FMO's internal evaluations: Informing policy and strategy

FMO's 6th Annual Evaluation Review, 2007/2008,
along with the response from FMO's Management Board

May 2008

FMO
Finance for Development

Evaluation Unit
Investment & Mission Review
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Note to the reader

FMO’s 2007/08 Annual Evaluation Review is a concise presentation of the findings from project evaluations carried out by FMO’s internal Evaluation Unit in the course of 2007. Any opinions and conclusions contained in this report are those of FMO’s Evaluation Unit, and are derived from evaluation findings. They do not necessarily coincide with the views of FMO’s Management Board. Management’s position on the Review’s findings and recommendations is expressed in the Board’s Management Response, which is reproduced on page 23.

Interested readers may obtain further 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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Findings and conclusions in a nutshell

- FMO's making a difference in development remains a function of (1) ensuring clients' financial, environmental and social sustainability, (2) assessing the development relevance of the activities we support, and (3) supporting activities that are underserved by commercial banks and private investors. As the high correlation between projects' development outcome and FMO's investment outcome illustrates, clients' business success is a precondition for generating lasting development effects. An effective role further demands that investment choice is guided by careful scrutiny of projects' expected development effects, and by ensuring additionality.

- Last year's evaluations, relating to projects approved in 2002, show the highest development outcome success rates ever. These investments were made during a recessionary period when capital flows to our markets were sharply reduced, allowing FMO to invest selectively while being highly additional. Clients subsequently benefitted from the economic upswing, enabling them to generate strong development results and to contribute to FMO's improved profitability.

- FMO's work quality remains an import determinant of both development and investment outcomes. Particularly improved front-end work (project selection, due diligence and structuring) contributed to the high success rates of projects evaluated last year.

- Investments from FMO-managed government funds generally produced good development outcomes. Almost all investments from the Small Enterprise Fund - channeling local currency investment funding to small and micro enterprises through local financial institutions - produced strong development effects. The Seed Capital Fund, supporting start-up companies and financial services providers, understandably had a much higher failure rate.

- FMO generates the best investment and development results in sectors in which it has specialized, and developed a network and expertise. With regard to its strategy for the coming years, FMO is advised to devote appropriate resources to developing, disseminating and using knowledge pertaining to whichever sectors it chooses to focus on.

- Similarly, FMO has done well by focusing its efforts on a relatively limited number of countries. This has allowed it to acquire knowledge of the market, to pro-actively select partners and clients, and to efficiently monitor clients.

- Evaluation results show that FMO's investments have more often been financially successful in low and lower-middle income countries, rather than in upper-middle income countries. This holds for both our lending operations and our equity investments. The bulk of our investments in upper middle income countries did, however, produce good development outcomes, and FMO also managed to typically play a proper role in those countries, being additional and catalytic.

- Equity and mezzanine investments made in recently evaluated approval years have done well, helped both by positive economic developments in our markets and by increasing FMO experience in using and structuring these products. We note, however, that there is room for improvement in the management and supervision of mezzanine transactions.

- Through its own work quality, FMO can have a significant influence on clients' environmental and social performance. We are most effective in achieving improvements if clients see the benefits and have a prior commitment. We have noted that monitoring social and environmental performance - and following up on agreed environmental and social action plans - often shows shortcomings and should be strengthened.

Introduction

Each year, FMO's internal Evaluation Unit publishes a review of the findings emerging from project and thematic evaluations that it has undertaken during the past year. We evaluate all our investments five years after they have been approved. In 2007, we thus evaluated investments approved in 2002 (52 project evaluations), plus later years' approvals that have meanwhile been terminated (12 project evaluations), using the project evaluation framework described in Annex 1.

"***FMO's internal evaluations: Informing policy and strategy***" describes the outcomes of project evaluations undertaken by FMO's internal Evaluation Unit in 2007. We analyze them in combination or in comparison with those of prior years (to show trends, or to illustrate outcome patterns for which a single year's project evaluations form too small a base). The first part of this report deals with one of the key functions of our evaluation system: accounting for FMO's results in relation to its mission. In the second part, we consider what outcome patterns and other evaluation findings can tell us about the way forward for FMO.

For the second year, investments from FMO-managed government funds were evaluated alongside those made for FMO's own account (referred to as FMO-A). The government funds comprise of the Small Enterprise Fund (SEF) and the Seed Capital Fund (SC; merged with the SEF and the Balkan Fund into the MASSIF Fund in 2006) and, newly established in 2002, the Netherlands Investment Matching Fund (NIMF) and the LDC Infrastructure Fund.

Historic perspective

In 2002, emerging market investments where generally depressed. Commercial investors acted cautiously after the events of 9/11 (2001) and the ensuing tense world political climate. Recession set in seriously in Latin America after the financial crisis in Argentina, which not only spilled over into Uruguay, but also made international providers of capital withdraw elsewhere in the region, affecting among others Brazil with its high debt burden. Much of Asia was characterized by instability: political and social unrest in the Philippines and Indonesia, military intervention in Afghanistan, crisis surrounding Iraq. Investors there also adopted a cautious stand.

These circumstances actually created good opportunities for FMO to play its proper role: we could be highly additional while serving relatively strong corporate clients and financial institutions in, among others, post-crisis or recession hit Argentina, Brazil, Mexico and Turkey. In some of these countries, we were able to help soften the impact of recession by providing trade related finance. But also in low income countries, FMO could build relationships with relatively stronger partners (the stronger banks in Nigeria and Ukraine, a telecom operator in Nicaragua and a power developer in Bangladesh).

