Going for results in private sector development

FMO's 5th Annual Evaluation Review, 2006/2007
April 2007

FMO
Finance for *Development*

Evaluation Unit
Investment & Mission Review
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Note to the reader

FMO's 2006/07 Annual Evaluation Review is, like last year's report, a concise presentation of the findings from project evaluations carried out by FMO's internal Evaluation Unit in the course of 2006. Much of the detailed statistical data and analyses contained in earlier reports have been left out. We trust that this helps the reader to concentrate on the main findings. Interested readers may obtain background documentation, data and analysis (as listed at the end of this report) from FMO's Evaluation Unit (**evaluation@fmo.nl**).

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In a nutshell

- FMO and its clients have benefited from recent favorable economic conditions prevailing in many emerging markets. These have not only influenced FMO's investment results, but have also helped our clients to more often generate good development outcomes. A reversal is to be expected should economic fortunes in our markets change. Good outcomes have been further enhanced by improved FMO effectiveness. We have been professionalizing and focusing our activities. Both have clearly contributed to higher success rates.

- A study of 2001 project approvals confirms the merit of FMO's recent efforts to explicitly focus on development impact in the investment selection and approval process. Projects with a high expected development impact (as measured by our Economic Development Impact Score or EDIS) and an acceptable risk profile are indeed likely to produce good development outcomes.

- Clients have been particularly successful in those sectors that FMO identified as highly relevant to development in 2000. Specifically, financial institutions and infrastructure. FMO is currently defining region and sub-region market plans that build on these sectors and on FMO's corresponding experience and expertise. It is advised that FMO keeps building up its expertise and networks in those sectors where it is active, and where it wants to be so in future. One means is by making better use of its 'knowledge streets' and by establishing new ones if required.

- FMO's Dutch Government-supported funds are set up with specific objectives. These should be carefully monitored if FMO is to properly account for its stewardship. Among 2001 Small Enterprise Fund approvals we saw that the fund's objective was sometimes poorly monitored. Improved reporting and monitoring formats have meanwhile been adopted for the new MASSIF fund. It should be more generally recognized that MASSIF clients generally demand – and should get – more supervision and assistance than typical FMO-A clients.

- In 2006, we undertook our first evaluation field visits. These illustrated that results on the ground can be quite different from impressions obtained from desk research. This serves as a reminder that claimed development effects should always be substantiated by monitoring data. Nothing can be taken at face value. The visits also gave evaluation staff important insights regarding conditions on the ground, the challenges faced by our clients, and what can and cannot be reasonably expected from our investment staff.

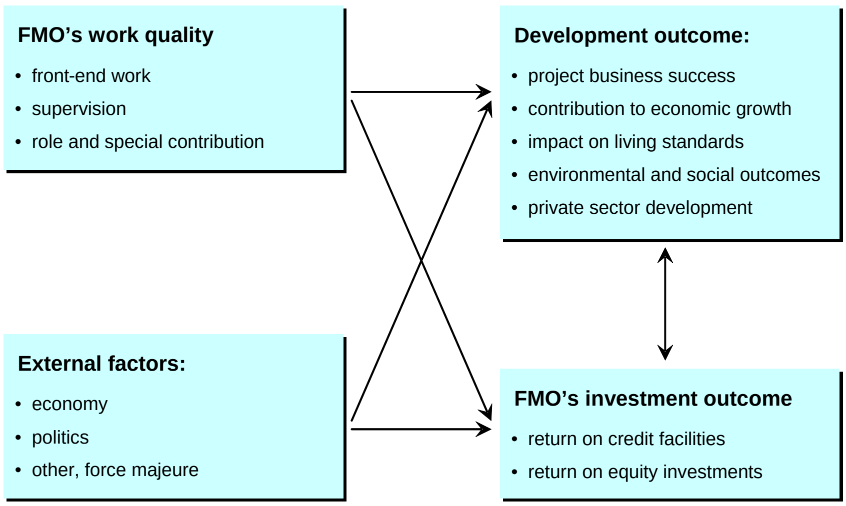
Introduction

Project evaluations are essential to FMO's being able to account for its development achievements. Targeting development outcomes has in recent years, taken on an increasingly central position in FMO's work. In the investment selection process, FMO now more explicitly assesses the development outcomes that may be expected from new investments. It does this by making use of a scorecard. An Economic Development Impact Score (EDIS) is calculated for each contemplated investment. The Development Impact Indicator (average EDIS times the volume of annual commitments) has been selected as the key target variable in FMO's medium to long term strategy.

To ensure accountability, these ex-ante assessments need to be supplemented by ex-post evaluations. To what extent are our – and our clients' - expectations translated into real results on the ground? Are our assessments a good predictor for actual outcomes? When expectations are not met, what are the reasons? And what can we do to ensure optimal outcomes?

We address these and similar questions through project evaluations. Individually, these evaluations furnish a wealth of lessons from experience. We feed these into a lessons database that is used in our investment process. This helps to ensure that we make use of what we have learned. In addition, all project evaluations taken together reveal patterns and trends that provide data for accountability. They generate insight into what works and what is less effective towards achieving FMO's goals.

FMO's evaluations follow – to the extent feasible for an institution of FMO's size - the methodology prescribed by the Good-Practice Standards for Evaluation of Private Sector Investment Operations (developed by the Multilateral Development Banks' Evaluation Cooperation Group – MDB-ECG). As illustrated below, FMO's project evaluations assess (1) projects' development outcome, (2) FMO's investment outcome and (3) the quality of FMO's work in relation to the project.



Having work quality, development outcome and investment outcome as separate evaluation dimensions allows us to investigate the extent to which various outcomes are interrelated. And we are in a position to determine the degree to which FMO itself can influence the outcomes of the activities in which it invests.

"***Going for results in private sector development***" describes the outcomes of project evaluations undertaken by FMO's internal Evaluation Unit in 2006. The 2006 evaluations looked at 2001 investment approvals. For the first time, investments from FMO-managed government funds were evaluated alongside those from FMO's own account (referred to as FMO A). In 2001, these were the Seed Capital Fund (SCF) and the Small Enterprise Fund (SEF). In 2006, the two were merged (together with the Balkan Fund) to form the MASSIF Fund. For analytical purposes, current outcomes are at times presented together with those of earlier years. By doing so, we are able to show trends or to illustrate outcome patterns for which a single year's project evaluations form too small a base.

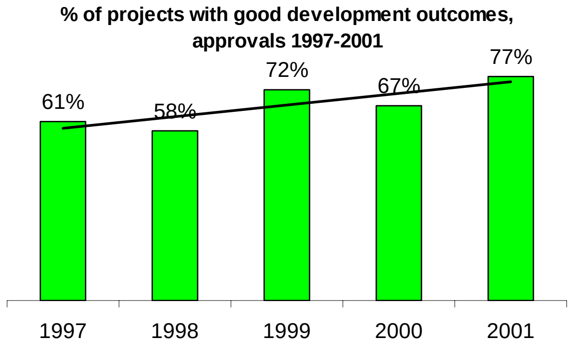
Implementing the focus strategy launched in 2000, FMO approved a record amount of investments in 2001. The approvals volume reached a level € 602 million for FMO A and another € 27 million for MASSIF. However, 20 of the 65 approved investments did not lead to evaluations. In some cases, this was because the approvals only related to a restructuring or a capital increase. The lion's share was attributable to approvals that did not result in signed investment agreements and subsequent disbursements. This high rate of attrition among 2001 approvals was due largely to investments being cancelled or postponed. Contributing factors included 9/11, the global recession that started in 2001, and the bursting of the IT- and telecom bubble.

