing development impact goes hand in hand with good returns.



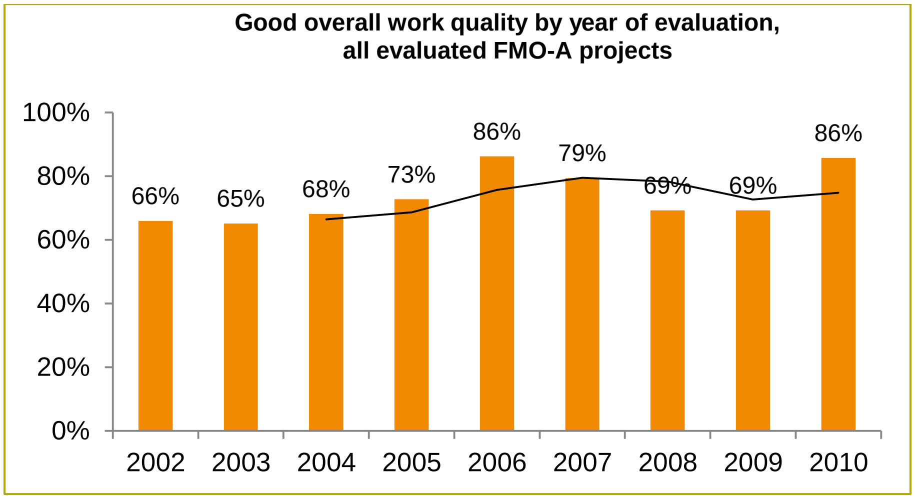
Work quality

Evaluation reports in the past have shown that the development and investment outcome of projects are strongly correlated to FMO's work quality. The graph below shows the link between work quality and development outcome of projects evaluated in the last three years.



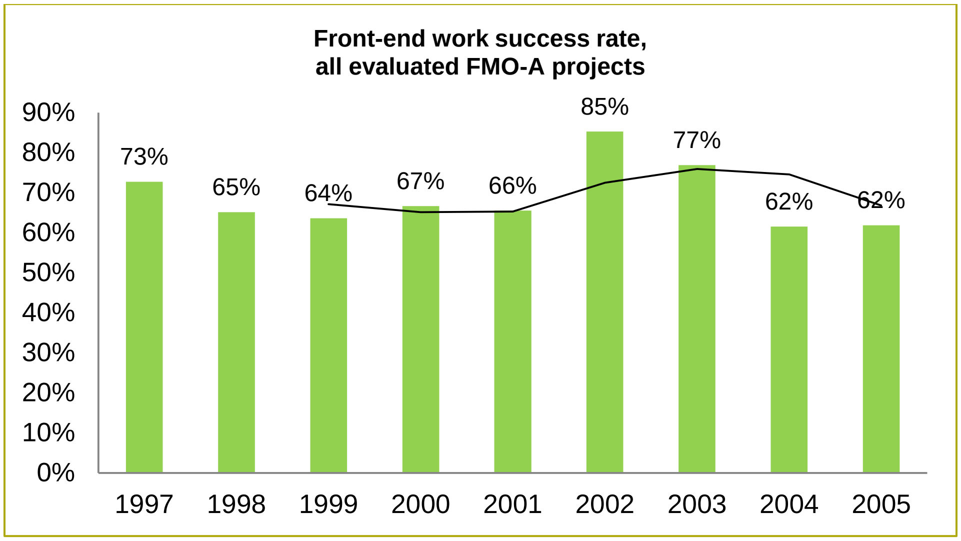
For projects where the work quality by FMO was deemed to be of a professionally sound level, only 1 out of 5 had a poor (i.e. partly unsatisfactory or unsatisfactory) development outcome. On the other hand, when work quality was poor, more than 1 out of 3 had a substandard development outcome.

Below is the development of FMO work quality over the years. With regard to work quality, the overall score is based on three separate items: (1) ex-ante front-end work (screening, appraisal and structuring), (2) monitoring and supervision of the project and (3) the role of FMO in terms of additionality and catalyzing other investors.



The 2010 results (reflecting projects contracted in 2005) are a significant improvement compared to 2008 and 2009. The high score for 2010 was mostly due to high success rate for monitoring and supervision (86%). This development can be partly attributed to the economic crisis as well; after the fall of Lehman Brothers in 2008, FMO was more cautious with new clients, while the monitoring on existing clients was strengthened considerably. Liquidity overviews were analyzed more thoroughly, and additional review rounds were planned to discuss the development of client and portfolio credit risk.