The emerging market investment climate did, however, also imply uncertainties for FMO's clients and investment partners, leading to delays in arranging finance. Under these circumstances, FMO itself also adopted a cautious approach.

FMO's 2002 investment approvals

FMO-A investment approvals slowed down compared to 2001, and declined from € 602 mln to € 549 mln. At the same time, approvals for investments from the government funds showed a sharp increase, in response to tight market liquidity. Approvals for SEF and SC shot up from € 27 mln to € 79 mln, and NIMF and the LDC Fund realized their first approvals, for € 33 mln. About a third of the approved projects did not lead to evaluations. In some cases, this was because the approvals only related to a restructuring or a capital increase. Mainly, however, this was due to approvals that did not result in signed investment agreements and subsequent disbursements, as investments were cancelled or postponed.

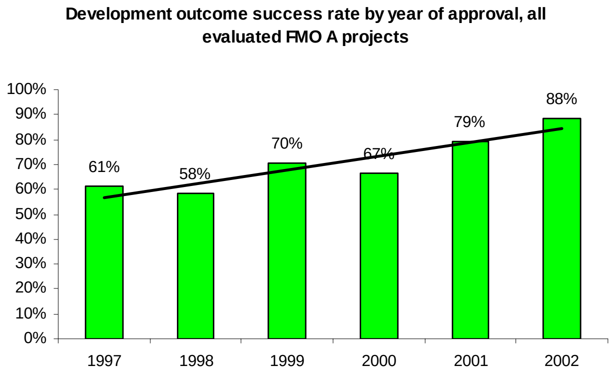
We ended up evaluating 52 projects approved in 2002, 34 of which were funded from FMO-A (€ 327 mln), 13 from the SEF (€ 42 mln), eight from the SC Fund (€ 11 mln) and one from the LDC fund (€ 9 mln). Four projects received funding from a combination of sources (FMO-A / SEF; FMO-A / SC; FMO-A / LDC and SEF / SC). In 2007, we also evaluated 12 projects approved in later years that had meanwhile been prepaid or exited, and executed one mid term review of a project that was insufficiently mature for evaluation. The latter projects have not been included in the statistical analyses contained in this report.

I. Outcome trends and patterns

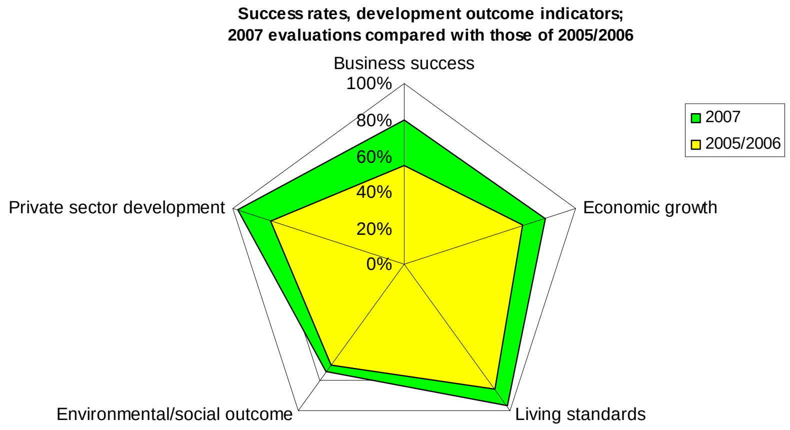
Investments for FMO's own account, FMO-A

Development outcome

Of the FMO-A financed projects evaluated in the last three years[1], an unprecedented 78% were successful from a development point of view (with 2002 approvals having a development outcome success rate of 88%). Together, the developmentally successful projects accounted for 81% of the total disbursed investment volume. Of the projects approved in 2000-2002, 68% (76% in terms of volume) contributed adequately to FMO's financial continuity. This success rate is also higher than ever reported before.



The proportion of 2002 approvals scoring well on each of the development outcome indicators is illustrated below, relative to the same figure for the two previous years.



Better development outcomes are visible on all sub-dimensions, mainly driven by the very high proportion of projects that were successful from a business point of view (where the success rate increased from 48% among 2000 approvals to 79% among 2002 approvals). Clients whose businesses have performed well typically also made good contributions to economic growth in their respective countries of operation, generated net benefits for others than their shareholders and financiers (and thus contributed to improved living standards), and made positive contributions to broader private sector development. In the depressed emerging market investment climate pertaining in 2001/02, FMO was able to selectively support clients with strong fundamentals. They were able to take full advantage of the recovery and strong economic growth that took place in the ensuing years.

Success rates for environmental and social outcomes also showed an improvement, but maybe not as much as might be expected given FMO's increased attention to sustainability

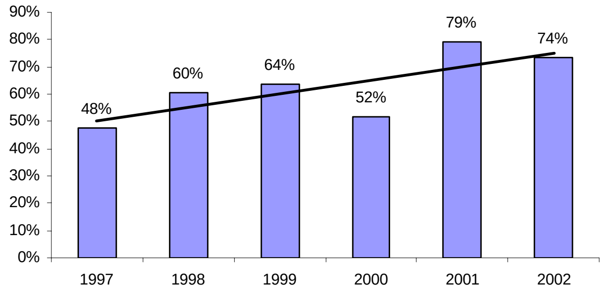
[1] For FMO-A, the analysis relates to 96 projects approved in 2000-2002, mostly evaluated in 2005-2007; as we only started evaluating government fund investments in 2006, the outcomes of their 2001 and 2002 approvals are analyzed separately, to avoid distortion of trends and patterns.

in recent years. While negative environmental and social outcomes were rare, projects' environmental and social outcome was often rated as partly unsatisfactory because of inadequate monitoring and reporting, or because of inadequate follow-up to action plans, by the client, by FMO or by both.