The remaining 45 projects led to disbursements of € 309 mln for FMO A and of € 24 mln for MASSIF projects. Evaluation of four of these projects was postponed, as investments in an African infrastructure project and in three investment funds were still insufficiently mature to establish their outcomes with enough confidence. We thus evaluated only 41 projects, of which 30 were funded out of FMO A and 12 out of MASSIF[1].

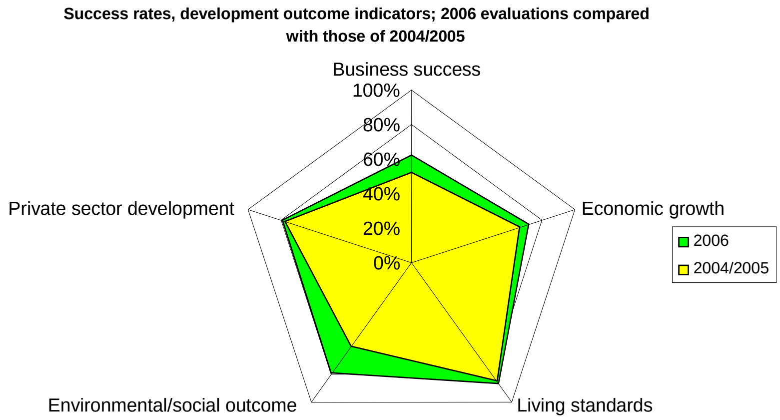
[1] One project was funded by both an FMO A equity investment and a local currency SEF loan.

I. Development outcome

Of the FMO A financed projects evaluated in the last three years[2], 72% were successful from a development point of view. Together, these accounted for 78% of the total disbursed investment volume. Of the evaluated projects, 64% (76% in terms of volume) contributed adequately to FMO's financial continuity. Last year's success rate is higher than ever reported before. In recent years, relatively more clients made good contributions to development.



The proportion of 2001 approvals scoring well on each of the development outcome indicators is illustrated below, relative to the same figure for the two previous years.



Clearly, the most recently evaluated projects more often show good environmental and social outcomes, having fully benefited from FMO's increased attention to sustainability since the turn of the millennium. At least as important is the fact that the proportion of clients considered successful from a business point of view has steadily increased. This is mainly thanks to an improved economic climate in FMO's markets. Among the1997/98 approvals, more than 60% were (partly) unsatisfactory from a business point of view. This was true for less than 40% of the 2001 projects. In terms of volume, as much as 75% of disbursements resulting from the 2001 approvals went to clients with a good business performance.

The recent trend towards more frequent business successes and better development outcomes is clearly related to the unprecedented levels of profitability that FMO has enjoyed in 2005 and 2006. FMO clients and FMO itself have benefited from the much improved economic climate since 2001. After the Argentine crisis, FMO clients have hardly been affected by serious crises in their countries. In previous evaluation reports, crises were often seen as a major cause of disappointing outcomes. On the other hand, as we shall demonstrate, improved outcomes can also be attributed to improvements in the effectiveness of FMO's work.

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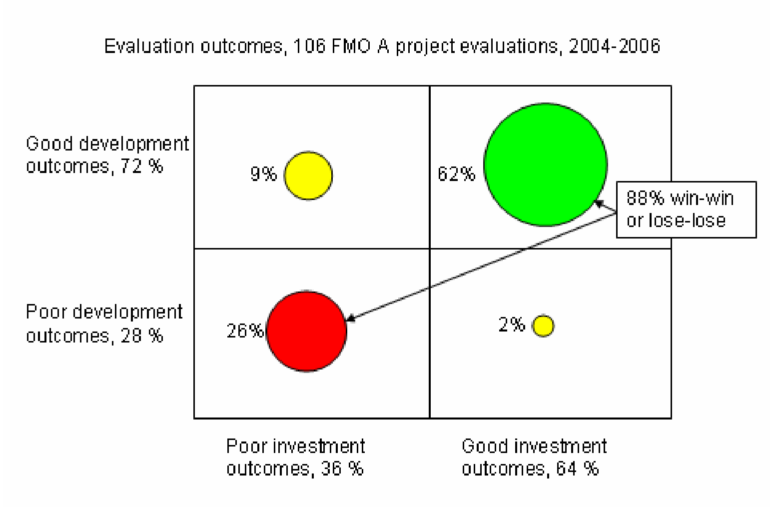
[2] In 2004-2006 we evaluated 106 FMO A financed projects approved in 1999-2001; we only started last year to also evaluate MASSIF financed projects (approved in 2001); including them in this type of analysis would distort trends and patterns.

Highlights

- **Development returns remain closely correlated with investment outcomes.** In 2006, only two projects that gave FMO a good investment return featured disappointing development results[3]. Conversely, five projects (including three MASSIF investments in Africa) with good development outcomes did not provide adequate returns on FMO's investment. Among FMO A financed projects, the vast majority (88%) across 2004 to 2006 had either a win-win (positive development and investment outcomes) or a lose-lose outcome. The spread of development outcomes relative to financial outcomes is as follows:



- **Riskier government fund investments typically give good development results.** For the first time this year, we have evaluated a limited number of investments from the pre-MASSIF funds: the Seed Capital Fund (SCF) and the Small Enterprise Fund (SEF). The numbers are small and, as such, our initial findings need to be treated with caution. We will be able to analyze these fund investments in more detail and with more confidence in coming years.

  The funds' combined success rate from a development point of view was 67%. The difference with FMO A is not statistically significant. The high success rate is remarkable when it is recognized that the government funds enable FMO to accept risks that it cannot prudently take on its own account. There is a higher chance of business (and developmental) failure with these projects. But if successful, they are typically expected to be highly relevant to development.

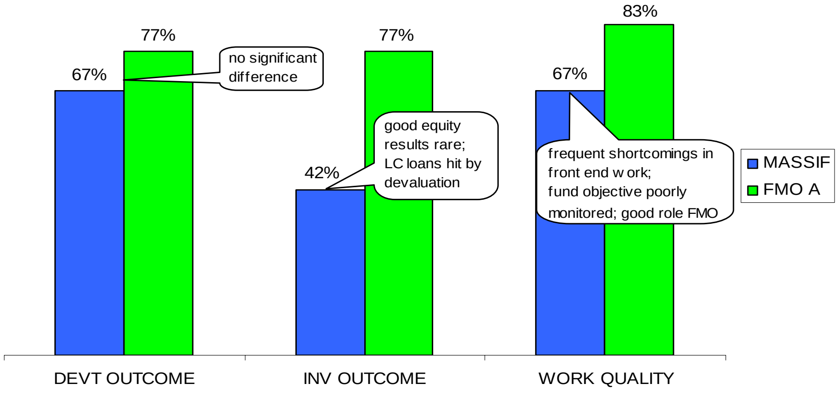
  The first four SCF clients evaluated generally showed poor development outcomes and poor contributions to the program's objective[4]. Of the eight SEF clients, however, seven were developmentally successful. This reflects a higher success rate than among FMO A clients, with three SEF clients even rated as 'highly successful'. The exception was an Asian small enterprise bank that collapsed as a result of poor governance. Most SEF investments strongly contributed to the program's objectives.