The development of ex-ante front-end work quality needs specific attention; work quality in this area has deteriorated from 85% three years ago, to 62% now (the same as last year).



The trend line of front-end work quality is quite similar to that of development outcome. An easy conclusion would be that the link between development outcome and work quality is a self fulfilling prophesy; once development outcome is poor, one is more likely to find flaws in the way a deal was structured. Although this effect is likely present, the 2010 evaluations do not support this theory; in the seven projects where development outcome was poor, in only two projects front-end work was judged to be poor.

Examples of poor front-end work from the 2010 evaluations, include inadequate mitigation of ESG risks for two production/processing companies. This can partly be attributed to low experience with ESG risk mitigation at the time. In the meantime, ESG development has become one of FMO's priorities, lowering the risk for repetition of poor work quality in this area.

Dominant market leader deems E&S issues unimportant

FMO was one of the financiers of a large production facility, to be constructed in Nigeria. From the start it was clear that E&S would be a major issue in this project. Therefore an extensive E&S action plan was developed. However, it soon became clear that in particular labor conditions continued to be poor in the company. This resulted at times in unrest and small riots among employees. In the end lack of progress on this front was one of the key drivers for FMO to end the relationship and ask for prepayment. Furthermore, impact on economic growth, although in some areas very positive (employment), was questionable; the resulting strong market position did not stimulate market development; the company could use its dominant position to push other competitors out and maintain high prices for the customer.

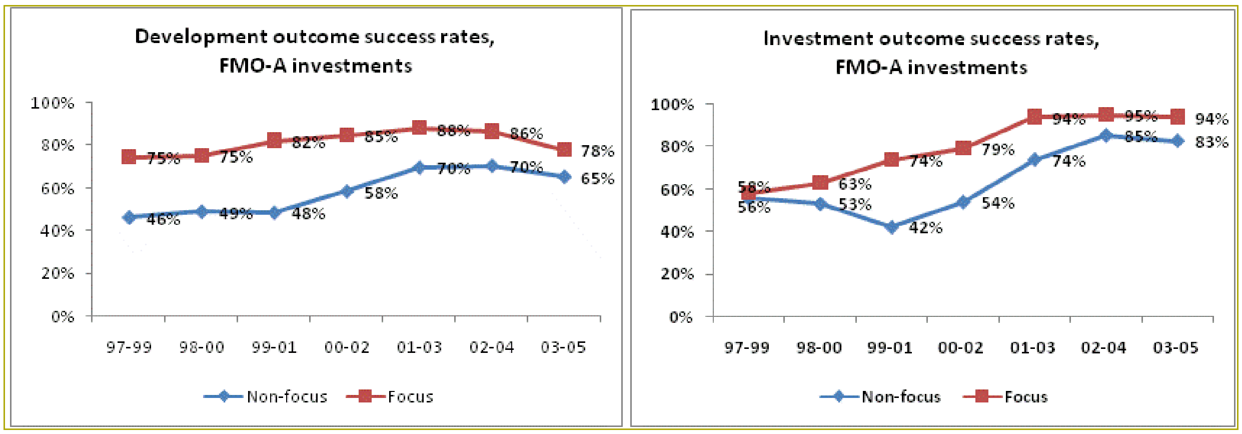
More concerning is that ex-ante front-end work quality for projects contracted in 2005 was also poor in the sector where FMO considers itself to be specialist, financial institutions; in 5 out of the 14 FI projects evaluated in 2010, front-end work was considered to be sub-standard. The flaws identified, included poor market-analysis and the use of a loan product while equity would have been more appropriate.

As was mentioned earlier, work quality is strongly related to development outcome. However, none of the FI projects with poor front-end work also had a poor development outcome. In most cases, the business case itself was strong enough, enabling FMO to 'get away' with lower standard work quality.

Focus on focus

Since 2000, FMO has expressed a focus on financial institutions and different types of infrastructure. Past evaluation results have shown that FMO manages to realize higher success rates in these focus sectors. This years results support this conclusion once more; the development outcome success rate was 78% for focus sector investments, compared to 65% for non-focus. For investment outcome, the difference is there as well, although it is smaller (94% vs 83%). The reason for the smaller difference in investment outcome, as earlier mentioned, is that most of the projects involved, scored moderately unsuccessful in terms of development outcome; results were below expectations, but financially still sufficient to be able to serve their obligations towards financiers.

In the graphs below the historic results[2] per evaluation period on outcomes per focus and non-focus sector, have been put together.