Investment outcome

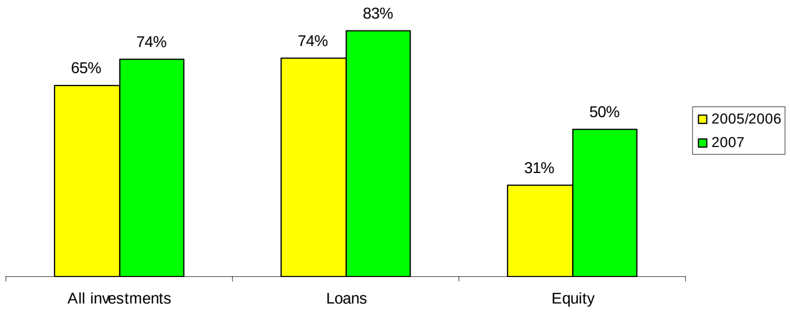
Much of the basis for FMO's good financial results in the last few years was laid in the years when the most recently evaluated projects were approved: 2001 and 2002. While 2001 FMO-A approvals showed a record investment outcome success rate, this actually declined somewhat among 2002 approvals. However, this does not mean that the 2002 approvals were less successful than those of the previous year: if we look at the projects with less successful outcomes, we see that hardly any 2002 project generated losses to FMO ('unsatisfactory' investment outcome). More projects fell short of expectations but still generated a positive return (scored 'partly unsatisfactory'). The latter were mainly the result of early repayments where no prepayment fee was charged. Here, FMO missed much of the interest revenue stream that was to compensate it for the risks initially taken.

Investment outcome success rate by year of approval, all evaluated FMO-A projects



In the graph below, we separately show recent developments in investment outcome patterns for FMO-A loans and equity investments[2]. Equity investments are, by nature, more risky, and a lower investment outcome success rate is to be expected. While successful equity investments were the exception in earlier years, financially successful investments have become more common among 2001 and 2002 approvals. Moreover, the majority of successful investments have produced excellent investment outcomes, thereby more than making up for those with unsatisfactory outcomes; the 2001 and 2002 vintages thus contributed significantly to FMO's high level of profitability in the past few years.

FMO-A investment outcome success rates, loans versus equity; 2007 evaluations compared with 2005/06



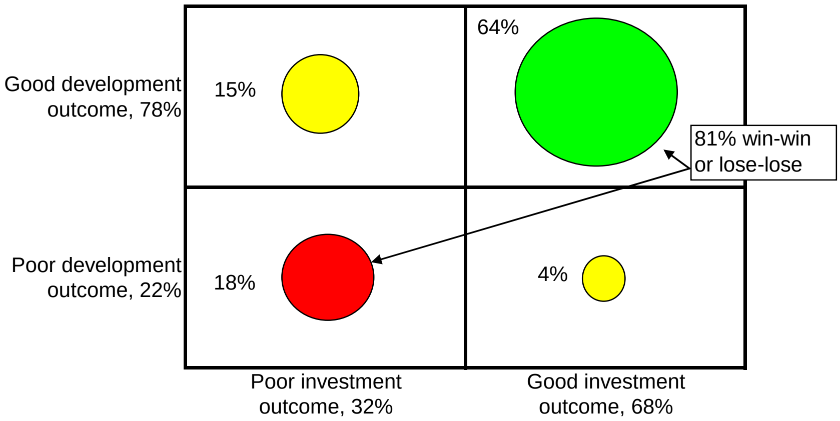
Both for loans and for equity, recent outcome trends are largely explained by economic developments in our markets. The most recently evaluated projects were approved at a time when the emerging market investment climate was depressed, and FMO thus could (or had to) invest cautiously and selectively. Clients subsequently benefited from recovery, helping their results, and thus their equity performance and loan servicing ability. Prepayments also typically reflect strong cash flows, improved liquidity and increased risk appetite of commercial financiers. At least in part, however, these improved outcomes also reflect good

[2] For this analysis, mezzanine investments (convertible loans, loans with warrants, etc.) have been classified either as loans or as equity, depending on the nature of the risk taken by FMO.

– and improved – FMO work quality: improved investment selection and structuring (especially for equity), adequate credit risk supervision and playing a good role as a DFI.

Interrelations and the influence of FMO's work quality
Among FMO-A financed projects, the vast majority (81%) approved in 2000-2002 had either a win-win (positive development and investment outcomes) or a lose-lose outcome. This picture would be even more pronounced in terms of Euros disbursed: in volume terms, 72% produced win-win results, and only 15% lose-lose. Development returns thus keep going hand in hand with investment outcomes.