  We frequently found that utilization of the SEF loans was poorly monitored. In some cases, it was unclear as to whether financial institution clients always used the funds

[3] In one investment, the business success was unsatisfactory, but FMO's guarantee was not called, as our partner institution put the relationship over short term interests; in another investment, a privatized utility was able to service its debt, but did not generate the expected benefits to society.
[4] The Seed Capital Fund aimed to provide risk-bearing start-up capital to new, promising enterprises, mainly in Africa and primarily through intermediary financial institutions. Success in terms of the program objective was interpreted as the degree to which the investees have outgrown their start-up character and gained broader access to funding. The Small Enterprise Fund was to stimulate small enterprise development by providing – mainly local currency – finance through local financial intermediaries. Success in terms of program objectives is measured by the extent to which the financial intermediaries have been able to successfully expand their small enterprise lending in a sustainable manner.

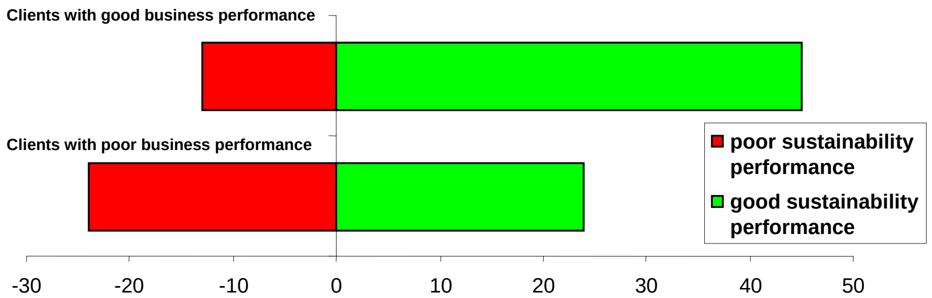
in compliance with the fund's criteria. This is cause for concern. Implementation of government funds and programs is entrusted to FMO. We are rightfully expected to account for development results relative to the very specific fund objectives. Better monitoring has been put in place in recent years, especially since the establishment of the new MASSIF fund. We expect this to lead to better monitoring and compliance scores in future years.

Success rates: FMO A versus MASSIF; approvals 2001



- **Environmental and social performance is linked to business performance.** In last year's report, we noted that most clients with good business performance also do well in terms of sustainability outcomes. Clients whose business performance is poor often have weak social and environmental management systems. They are unlikely to give sustainability a high priority. Profitability enables our clients to pay more attention to environmental and social matters. While we would only be able to establish causality from longitudinal studies, the outcome pattern indicates that paying attention to sustainability certainly does not harm profitability. And it is likely to be good for business, especially in the longer run.

Environmental and social performance, projects with good and with poor business performance, evaluations 2004-2006



As clients' business success is also the main determinant of FMO's investment returns, it may be said that FMO's financial success benefits when we select clients who perform well or are willing to improve their performance in terms of environmental and social sustainability. Clients that can give FMO a good return can, and typically do, look after their environmental and social performance.

Poor sustainability outcomes were frequently noted in agriculture and agro-processing. To a lesser extent, but somewhat surprisingly, this was the case among client banks as well. In the approval years under evaluation, client banks' environmental and social policies and management systems received less attention than they do nowadays. FMO had limited means to help clients improve their performance. Efforts to that effect have been recently intensified through the Netherlands Government funded Financial Institutions Program (FIP). FIP makes it possible for FMO to actively assist clients in improving their social and environmental management systems.

The added value of on-site evaluations

FMO's ex-post evaluation system is based on self-evaluations. Draft project evaluations are submitted by those responsible for monitoring and supervision of the client. Evaluation unit staff then ensures consistency and objectivity, mainly by doing desk research on the available project information in FMO's files and information systems.

In 2006 we were able to begin following up on one of the 2004 external evaluation recommendations. It suggested that regular on-site research could improve internal verification of actually realized development outcomes.

We visited three Seed Capital Fund clients in East Africa (Kenya, Uganda and Tanzania), to validate the development outcome picture emerging from self evaluation and desk research and to test the evaluation methodology introduced in 2006 for the evaluation of government fund financed projects.

We found, among other things, that the three banks visited did indeed, as indicated by self evaluations and annual project reviews, contribute positively to economic growth and development in their respective countries. However, the added value of these small banks to their countries' financial sector – especially in terms of creating access to finance for small enterprise – was quite limited. The credit reviews had suggested otherwise. Until recently, the banks had mainly been providing the same services to the same type of corporate clients as is done by the countries' larger banks, but then from a weak competitive position. Their contributions to development would remain marginal unless they could better distinguish themselves from their larger competitors. A real niche focus on small enterprise has only recently emerged, partly stimulated by the NFX program for East Africa.

For FMO's evaluation approach, this is an important reminder that claimed development effects should always be substantiated by monitoring data that are pertinent to the investment's stated objectives. They should not be taken at face value.

We also observed that proper management of small seed capital investments in young and small financial institutions is very supervision intensive. These clients – rightfully – expect an active role from FMO beyond the investment itself, through guidance at board level, by means of technical assistance or in the form of access to further funding. FMO should make proper allowance for this when entering into such investments. It must remain responsive to clients' needs for the duration of its involvement.

Our first on-site evaluation visits proved valuable, not only in terms of validating the outcomes of self evaluations and desk research, but also because it gave evaluation staff important insights in conditions on the ground. In particular, on the challenges facing our clients and the limitations to what may be expected from FMO staff.

On the ground – sometimes it works

Successful pioneering of microfinance in Georgia

In 1999, FMO was one of the co-founders of a new micro- and small enterprise bank in Georgia. The bank's objective was to provide small businesses with better access to finance. At the time, Georgia's financial sector was highly underdeveloped. After a couple of years, the bank needed additional funding to support its growth. FMO provided a loan and an equity investment from the Small Enterprise Fund. An internationally successful micro- and small enterprise finance group became a major shareholder in 2003 and fully integrated the bank into the group. The bank has been very successful in its strategy to target micro and small enterprises. With a 14% market share, it has become the fourth largest Georgian bank. It operates 32 branch offices and employs more than 1100 staff. The bank has played a pioneering role in the local financial sector role by showing that small enterprise financing can be profitable.