Although the gap is becoming smaller each year, the difference in outcomes between focus and non-focus sectors is still evident.

The evaluated non-focus sector investments mostly concern projects where FMO was in the lead and did not have a knowledgeable partner to compensate for possible limited expertise. In the new strategy 'Moving Frontiers', introduced in 2009, it has been FMO's conscious choice to become leading in its focus sectors and a follower of its partners in the other sectors. In these other sectors, we tend to lean on structuring and sector expertise of the selected partners. Ultimately, this approach should lead to more similar outcomes for focus and non-focus sectors.

2 Results reflected in the graph can deviate from earlier reports as slight deviations in interpretation of focus-sectors have been corrected for.

Policy research on consumer finance

In the context of expanding access to finance FMO had, in recent years, built up an exposure in consumer finance. Consumer finance refers essentially to salary based lending (and excludes mortgage based home finance and traditional microfinance). Investment proposals continued to lead to debates about fundamental questions of development relevance, (reputational) risk and the desirability of FMO's involvement. Last year, a study of the developmental relevance and impact of support to consumer finance institutions, was carried out.

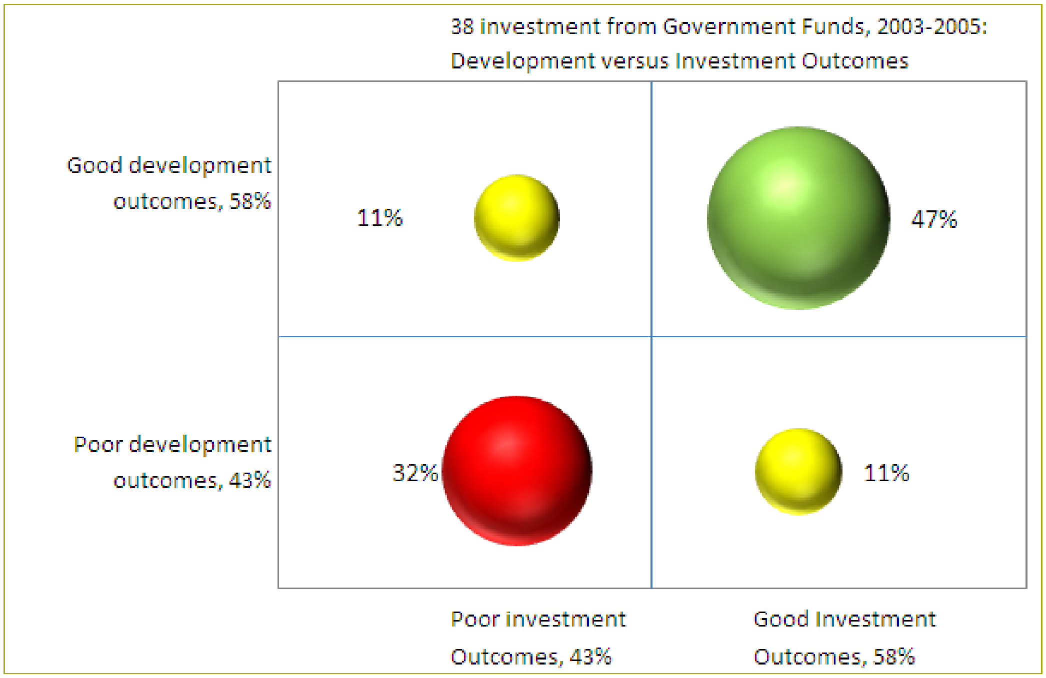
Our lines of research consisted of (1) a review of economic thinking and analysis with regard to consumer credit, (2) a review of existing empirical research on uses and effects of consumer finance, (3) fact finding missions to South Africa and Central America, (4) a review of FMO's consumer finance portfolio and (5) a survey of DFIs' and responsible investors' involvement in and position on consumer finance.

Based on the findings, we concluded that the developmental case for supporting consumer finance is weak, especially when compared to other forms of support to financial sector development. Potential benefits of access to credit can easily be overshadowed by negative effects such as over-indebtedness, especially for vulnerable low income groups. This depends, amongst others, on market conditions, on whether responsible lending practices are applied, on the presence of a social safety net, and on a consumer finance institution's business model and ethics. FMO's portfolio, moreover, illustrates that many forms of consumer lending are very sensitive to an economic downturn (when many people in low income and often less stable wage employment may lose their jobs or other sources of additional income, such as remittances). As consumer finance is often offered to clients without access to other financial services (such as savings, debit), financial literacy of borrowers is typically limited, as is the borrowers' track record. An (expensive) consumer loan, then, is not the most obvious introduction to financial services.