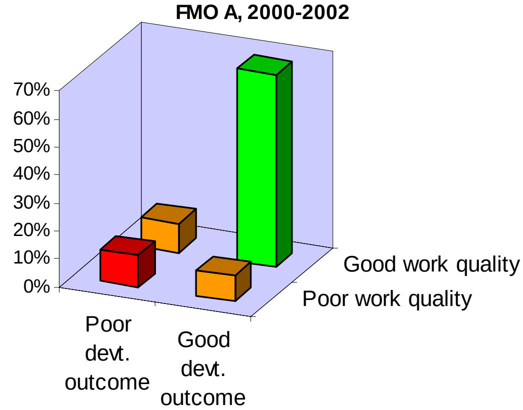
Evaluation outcomes, 96 FMO-A project evaluations, 2005-2007



Compared to last year's report, there is a marked increase in the proportion of projects that, while producing good development results, did not generate a good return on investment to FMO. Many of the projects ending up in this (upper left) quadrant involved clients, who, as the economic tide turned, were able to refinance their FMO loans.

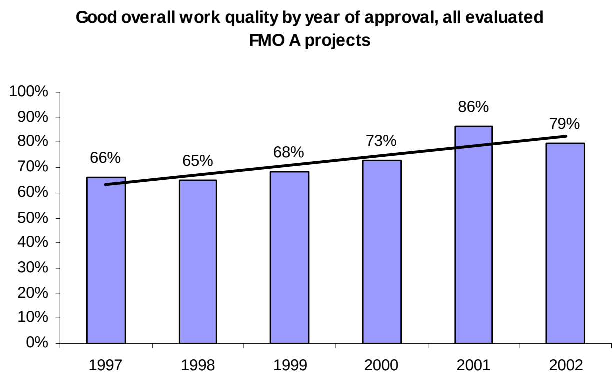
As also noted in all earlier evaluation reports, both development and investment outcome success rates are closely correlated with FMO's work quality. The correlation with development outcome is illustrated in the graph below.

FMO work quality and development outcome; FMO A, 2000-2002

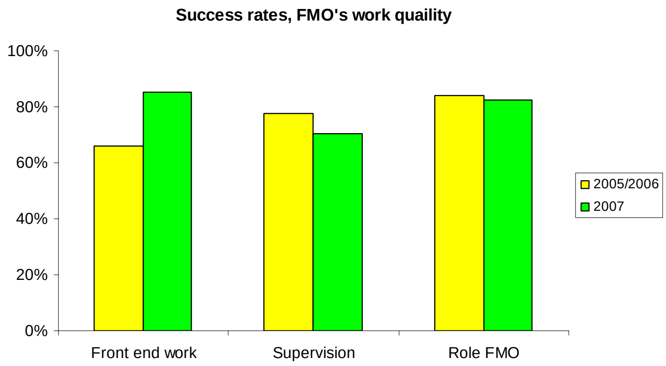


Among projects where FMO's work quality was judged to have been satisfactory or excellent, the vast majority produced good development and investment outcomes. On the other hand, where serious shortcomings were noted in FMO's work quality, a majority produced poor outcomes, both from a development and from a banking perspective.

While we saw before that the economic climate in FMO's markets has been a major explanatory factor for the high success rates in recent years, improvements in work quality have thus clearly also played their part: the professionalization of FMO's staff and organization. In recent years, the proportion of evaluated projects where overall work quality was judged to have been satisfactory or better was much higher than in the early evaluation years, although there was a decrease among last year's evaluations:



To better understand the slight decline in the proportion of projects with good work quality among projects approved in 2002, we look at the three elements of work quality that are evaluated: front-end work (project selection, due diligence and structuring), monitoring and supervision, and the extent to which FMO plays its proper role as a DFI and delivers the value added that the client could reasonably expect from FMO:



Front-end work quality, which has the highest correlation with outcomes, strongly improved under the influence of (a) building focus sector expertise, (b) strengthening of credit analysis and (c) the fact that, in the uncertain 2002 climate, FMO was more selective. On the other hand, we more often noted weaknesses in project monitoring and supervision (in about a third of the projects evaluated in 2007). Partly, this was due to the fact that front-end sector and country expertise among business development staff was insufficiently mirrored among portfolio management staff. Specific knowledge of the client and his project was, at times, insufficiently transferred to those placed in charge of monitoring and supervision. In quite some cases also, we judged monitoring insufficient because it was limited exclusively to monitoring client and credit risk, with little or no attention to the monitoring of operational performance and development effects.

FMO-managed government funds

For the second year, we have also evaluated the investments that FMO made with the government funds that it manages. While it is too early to separately comment on the few evaluated NIMF and LDC Fund financed projects, we have meanwhile evaluated 32 projects financed out of the predecessors of MASSIF: 12 investments by the Seed Capital Fund (SC) and 21 investments from the Small Enterprise Fund (SEF)[3]. For government funds, we evaluated - next to the standard development outcomes - the degree to which they helped achieve the funds' specific objective, and whether they complied with fund specific investment criteria.
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* aimed to stimulate small enterprise development by providing – mainly local currency – finance through local financial intermediaries. Here, success in

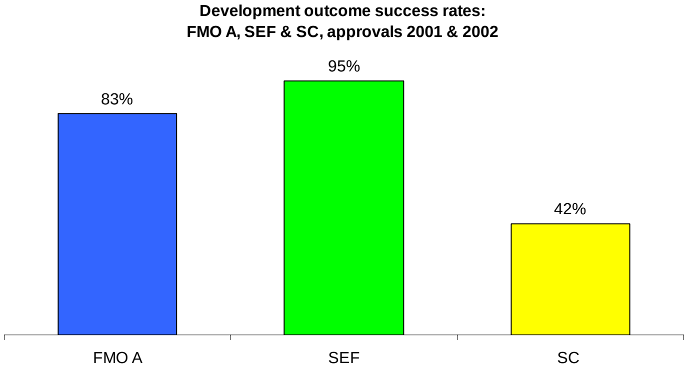
[3] One project received financing out of both funds.

terms of program objectives is measured by the extent to which the financial intermediaries have successfully expanded their small enterprise lending in a sustainable manner.