On the ground – sometimes it doesn't work

Failed assistance to a manufacturer in a post-crisis situation

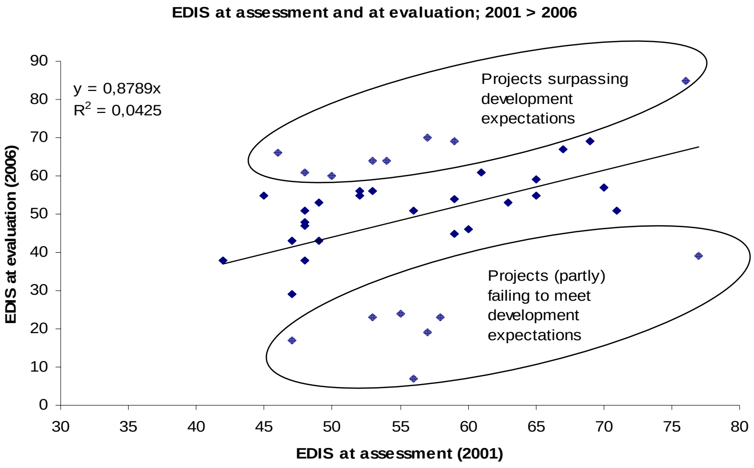
When a major South East Asian cotton spinner was (in the aftermath of an economic crisis) confronted with debt service obligations that were too large to handle, FMO and a multilateral development bank were prepared to help. The company had a positive track record and a strong, mainly export orientated market position. The challenge was to turn the company's financial management around. FMO decided to help refinance the company's debt, so that it could be reasonably serviced from its operational cash flows over a longer period of time. This way, a seemingly healthy company that employs approximately 5.000 workers could be preserved. Due to imprudent management, however, the company's margins once again came under pressure and results turned sour.

It started missing payments and despite several attempts to restructure the loan, it has still not been repaid. FMO had to fully provision its loan. The goal of preserving a profitable company operating under difficult circumstances was not reached. Neither jobs nor workers' incomes have increased. They have at best been temporarily saved.

Spotlight on – targeting development (EDIS/DII) improves results

FMO has recently set out to more explicitly target development impact in its investment selection process. Additional research on projects evaluated last year shows that the indicator used for this purpose – the Economic Development Impact Score or EDIS – does have predictive value. Projects with a high expected development impact do produce better outcomes than projects for which limited outcomes are expected.

In 2006, FMO introduced quantitative targets for its development impact, using the Development Impact Indicator or DII. This is the product of the volume of annual commitments and their concomitant expected contribution to economic development, as measured by the investment's EDIS. The EDIS was validated for the first time for all 2005 approvals. Given this, we would in principle only be able to compare these development impact expectations with the actual outcomes from the 2010 project evaluations.
As we did not wish to wait that long, we have reconstructed the EDIS for 2006 evaluations. We did so by assigning scores based on investment proposal[5] information. We have also scored the EDIS on the basis of outcomes achieved during the five years since approval. By comparing the two, we can see to what extent the expected development impact is actually realized, as illustrated in the graph below.



The slope of the regression line shows that 2001 project approvals realized on average 88%[6] of their expected development impact (as measured by the EDIS)[7]. Less than 100% is to be expected. The EDIS at project approval is scored on the assumption that everything will go as planned[8]. However, FMO operates in a high risk environment. It

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[5] At times, this involved a degree of conjecture, as development outcome objectives were, in 2001, not always explicitly stated in the proposals.
[6] As many of the projects performing below expectations were small (equity financed) investments, while outperformers often received relatively high amounts, the weighted average EDIS at evaluation (at 53.2) was only 3% less than the weighted average reconstructed EDIS at approval (54.8). The realized development impact of all projects combined was thus very close to what they set out to achieve.
[7] The correlation coefficient between expected and realized outcomes is quite low. The correlation strongly improves if we look at the 'net' EDIS, excluding the effect of the client's financial strength rating or FSF, particularly for FMO A. For the investigated projects, the FSF at approval in 2001 hardly correlated with the client's financial strength at the time of evaluation. The scorecard, including the FSF section, was new in 2001; there was no experience yet with using it for client risk analysis, and resulting risk ratings had not yet been tested. In later years, experience was built up and client risk rating tools have been refined. Improved client risk assessment may, meanwhile, also have improved the predictive value of the EDIS. Alternatively, the FSF at approval may not be the best indicator for a client's expected profitability.
[8] An exception is the impact of the project on shareholders and financiers. To assess this, a client's financial strength (FSF) at the time of approval is used: if everything goes as planned, this may well improve.

should accept risks that commercial banks are not prepared to take. A certain proportion of projects will thus fail as a business proposition. In these cases, the originally expected development outcomes will not be realized. Below the regression line, there are a number of failed FMO-A equity investments and also a few Seed Capital Fund investments. To substantially exceed the 'as planned' expectations is rare and exceptional.

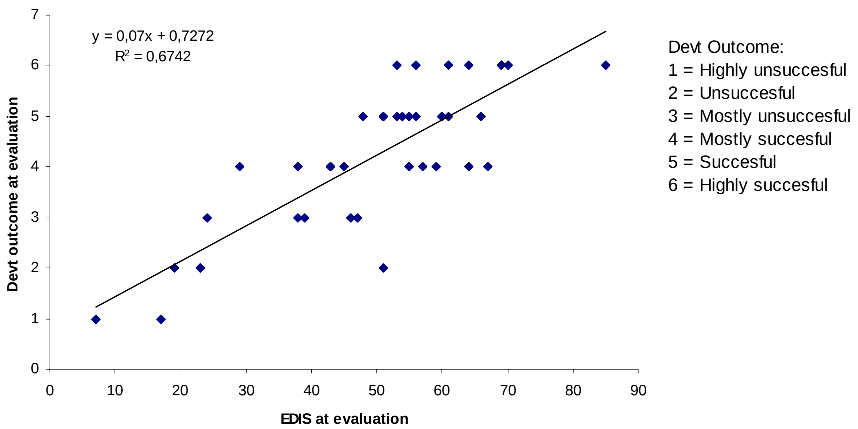
The above findings confirm the merit of targeting development impact. Projects with a high expected development impact and an acceptable risk profile often produce good development outcomes. FMO can thus improve its contribution to economic development through a careful project selection process. This includes seeking out high impact potential projects and avoiding those with a very limited expected impact. FMO has begun doing this in earnest in 2006.

Do we evaluate what we set out to do?

For evaluation purposes, it is important to make sure that, we judge FMO's (and clients') performance by what we have set out to achieve. To date, this has been a somewhat weak point at FMO. While we have been evaluating investments' development outcomes for five years now, until recently we have not always been very explicit about the development objectives of our investments. Investment proposals were mainly judged on risk/return considerations, while being checked for compliance with a range of investment criteria meant to ensure development effectiveness. The introduction of more explicit development impact assessment has changed all this. Project outcomes can in future be more clearly judged in terms of what the projects were meant to achieve.

In this context, it is important to see how well our evaluation methodology is aligned with the EDIS methodology as a means to target development impact. The graph below compares the EDIS at evaluation for 2006 project evaluations with each project's development outcome evaluation rating.