Increasing awareness in the industry of the risks associated with irresponsible lending practices has led to the formulation of Client Protection Principles or CPPs that can and should be used to screen lending practices of institutions lending to individuals. However, we want to emphasize that, while CPPs may help curb irresponsible lending and over-indebtedness, compliance does not yet imply a positive development impact.

Based on our findings and conclusions, FMO has meanwhile adopted a more cautious and restrained approach to consumer finance. FMO will continue to support institutions that are primarily engaged in credit card lending (supporting such institutions' other business lines) and in specific purpose (motorcycle) finance. Such institutions compliance with responsible lending practices will be checked (against the CPPs, and by carefully analyzing their business model) and assured. With regard to the two types of consumer lending that are aimed at more vulnerable low income groups, FMO will no longer support retail store credit, and support to general purpose consumer lending will only be provided in certain special cases, for example where an institution responsibly offers consumer loans to customers that are being provided with a full and empowering package of inclusive financial services.

Investments for government funds
On behalf of the government, FMO manages several funds. These funds focus on specific sectors or target groups and are generally meant to finance projects that are considered too risky to finance on FMO's own account. Due to the higher risk profile, success rates typically are lower than for FMO-A investments. This is also illustrated by the results for government funds over the last three years.



The effects on business due to the global economic crisis as noted for FMO-A projects evaluated in 2010, were hardly present for the sampled projects financed with government funds. The only project that had to deal with this, was a financial institution in Honduras, in which case development outcome was still positive.

Overall, development outcomes over the 2003 to 2005 evaluated period, are lower than last years' results (58% vs 67%), although results in the individual year 2005 were better than in 2003 and 2004 (63% vs 59% and 54% in 2003, 2004 respectively). Main reason for the lower outcome is the fact that 2002 is no longer part of the three year average. In that year a high number of SEF (former name of Massif) investments were made with historically high development outcome success rates.
FMO's investment outcome for government fund projects has improved from 52% to 58%.

Not only do government fund projects have lower success rates than FMO-A projects, the high risk profile also leads to more volatile results. This means that if a project is successful, it is more likely that it is highly successful and vice-versa, from both a development and an investment outcome perspective. FMO-A projects on the other hand, tend to be more concentrated in the moderately successful classes. In the last three years, 21% of all evaluated government fund projects scored 'highly successful' for development outcome, for FMO-A projects this was 12%.

The SEF/Massif projects are by far the best performing projects in terms of development outcome amongst government funds. With a success rate of 76%, the fund was in line with the success rate of FMO-A investments in financial institutions. The Massif fund extends risk capital and medium and long term debt in local or hard currency to financial intermediaries in developing countries. These institutions in turn, serve micro- and small-scale entrepreneurs and lower income consumers/households. Here, success in terms of program objectives is measured by the extent to which the financial intermediaries have successfully expanded their micro and small enterprise lending in a sustainable manner.

The limited number of Infrastructure Development Fund[3] (IDF) project evaluations (only one IDF project was evaluated in 2010), does not allow for generalization of results.

[3] formerly LDC Infrastructure Fund

2. NEW SET-UP EVALUATION PROGRAM

Introduction

We have, over the past eight years, evaluated (a stratified, representative sample of) all projects to which FMO committed itself five years before the year of evaluation. The current approach has allowed us to be accountable towards our stakeholders, provide FMO with essential input for formulating new strategies and a well filled lessons learned database.

The last few years we have noticed that the approach, while being strong on accountability, goes at some cost to learning, and to relevance to FMO's current sector-based organization structure. This is caused largely by the need for stratified representative sampling, which leads, among others, to the following:

- Few evaluations within certain focus sectors, limiting the potential for exploring policy relevant questions in-depth (e.g. renewable versus non-renewable energy, small enterprise funds versus other PEFs, nature of partnerships and investment and development outcome);
- Limited opportunity for, and little focus in, on-site evaluations. While useful for validating development outcomes on the ground, findings hardly provide a basis for generalization and tend to remain anecdotal.
- Finally, having used this evaluation approach for eight/nine years, through all phases of world-wide economic cycles, annual evaluation reports tend to keep revealing known patterns, and add limited knowledge that helps policy formulation.