Development outcome

The fund investments' combined development outcome success rate, at 76%, does not compare too badly with that of the FMO-A investments in the same two years (83%). It is, in fact, quite remarkable, as the government funds enable FMO to accept risks that it cannot prudently take on its own account. The funds take on specific risks: local currency risks in the case of SEF, and product and start-up risk for SC. There is a higher chance of business (and developmental) failure with these projects. But if successful, they are typically highly relevant to development.

As shown in the graph below, there is a remarkable difference in the success rates of SEF and those of SC. A very high proportion of SEF investments produced good development results (even more frequently than FMO-A investments), but 2001/02 SC investments did only do so in a minority of cases. This reflects the risk profile of both funds' clients and products, with SEF mainly lending to (or rather: through) relatively well established financial institutions, and SC (typically) taking equity investments in start-up financial institutions, financial services providers and small enterprise equity funds.



As two-thirds of the SC clients did not achieve acceptable business results, they also made only limited contributions to broader development outcomes, although three quarters of the evaluated SC investments still made a satisfactory contribution to improvements in living standards and to private sector development. They were mostly not successful in terms of the program's objective: to help clients outgrow their start-up character.

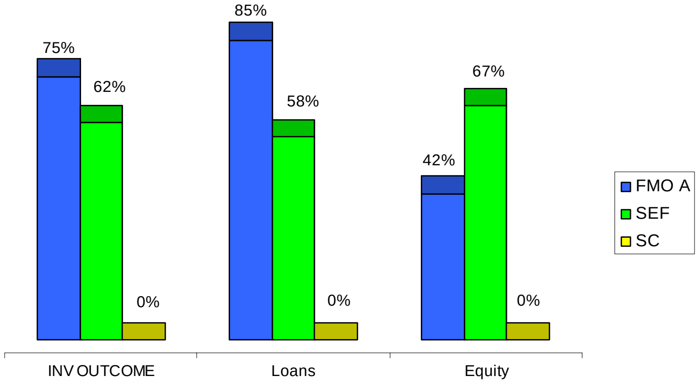
The vast majority of SEF clients, on the other hand produced good development results across the board, and the overall development outcome of eight out of 21 SEF investments was even evaluated as having been 'highly successful'. Among these, we find several of FMO's early ventures in micro-finance, some leasing companies and a housing finance institution. Almost all SEF investments made good contributions to the program's objective, although compliance with SEF on-lending criteria was often poorly monitored.

Investment outcome

The fact that FMO is to employ government funds for relatively higher risks that it cannot prudently take on with FMO-A is clearly reflected in the investment outcome success rates for the funds, as compared with FMO-A. Fund investments are considered to have produced good investment outcomes if Euro-returns more than compensated FMO's management fees of about 3%[4]. Returns are thus considered to have been good if investments have helped to maintain or increase the size of the revolving funds.

[4] The definition of investment outcome success is somewhat different for government funds than for FMO-A. For FMO-A, investment outcome is scored depending on whether agreed repayments and interest payments are fully realized (loans) or on whether investment returns have properly compensated FMO for the risks taken (equity).

Investment outcome success rates:
FMO A, SEF & SC, approvals 2001 & 2002



The 2001 and 2002 **SEF** investments were indeed less frequently successful from an investor's point of view, if compared to FMO-A. The main reasons for disappointing investment results were depreciations and devaluations of the local currency in which SEF loans were expressed. Out of the three equity investments made with SEF, two investments in microfinance institutions have produced good equity returns.
None of the 13 evaluated **SC** investments (ten equity investments and three mezzanine loans) were seen to have produced acceptable investment outcomes. As a third of the SC clients were, however, seen to be producing good business results, there is a good chance that such equity holdings in start-up operations need just a bit longer to start generating positive investment outcomes for FMO as well. This is illustrated by the fact that some SC investments made in other years were performing well enough to be acquired by FMO for its own account, when SEF and SC were merged into MASSIF in 2006.
Although the SC program as a whole has thus not been as universally lacking in overall successes as the 2001 and 2002 SC approvals, the high incidence of developmentally and financially unsuccessful investments did lead to various policy adjustments in later years. A first step was the formulation of FMO's 'Access to Finance 2010' strategy, which focused the Fund's utilization on selective regions (such as West Africa and the Mekong region) where FMO aims to make a tangible impact on the development of inclusive financial systems. The second was an adjustment of acceptance criteria when MASSIF was formed. To what extent these have helped to raise the proportion of successful fund investments will become apparent in future evaluation years.