EDIS score and Development Outcome at evaluation (2006)

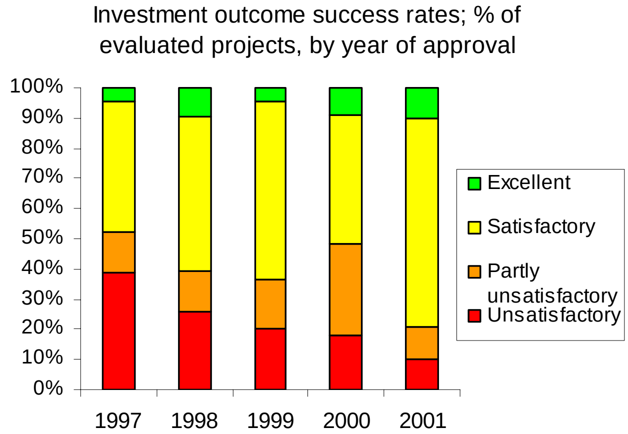


It is reassuring to see that the two approaches to development outcome evaluation show a very high correlation. The EDIS typically[9] measures what is also assessed at evaluation. The processes and targets introduced for ex-ante impact assessment are thus largely in line with how we judge our investments' development performance ex-post.

[9] Outlier outcomes have specific reasons. For example, one client with an EDIS at evaluation of more than 50 was nevertheless evaluated as unsuccessful. The story here is that, although the client as such is performing well, his specific FMO-funded investment project failed. On the other hand, a leasing operation where the mother company went bankrupt scored a low EDIS (because of a low FSF). The investment was, however, still evaluated as mostly successful, as the client had opened up the market and his well performing lease portfolio was successfully handed over to another operator.

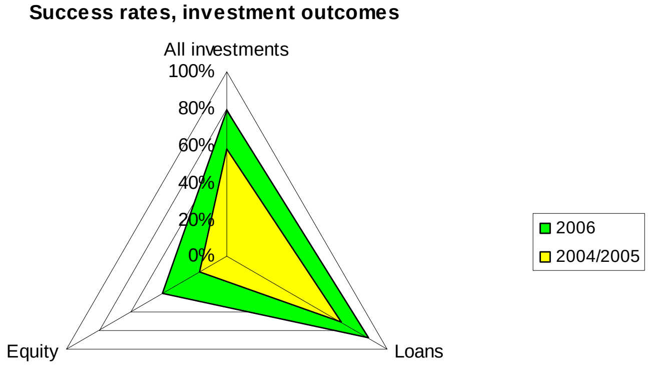
II. Investment Outcome

Last year, we reported a somewhat mixed though still positive trend in FMO's investment outcome. The success rate clearly improves after adding the 2006 evaluation outcomes. Relatively more projects than ever before ended up in the 'satisfactory' and 'excellent' categories in terms of investment outcome. Moreover, FMO invested comparatively large amounts in the projects with 'excellent' returns and only small amounts in those resulting in losses to FMO. Taken together, this means that 2001 approvals contributed more than ever before to FMO's profitability.



Improved economic conditions in many emerging markets are largely responsible for the declining number of poor investment outcomes (see the 'spotlight'-section below). Improved investment selection and structuring also played a significant role. FMO work quality and FMO investment outcome have a strong correlation and, as we shall see below, FMO's work quality has also improved in recent years. In particular, better structuring has led to more 'excellent' outcomes. An example in practice is creating an upside in a loan product – mezzanine financing.

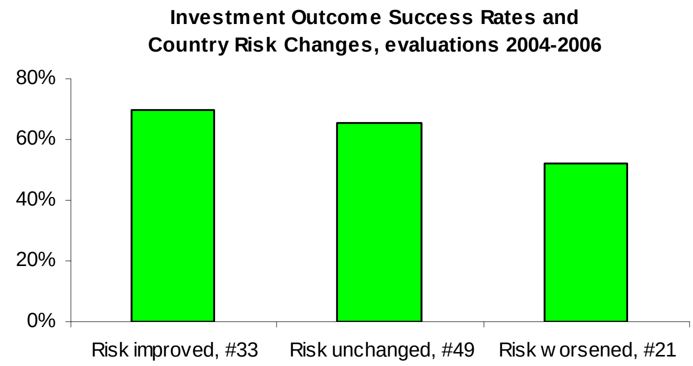
As illustrated below, loan products with a poor investment outcome were rare among 2001 approvals. The proportion of equity financed projects with good returns markedly improved. In the 'highlights'-section below, we analyze the latter in greater depth.



Highlights

- **Improved investment outcomes are largely due to improved circumstances.** Projects' investment and development outcomes are not fully in FMO's hands. Work quality does affect outcomes, but external factors like macro-economic and political developments play an important role. In earlier evaluation reports, we found that the incidence of economic crises was an important determinant of investment (and development) outcomes. Good investment outcomes occurred less frequently in countries struck by an economic or financial sector crisis after FMO made its investment. Conversely, projects were often very successful when FMO intervened after the onset of a crisis. Since the 2001 Argentina crisis, few country or financial sector crises occurred in FMO's focus countries.

  Crises are extreme changes in countries' economic climates. By reviewing country risk ratings, we can more generally investigate how changes in the investment climate affect investment outcomes. For our analysis, we have used the OECD's Country Risk Classification[10]. This assesses country credit risk, i.e. the likelihood that a country will service its external debt. Countries are classified into eight country risk categories. The OECD classification is readily available for almost all countries in which FMO is active. We have examined the relation between projects' investment outcomes and changes in country risk level[11].

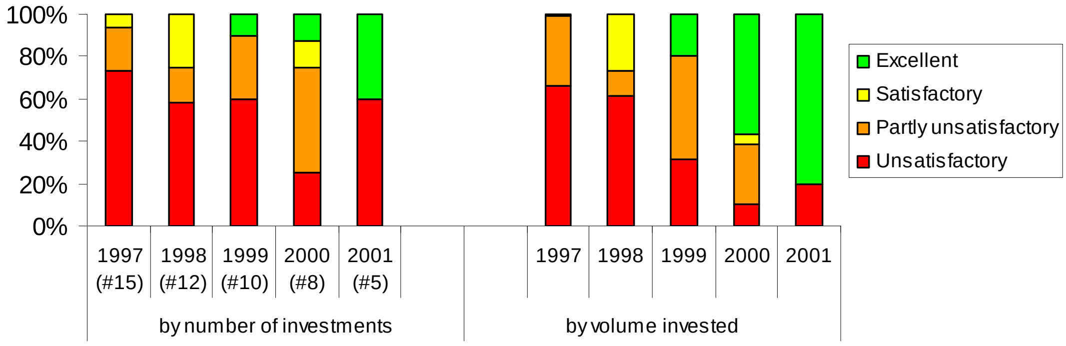
  The majority of projects in countries with an improved country risk deliver good returns to FMO. Conversely, projects in countries with a deteriorated country risk frequently generate poor investment outcomes. Worsened economic circumstances in these countries are reflected in the lower projects' success rates. As decreases in country risk have outnumbered increases, overall investment outcome success rates have benefited from improving economic circumstances. This effect has been more visible in the most recent years. Of the 1999 project approvals, 21% experienced country risk improvements and 27% saw country risk deteriorate. For 2001 project approvals, as many as 46% saw the economic and political climate improve while only 14% saw it worsen.