Time for change

Based on the arguments presented above, we decided to change to a sector-based annual evaluation program. Each year, starting in 2011, we will focus on a different sector / department, thus covering the entire portfolio width over a period of, say, four years. Priorities will be set in consultation with MB. Both FMO-A financed projects and investments out of government funds will be covered.

We expect to be able to realize major gains in relevance and learning, as specific policy questions within sectors may be researched, more purposeful sampling and on-site evaluations become possible (making findings at project level less anecdotal and allowing for more meaningful recommendations), and the evaluation methodology may be more closely attuned to the nature of projects in particular sectors . Evaluations may, finally, more easily be placed within the context of developments at department portfolio level (e.g.: we would not just look at PEF investment outcome success rates, but also at PEF portfolio IRRs).

The approach will be supplemented by an evaluation tool that specifically serves portfolio-wide accountability. For 50% of the projects that would have come up for evaluation according to our current approach, a short evaluation annex to the annual project review has been developed. This annex is a relatively simple rating tool for development outcomes, investment outcome, and role FMO. Other work quality elements – which would require closer investigation – have been dropped, and formulating lessons learned is optional, with sector-based evaluations becoming the main source of high quality lessons.

This evaluation rating tool is like an ex-post scorecard (with room to substantiate scoring), and maximizes use of information already recorded through the client scorecard. Scoring has been made as objective / intersubjective as possible (proper guidance tools have been developed), and will – to ensure independent validation - be checked by evaluation unit staff.

The ex-post assessments/evaluations will continue to be in line with the MDBs' Good Practice Standards (GPS) for Private Sector Evaluation in terms of judging outcomes and FMO's role as a DFI, and thus for accounting for (development) results. We will deviate from the GPS in no longer evaluating work quality portfolio-wide, but make up for this in sector studies. We will remain a front-runner among the EDFI members in having an ex-post evaluation system that evaluates on basically all relevant dimensions.

In addition to accounting for results through ex-post assessments / evaluations, we are strengthening our accountability (and the basis for future project evaluations) by monitoring (and reporting on) quantitative impact and outreach indicators (QIs) for the whole portfolio. Here, again, we are fully aligned with other EDFI members (and ahead of most, who only do ex-ante assessments and no monitoring, and who assess and monitor fewer QIs).

Accountability for our results is further strengthened by the fact that every five years external evaluations are commissioned for FMO as a whole, as well as for each of the FMO-managed government funds. Such external evaluations should ideally include a check on the internal evaluation findings reported, and express an opinion on the quality of internal evaluations and of FMO's evaluation approach.

Overall, the new set-up remains strong on accountability, while it is expected to much improve the internal usefulness of the evaluation function by enabling purposeful research of policy choices faced by FMO.

Management response to the Annual Evaluation Review 2010/2011

We herewith present you with the report ”Development in times of crisis” – the Annual Evaluation Review 2010/2011 – from FMO's Evaluation Unit. The report presents the evaluation findings of the 2005 vintage of investments financed by FMO. The evaluation results of this year show for the first time that the economic crisis of the past few years has had a real impact on financial and developmental success rates. This is a logical effect that was to be expected given macro trends, while it is still encouraging to see that a large majority of projects is still developmentally successful (2 out of 3) and financially successful (4 out of 5). This result is in line with the ongoing strength of the quality of FMO's loan portfolio, showing a level of non-performing loans of 3% of the total loan portfolio. We do however want to emphasize that due to the relatively low number of evaluations in 2010, we should be careful with generalization of results.

In this light, we welcome the initiative of the Evaluation Unit to change the annual evaluation program to a sector based program in which one of FMO's key sectors or products will be object of an annual evaluation report. More evaluations of projects within one specific area should make the outcomes more purposeful. On top of that, the new set-up should give more room for addressing particular (sector specific) issues and assessing strategic choices made per sector. This will ultimately enable the Evaluation Unit to provide specific lessons learned to FMO's front office and input for FMO's overall strategy. For accountability purposes, the approach will be supplemented by an evaluation tool that serves portfolio wide accountability.

In addition to the “normal” evaluation program, the Evaluation Unit and the Credit Analysis Unit researched the developmental effectiveness and FMO's own experiences with consumer finance.
This research led to a more restrained approach vis-à-vis consumer finance and a stronger emphasis on ensuring responsible lending practices of such companies. This proved to be a valuable report that collected lessons learned from experience and helped to create more focus in our approach to this sector. Given the very limited body of existing research on this subject, the report created strong interest within the development finance community and will therefore be shared and discussed in a wider international audience.

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