Investment outcomes of FOM, the "Fund Emerging Markets"

FOM (the Dutch abbreviation for Fund Emerging Markets) is an investment fund that FMO manages on behalf of the Ministry of Economic Affairs. It provides finance to Dutch companies (mainly SMEs) investing in emerging markets, either in local subsidiaries or in joint ventures. FMO only started managing the fund in the course of 2003, so investments approved under FMO's auspices have not yet come up in our regular evaluation process.

In 2007, FMO's investment review committee noted that a relatively high proportion of the fund's investments was generating poor investment outcomes and required provisioning and/or intensified monitoring and supervision. It therefore requested the fund manager and the evaluation unit to carry out an evaluative review of the program, with a focus on the causes of problems in the fund's portfolio and on emerging lessons of experience that might help to improve the portfolio's quality going forward. The portfolio and its characteristics were analyzed. Causes of poor performance were identified and categorized. It was investigated whether these stemmed from risks that were (or could and should have been) identified in advance. And an evaluation workshop was held with all investment and special operations staff involved in managing the fund's projects, to validate preliminary findings against all available knowledge of FOM's clients.

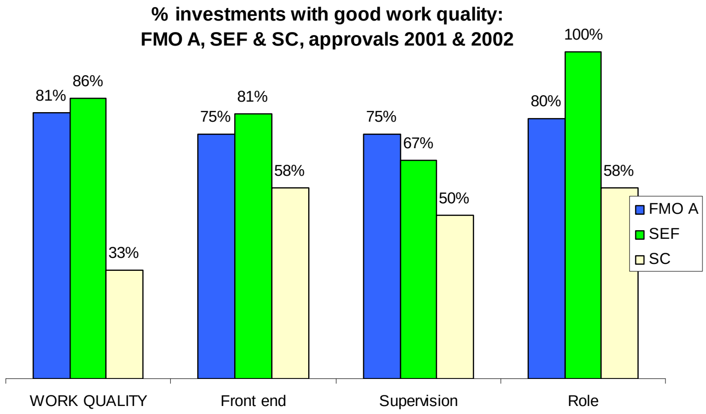
The review clearly brought out that the FOM mandate and criteria imply that projects are generally characterized by the presence of many critical risk factors, such as the Greenfield character of investments (regulatory, start-up and completion risk), promoters that often are financially weak, untested partnership relations and inexperienced local management. Typically, these have indeed been at the root of the financial difficulties encountered by problematic projects, especially where such risk factors were clustered, or where weaknesses in certain areas were insufficiently balanced by strengths in others.

Lessons were drawn with regard to project acquisition and due diligence, deal structuring and risk mitigation, risk acceptance, and supervision in the disbursement and monitoring stages. Addressing these in current and future projects should help reduce problem incidence. Moreover, the fund management team appears to already have internalized many of these lessons and has meanwhile strengthened its deal management, as evidenced by the fact that the more recently contracted projects are relatively problem-free, whereas problems in the older part of the portfolio often emerged soon after disbursement.

Interrelations and the influence of FMO's work quality

The positive relationship between investment and development outcome noted for FMO-A also holds for the evaluated SEF and SC investments, with 42% of the investments producing a win-win result and 24% generating both poor development outcomes and poor investment outcomes. A further one third of the investments was developmentally successful, but generated poor financial returns.
SEF and SC contributed in equal parts to the mixed (developmentally good, financially poor) results. In the case of SEF, this was mainly the result of devaluations of local currencies leading to an insufficient Euro return; among SC investments, five of the financially unsuccessful projects still generated positive development outcomes. No SEF- or SC-financed projects paired good investment outcomes with poor development results.

As for FMO-A financed projects, we also find a strong correlation between work quality and outcomes in the evaluated SEF- and SC-financed projects. The good outcomes of SEF financed projects are associated with good overall work quality. Monitoring and supervision of SEF clients is the only area where work quality falls behind that of FMO-A. The low outcome success rates of SC financed projects are also reflected in frequent shortcomings in work quality; in only four out of the twelve evaluated projects, overall work quality was judged to have been satisfactory.



For SC, front-end work often was characterized by uncritically accepting a clustering of risks (start-up operations, unproven business concept, financially weak promoters) that was insufficiently mitigated through selection and structuring. To a large extent, risk clustering followed from the program's mandate, 'to provide risk-bearing start-up capital to new enterprises in developing countries, with a total invested capital of less than € 5 mln'.
Shortcomings in supervision and in fulfilling FMO's role are also related to the nature of the clients: being inexperienced start-ups, they require intensive monitoring and supervision, and would typically require FMO support in various areas other than the financial injection as such. The small investment size of SC investments on the one hand and staff capacity constraints on the other made it hard to ensure enough supervision, guidance and support.

II. Implications for policies and strategy

INTRODUCTION

FMO has, over the past years, continued to build its organization and expertise, succeeding in strengthening its position as one of the leading bilateral DFIs. Meanwhile, many of our markets have seen profound change. In some of our most active regions and countries, the financial sector has deepened significantly, private equity flows have multiplied in recent years, and economic liberalization and globalization have progressed at a rapid pace. In this context, FMO is, in 2008, developing its strategy for the coming years. Where is a DFI like FMO going to be most needed, how do we ensure continued additionality, and what has to be done to optimize our development impact while guarding our own financial continuity?