- **Equity investments starting to contribute to profitability.** Previous evaluation reports concluded that FMO's equity investments had generally not been very successful. They often produced poor investment outcomes and also less positive development outcomes. Here, we have compared the number of successful investments to the number of unsuccessful investments using the same methodology as with FMO's loans. However, equity investments are different from loans as the risk is much larger. The returns are potentially higher, but so are the chances of failure. At portfolio level, a minority of high performers is expected to more than make up for the poor performance of the rest. So instead of focusing solely on the number of successful equity investments, one should also look at equity investments' aggregated return.

[10] The OECD Country Risk Classification Method and historic Country risk classifications can be found on: http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_37467,00.html
[11] A project's country risk classification in the approval year was compared to its classification 5 years later.

The number of equity investments dropped sharply from fifteen in 1997 to five in 2001[12]. After a lull in equity investments, FMO changed its strategy to favor equity in 1997. A new equity portfolio had to be built in a short time. Most of the investments stemming from this period turned out unsuccessful. Unfavorable market circumstances played a role. So did FMO's relative inexperience with private equity. The negative results urged FMO to improve its deal selection process and to increase its expertise in private equity. Selection and structuring became more prudent and the number of deals temporarily decreased.

Trend in equity investment outcomes by year of approval, numbers of investments and volumes invested



Only two of the five equity investments evaluated in 2006 produced good - in fact excellent - investment outcomes. However, these two deals represented 80% of the equity investment volume. So in fact, 80% of the equity invested in 2001 generated very good FMO returns. Compared to previous years, this is a marked improvement. But how well did FMO do relative to the markets? To make this comparison, we calculated the IRR of FMO's equity invested in 2001 and compared it to an appropriate Emerging Market Index[13] for 2001-2006.

The IRR of FMO's 2001 equity investments amounts to approximately 16%[14] per annum over the period to 2006. The Emerging Markets Net Index (in EUR) grew at a rate of 17% per annum during 2001-2006. The performance of FMO's 2001 equity investments was thus in line with the growth of the emerging markets index. A good result for FMO. But what was the cause? To a large extent it can be explained by improved market conditions. In recent years, exit opportunities in emerging markets improved considerably due to strong economic growth. This, together with highly liquid international capital markets, attracted many international investors seeking better investment returns. Direct investment flows increased tremendously in 2005 and 2006. So did equity returns as illustrated by FMO's equity results. Improved work quality also had an impact on FMO's equity returns. From 1997 onwards, FMO has continuously professionalized its private equity department and this is clearly starting to pay off.

- **Smaller investments more often show poor investment outcomes.**
  Investment outcome (and most development outcomes) shows a higher success rate in terms of *amounts* disbursed than in terms of the *number* of projects. This implies that projects involving higher investment amounts did, on average, more often produce good investment and development outcomes.
  The main factor here is the fact that the average size of equity investments (with a much lower investment outcome success rate) is much lower than the average size of loans or guarantees. When looking at loans and guarantees only, however, it is remarkable that only 20% of loans of more than € 10 mln show poor investment outcomes, while as many as one third of the loans of less than € 5 mln did not give

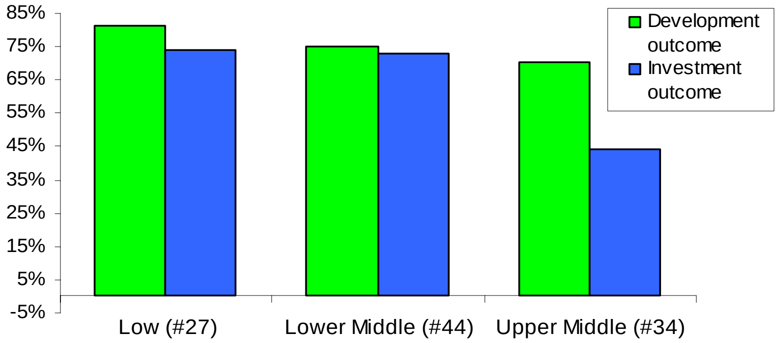
[12] In order to compare the results 1997–2001, the analysis is limited to FMO-A equity investments.
[13] Index used was MSCI Barra Emerging Market Index, Net Index in Euro, 31 Dec 2001- 31 Dec 2006. Indices can be found on http://www.mscibarra.com/products/indices.
[14] 16% IRR is for FMO-A only. Including MASSIF investments, total IRR is 13%. As some investments are still in FMO's portfolio, the IRR is partly based on unrealized results, reflected in Fair Values.

FMO a good return. While larger loans would typically have been extended to larger, more established clients or projects with strong and experienced sponsors, there also is a link with FMO's work quality. Significant shortcomings in work quality only showed up in 7% of large loan (> € 10 mln) financed projects, and in almost one third of the projects where we provided a smaller loan or guarantee. These findings suggest that smaller investments can be more successful if they receive the same level of FMO work quality – from approval to supervision – as is applied to larger investments.

- **Outcomes are better in lower income countries**
  Similar to last year's evaluations findings, we find a clear relationship between a country's income level and a project's developmental and financial outcomes. Evaluations carried out in 2004-2006 reveal significant differences in project success rates across the spectrum of income levels. Positive outcomes are more frequently seen in lower income countries than in the upper middle income countries. In particular, good investment outcomes were much more prevalent in lower income countries than in upper middle income countries.

  This is partly due to the fact that FMO-A equity investments were concentrated in upper middle income countries. We saw that their success rate is inherently lower than that for loans. Equity investments are often made in upper middle income countries as these economies are more attractive (e.g. fund raising, regulatory environment, exit opportunities). At the same time, loans frequently perform less successfully in these markets. The financial sector is typically more developed and FMO has to move into higher risk activities if it is to remain additional.

Development and Investment Outcome Success Rates by country income level, 2004-2006 evaluations



On the ground – sometimes it works

Mobile telephones for Africa

Having invested in two telecom companies in Congo and Zambia, FMO was asked to participate in the group's holding company. But because the group was still in its early growth phase, FMO considered an equity investment too risky. Instead, it provided a subordinated convertible loan. The loan was part of a larger financing package, meant to finance the expansion of the group's mobile telecom network in Africa. Shortly after our investment, the group left its start-up losses behind and began expanding rapidly. It soon needed additional equity in order to keep up its high growth pace. The risk was still considered too high for an FMO-A equity investment, so FMO used the LDC Fund. During the next years, the group continued its high growth and exceeded all original projections. It created tremendous value, not just for its shareholders but also for the African telecom consumers. Thanks to major network investments and increased competition, access to telecommunication has increased strongly and mobile tariffs have gone down. For FMO-A, the 15% return on the subordinated loan was a good investment outcome, while the IRR of more than 65% on the LDC Fund investment was even better.