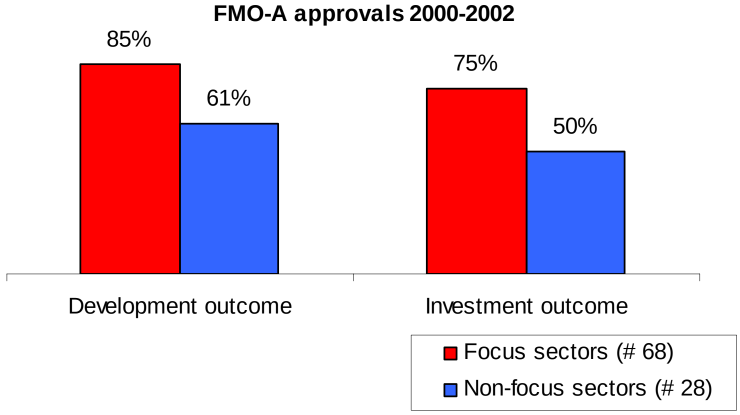
Evaluation findings can shed light on some of these questions, and the following paragraphs present our findings in the context of some of the choices that FMO is facing.

SECTOR FOCUS AND EXPERTISE

One of the strategic choices that FMO is facing is whether it should continue to focus on specific sectors and, if so, on what sectors. In 2000, FMO decided to focus not only on a limited number of countries, but also to limit itself in terms of the sectors it wanted to target. Sector choice was based on what we considered ourselves to be good at, and on where we were likely to be most needed. This applied to the financial sector (banks and non-bank financial institutions) and a number of infrastructure sectors (power and water, telecom and transport infrastructure). Deepening of the financial sector and broadening access to finance were seen to be particularly relevant to private sector development. The same applied to infrastructure projects as they provide access to basic necessities for people and business alike. Both, moreover, required the type of long term finance that was typically scarce in FMO's markets, thereby ensuring continued additionality. For the various (sub-)sectors, so called 'knowledge streets' were set up in order to build and share networks and expertise.

Evaluations of all projects approved in 2000-2002 demonstrate that 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, 85% of projects had good development results, and 75% generated good financial returns. By contrast, only 61% of projects in non-focus sectors had good development outcomes, while 50% showed poor investment outcomes.

Outcome success rates, focus and non-focus sectors; FMO-A approvals 2000-2002

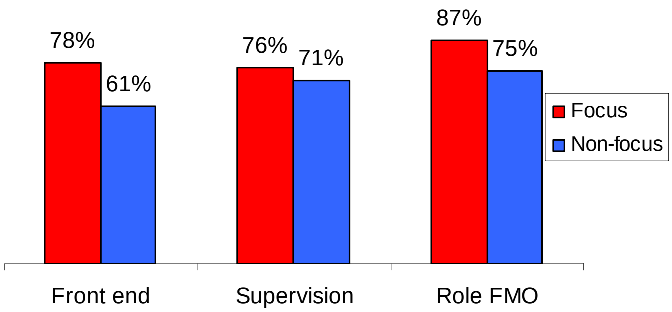


All 2002 projects that were evaluated as having been 'highly successful' in terms of development outcomes were either in infrastructure (power, telecommunication) or in the financial sector (leasing in South Asia, microfinance in Latin America, and housing finance in South Asia and Latin America).

Investments outside the focus sectors were made in agro-processing, in general manufacturing, in investment funds and in services, including ICT. Here, FMO was less experienced and had not developed specific expertise[5].

The very high success rates in focus sectors are striking. Moreover, they have a clear relationship with FMO's work quality:

% of projects with good work quality;
focus- and non-focus sectors, FMO-A, 2000-2002



As may be expected, the largest difference shows up in the quality of front-end work (which, as we saw, shows the highest correlation with outcome success rates). Developing sector expertise and building a network among the players in a sector helps to select the right clients and to structure transactions sensibly. In the financial sector – as we will see in the section on country focus below – the entire sector was typically mapped in focus countries, enabling FMO to select the partners that it wanted to work with, rather than to opportunistically finance the actors that happened to cross our path. Broad sector experience (and factors like development of sector-specific due diligence instruments, ratio requirements, etc.) clearly helped our performance.
In infrastructure, the knowledge street sector specialists were able to build strong relations with major international players, allowing us to follow them into countries where DFI funding was essential to get projects off the ground. Individual project evaluations in power and telecom illustrate that FMO had come to 'understand the business.' It knew what it was doing.
In focus sector projects, we were also more frequently able to play a good DFI-role, being highly additional and catalytic, and bringing value added to our clients wherever this was desired.

Looking forward, we are currently facing a landscape that is quite different from when we first developed a sector focus. In many of our markets, the financial sector has significantly deepened. While Central America's banking sector was highly fragmented and immature when we targeted it at the start of the millennium, it has meanwhile gone through a process of consolidation. International banks have entered the scene on a large scale and our additionality is getting depleted, as evidenced by shrinking margins and prepayments. A similar process is even seen in a country like Nigeria. Outside the financial sector, the need for DFI financing is also changing. Other than in the past, telecom providers for example can now finance their new investments from commercial sources in all but the most risky and difficult countries.
FMO will thus have to rethink its focus. This means identifying new niches in existing focus sectors – providing financial services to underserved sectors, regions or population groups, for example - , or developing a modified sector focus, based on what sets us apart (in terms of risks appetite or funding opportunities) from commercial banks. For example, long term finance, especially in local currency, is still needed and scarce for the housing and mortgage finance sector in just about all low and middle income countries. Mezzanine finance can make a big difference, especially to family owned enterprises in agriculture and manufacturing. And agriculture, despite recently booming commodity prices as a result of increased feedstock demand from Asia and increasing production of bio-fuels, continues to see underinvestment, as banks consider it to be a high risk sector.