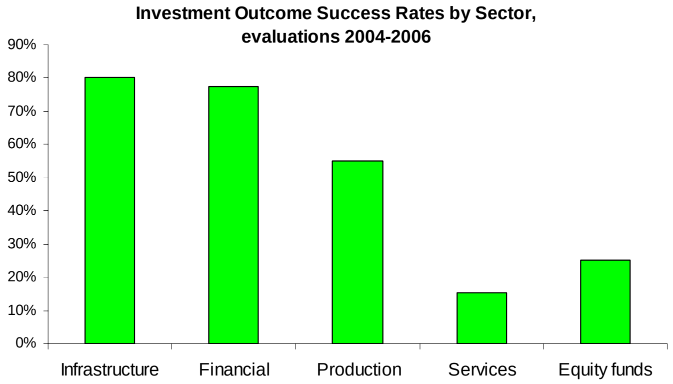
On the ground – sometimes it doesn't work

An equity investment in services hit by recession
Advertising can be risky business. The sector is highly cyclical. Demand goes up during periods of economic growth, and sharply downwards during recessions. Growth projections for advertising companies should therefore be based on a fundamental analysis of the companies' market potential, rather than on short-term results. When FMO made an investment in an advertising company in Brazil, the company had just experienced a period of continuous growth. Prospects therefore seemed good. But shortly after we invested, a recession set in and the advertising sector was hit hard. Demand dropped and the company ran into trouble. FMO's investment decreased in value and We saw no possibilities to assist in a turnaround. We sold our shares - for a nominal amount - to the company's original owners.

Spotlight on – Focus sectors and sector expertise

In the year 2000, FMO decided to focus its efforts on a smaller number of countries and sectors. Focus sectors were selected on the basis of FMO's perceptions of where it could make a difference as a DFI. The financial sector and infrastructure were seen to be particularly relevant. Financial sector development was seen to be crucial for stimulating investments and economic growth. In addition, among the DFIs, FMO had already been comparatively concentrated in the financial sector, both in banking and in non-bank financial institutions (NBFIs). Given the relevance of long-term finance to infrastructure, it was seen as another area where DFIs like FMO have an important role to play; particularly in an era of privatization and liberalization. FMO established so called 'knowledge streets' for building and sharing networks and expertise. Streets covered banking, NBFIs (leasing and housing finance), power and water, telecommunication and other physical infrastructure.

This sector focus clearly paid off, both in terms of development outcomes and in terms of financial returns. Of all projects evaluated over the past three years, those in FMO's focus sectors often produced good investment outcomes. In infrastructure and the financial sector, 78% of projects had good investment results. Investments in infrastructure (telecom, power, transport infrastructure) show a success rate of 80%, those in the financial sector (banking, leasing and insurance) of 77%.
By contrast, only 38% of projects in non-focus sectors led to good investment outcomes. The success rate was only 55% in agriculture, agro processing and manufacturing, and just 15% in other services. Poor investment outcomes in the latter category include all investments in (often ICT-based) services. This outcome pattern is partly related to product choice. In the directly productive sectors we largely provided loans, whereas in the services sector we typically made equity investments.



The very high success rates in focus sectors are striking. Individual project evaluations in power and telecom for example, illustrate that FMO had come to 'understand the business.' It knew what it was doing. In the financial sector as well, experience - plus other factors like development of sector specific due diligence instruments, ratio requirements, etc. - clearly helped our performance.

FMO is currently redesigning its business processes, aiming for more pro-active business development and focusing on client and market needs. Regional and sub-regional marketing plans are being developed, and co-operation with partner institutions is being intensified. In this context, the need for sector focus and expertise should not be overlooked, especially since it clearly helps work quality. In evaluations of financial sector and infrastructure projects, FMO's work quality was rated as good in 84% of all cases. On the other hand, 43% of the projects in non-focus sectors showed serious shortcomings in FMO's work quality. Depending on the choices made in our market plans, the knowledge streets may have to be redesigned. In any case, up-to-date sector expertise will be called for if FMO is to make the best choices and is to understand and serve its clients best. FMO is advised to keep on developing such expertise, to give it a clear place in its organization, and to make optimal use of it.

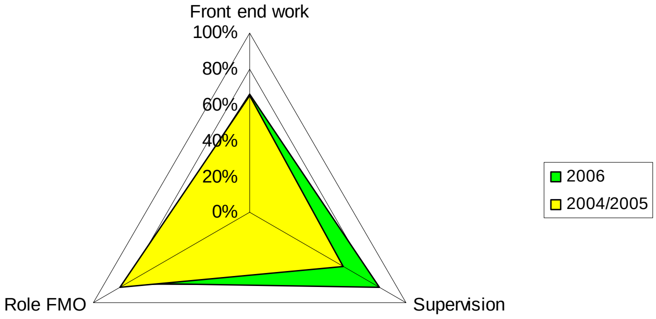
III. Work quality

Alongside project development and financial outcomes, project evaluations also assess FMO's work quality. The most important reason for evaluating work quality is to derive lessons and to account for FMO's influence on project outcomes. Project by project assessment of FMO's work quality helps to identify strengths as well as weaknesses, best practice examples, and shortcomings to be avoided in future. All can be used to shape and formulate more effective policies, procedures and practices. Specific experiences are recorded in FMO's Lessons Learned Database (see 'spotlight'-section below).

Evaluations provide separate assessments of front-end work quality (project selection, due diligence and structuring), the quality of project supervision and monitoring and the extent to which FMO played its proper role as a development finance institution. FMO's role is to be additional to the market, to be catalytic to other investors, and to contribute to a project's performance where this is called for.

Projects evaluated in 2006 once again show a decline in the number of projects suffering from shortcomings in project monitoring and supervision. Projects where FMO's role and contribution were judged to have been poor have become exceptional. Recently evaluated projects have benefited for a longer period from tightened credit review procedures instituted by FMO's Investment and Mission Review Department (established in 2000), from improved workflow management systems and from the establishment of dedicated Portfolio Management Clusters. As in 2005, the 2006 evaluated projects show FMO's front-end work as the area with the greatest scope for improvement.

Success rates, FMO's work quaility



Highlights

- **Good work quality central to good outcomes.**
  FMO's work quality, especially front end work quality and playing a proper role as a DFI[15], strongly correlates with both development and investment outcomes. Where FMO's overall work quality is assessed as having been good, the vast majority of projects resulted in positive development outcomes. Conversely, where FMO's work quality revealed serious shortcomings, most projects produced poor outcomes.

  The trend towards better development and investment success rates can thus be ascribed, at least in part, to the simultaneously observed increase in the proportion of projects where FMO's work quality is judged to have been good: the percentage of projects where overall work quality was less than satisfactory declined from 34% among projects approved in 1997/98 to only 14% of the 2001 approved projects.

[15] The statistical link between project supervision and outcomes is less firm, as FMO may intensify monitoring and supervision when a project goes (or tends to go) off track, whereas supervision may be relaxed when everything goes according to plan.

- **Poor work quality in pre-MASSIF investments.**
  The quality of FMO's work in 2001 MASSIF-financed projects more often shows shortcomings than that for FMO-A projects. It is important to note that this tentative conclusion is drawn from a small sample. In half of both Seed Capital Fund (SCF) projects and Small Enterprise Fund (SEF) projects, the quality of front-end work and that of supervision was judged to have been less than satisfactory.

  We observed SCF projects where the institutional sustainability was insufficiently ascertained and where, given the experimental nature of the project, a grant would have been more appropriate than an equity investment. This was especially the case where the very small size of the investment made the cost of proper supervision almost prohibitive. In SEF projects, we saw cases where local currency loans were made in countries with an overvalued currency and where FMO's pricing did not take this into account. In one or two other projects, the financial institution's focus on small enterprises was insufficiently assured. Clear guidelines for government fund investments as well as strengthened fund management should help to prevent such shortcomings in future. These were introduced when MASSIF was established in 2006.

  Apart from standard monitoring, the fund specific objectives and criteria of MASSIF projects also need to be monitored. This has tended to receive insufficient attention, contributing to low evaluation scores on supervision quality. The relatively frequent shortcomings in MASSIF project monitoring and supervision may also reflect the finding of last year's evaluation report: work quality including that of supervision, is positively correlated with investment size. Given the fact that management of these fund investments is delegated to the regional and equity departments, MASSIF clients compete with other FMO clients for the attention of investment staff. This may create tension, given that investment staff incentives are largely volume based.

  If anything, the often small and young MASSIF clients demand more staff capacity than established FMO-A clients. Priority for such smaller clients has increased, through the Access 2010 strategy. Here, FMO aims to make a marked impact on access to financial services at the bottom end of the market in specific regions. A combination of funding and active involvement, guidance and assistance is the tactic to achieve this objective. MASSIF's remuneration structure should enable FMO to do so.

- **Room to improve our front-end work**
  Remarkably, the proportion of projects where shortcomings were identified in FMO's front-end work continues to remain more or less stable[16]. Of the work quality indicators, front-end work quality has the highest correlation with outcomes. Improving front-end work quality carries with it a multiplier effect and it should be prioritized. Some initiatives are already in place towards this end, including: (1) applying lessons from FMO's Lessons Learned Database as part of the due diligence process (see 'spotlight' section below), (2) increasing attention to ex-ante development impact assessment and (3) increased staff training efforts. Towards the latter, FMO started off "Introducing Development Banking" in 2006 and the "FMO Academy" from 2007 onwards. Training efforts aim at imparting essential front-end skills to (new) FMO investment officers. The 'Business Process Review' corporate initiative may further enhance effectiveness of our staff, allowing better use of our staff's key competencies.

[16] However, within the category of projects with poor front-end work, in recent years fewer projects were rated 'unsatisfactory', and more projects 'partly unsatisfactory'. Among projects with good front-end work, the proportion of projects that score 'excellent' rather than 'satisfactory' keeps on increasing.

On the ground – sometimes it works

Helping a Latin American construction company through difficult times
A large Latin American construction company was suffering as a result of persistent regional economic recession. Due to insufficient cash flow in 2001, the company was looking for additional finance in order to repay a USD 10 million bond. FMO wanted to lead the company to safer waters, ensuring the employment of some 4000 employees. FMO teamed up with a local bank and provided a bridge loan meant to repay the bond. In the meantime, FMO became involved in the structuring of a new bond issue that would be used to repay the bridge loan. In order to increase the bond rating, FMO provided a guarantee on the bond repayments. The bonds thus became more attractive for commercial investors. The new bond issue was a big success and has broadened the company's access to commercial financiers. FMO not only helped to secure the jobs in the company, the deal also stimulated the development of the country's capital market. The bonds offered investment opportunities for recently established institutional investors such as pension funds.

On the ground – sometimes it doesn't work

Setting up a financial institution does not work without an aligned shareholder base
When FMO was asked to invest in setting up a new Micro Finance Institution (MFI) in the Philippines, it reacted enthusiastically. Investing in a small local bank fitted perfectly with FMO's development objectives and was in line with the Seed Capital Fund criteria. But not every MFI is a success story. Shortly after the MFI was established, it became clear that competition was much stronger than anticipated. The bank wasn't a first mover in the sector and building up a good portfolio proved to be difficult. On top of that, the shareholders had different views on how best to run an MFI. Also, the expatriate management did not agree with the local shareholder's business approach. If the due diligence had been more thorough, these issues could might have been identified beforehand. After making the investment, FMO played a marginal role. Because of frequent changes in responsibility, FMO's monitoring process was diffuse and much knowledge was lost along the way. Supervision was neither efficient nor effective. In proportion to the very small size of the investment, FMO had to spend much time and energy on the project. Still, the results were disappointing. The MFI has recently been taken over by one of the local shareholders specialized in SME finance.

Spotlight on – Using our lessons from experience

In our earlier evaluations, we concluded that the quality of FMO's front-end work is a very important determinant to project final outcomes. At the same time, we concluded that it was an area with significant room for improvement. In order to do so, we felt that the Evaluation Unit itself also had a role to play. Most importantly, by sharing specific evaluation findings in a more structured way with the rest of FMO. After all, the relevance of evaluations mainly depends on whether the business can make good use of the evaluative findings. Therefore we decided to create a knowledge sharing instrument called the "lessons learned database" (LLD). This LLD has closed the gap between ex-post and ex-ante evaluations. Simply put, lessons collected earlier by the Evaluation Unit are now being fed back into the business. The aim is to enhance the quality and effectiveness of new finance proposals through knowledge sharing on what worked and what didn't. By using the LLD, FMO can take into account lessons learned during the selection, structuring and approval of new finance proposals.

The LLD was launched in May 2006. Since then, the usage of the LLD has become an integral part of FMO's investment procedures. The Evaluation Unit provides lessons to the deal teams directly after their preliminary finance proposals have been approved. The deal teams are then required to consider these lessons during their due diligence and to address them in their final finance proposals.

The lessons in the database have a wide variety of themes that can vary from specific structuring lessons (include a prepayment fee) to more sector related lessons (corporate governance issues in the financial sector) to country related lessons (in country X, Central Bank supervision is inadequate). By creating different search queries, users can easily find the relevant lessons. The LLD currently contains around 250 lessons learned. The content is continuously expanding with new lessons coming from evaluations, knowledge streets and other sources such as presentations. A survey held in September 2006 among IOs and PMCs, indicated that people were positive on the usage and the LLD content. Further improvement could be made by adding more specific, less general lessons. In order to meet this demand, we have planned to incorporate more lessons from the knowledge streets. Furthermore, in 2007, we want to start exchanging and sharing lessons with other DFIs such as IFC and DEG.

Annex 1. Supporting documents and data

Additional data and information is available from FMO's Evaluation Unit:

1. FMO's project evaluation process and procedures in 2006: a description
2. FMO's 2006 evaluation instruments: evaluation form and detailed guidelines
3. Determinants and characteristics of the 2006 evaluation population
4. Statistical analysis of the 2006 evaluation outcomes
5. Combined analysis of the 2004-2006 evaluation outcomes