[5] A knowledge street 'business of the future', focusing on ICT, was set up, but it quickly became defunct.

When looking at FMO’s past experiences with agriculture projects, we see that FMO historically had poor success rates. This does not mean that we should avoid the sector, but it poses questions as to how we may best play a role in it, and what expertise we should develop in order to be more effective. We already have some good examples, such as the support we provided to the sector in Argentina following that country’s 2001/02 crisis. This project scored excellently on almost all development outcome and work quality dimensions. Evaluations show us that clear choices, the development of proper partner and client networks and a solid understanding of our clients’ business and needs can make all the difference.

COUNTRY FOCUS, COUNTRY INCOME AND ADDITIONALITY

In 2000, FMO not only decided to focus on specific sectors, but also to concentrate its attention on a limited number of countries, where it would be better able to develop knowledge of the market, particularly within selected focus sectors. As we noted in earlier evaluation reports, this has indeed brought benefits. We not only gained good insight in markets in selected countries, but could also monitor and supervise our clients in a more efficient and effective manner. Therewith we avoided situations where we paid insufficient attention to clients in countries where we hardly did any business.

Looking at the evaluations of 2005-2007, we see that combinations of both a country- and a sector focus were very successful. A good example is Bangladesh. We carried out on-site evaluations of four of our projects there, and report on our findings in the box below.

FMO’s country focus illustrated: the case of Bangladesh

Bangladesh is one of the world’s poorest countries and is one of the Least Developed Countries (LDCs). Since its independence in 1971, Bangladesh has been plagued by political instability. High levels of bureaucracy and corruption negatively impacted the economy, and held back foreign investment. Thanks to economic reforms and high economic growth in the region, the economy has recently picked up speed.

Whereas FMO had already been active in Bangladesh for a long time (with mixed results in manufacturing, and an early response to liberalization of the financial sector), the country was selected as one of Asia’s focus countries in 2000/2001. The primary emphasis was to be on financial sector development, with a secondary focus on infrastructure.

In the nineties, the financial sector was poorly developed and dominated by large, inefficient state owned banks with high levels of bad debt. Opportunities were plenty for FMO, but how to start building up a portfolio in such a high risk environment? The first thing FMO did was to explore the financial sector. Having co-founded a new local bank in 1997 in which FMO played an active role, we had acquired a good insight in the country’s financial sector. In 2001, FMO started broadening its financial sector involvement by means of a Trade Enhancement Facility for six private banks, set up with IFC and Standard Chartered Bank. An improved TEF was launched by SCB and FMO in 2003, guaranteeing L/C payments for seven banks. Through these facilities, FMO extended its relations with local banks, building a network that functioned as an important source of information. As a result, FMO has become very active in the country’s financial sector, both via investments but also through various trainings it offers to banks (Asset Liability Course, E&S training). Some FMO deals really made a mark, such as the first microfinance securitization for microfinance institution BRAC.

FMO also succeeded in playing a role in developing the country’s infrastructure, providing scarce basic necessities, and helping to create preconditions for broader private sector development. To date, FMO invested in two successful power projects, addressing shortages that put a brake on development. Further progress in this sector has been hampered by the Government’s reluctance to proceed with wider sector liberalization and privatization. In recent years, FMO broadened its infrastructure focus to the telecom sector and social infrastructure (health care and education).

In 2007, four projects in Bangladesh were evaluated on the ground; two financial sector transactions and two infrastructure related investments:

Stimulating commercial banking and private sector investment
The first evaluation examined a USD loan to the bank that FMO had co-founded in 1995. The loan was meant for on-lending to larger and medium sized exporting companies who needed USD-financing for their import requirements (machinery, semi-manufactured products and other inputs). It was the first time that USD loans became available to companies through a private bank in Bangladesh. The evaluation showed that the bank was able to use the loan in a successful manner, especially during the first years when the demand was high. In total, nine exporting companies were granted loans that helped them to expand their businesses. At the moment, the bank is operating successfully as a medium sized bank. FMO has sold most of its shares but is still actively involved through various products. Development outcome was evaluated as ‘successful’, investment outcome and FMO work quality as ‘satisfactory’.

Starting up housing finance
FMO's role in the financial sector isn't limited to banks, but also includes non-bank financial institutions with specific (developmental) goals. We evaluated our investment in the first private home finance provider in the country. FMO supported this institution to stimulate the provision of long term mortgage loans to lower income segments. The evaluation brought out that mortgages had actually been provided mainly to the upper and middle income segments. The reason was that the market for lower income segments didn't exist yet; project developers were simply not building houses for the lower end of the market. Although not quite in line with FMO's original goal, the project did have positive developmental effects by stimulating the construction sector, an important provider of urban employment. Furthermore, the institution played an important role in the development of the mortgage sector in Bangladesh. It introduced new mortgage techniques and products and demonstrated that it is possible to profitably engage in mortgage lending. In the near future, the construction sector is expected to become more mature, so that it will eventually also target the lower segments of the market. Once that happens, the mortgage providers will also follow. Development outcome 'highly successful', investment outcome 'partly unsatisfactory', FMO work quality 'satisfactory'.

Powering the economy
As mentioned, FMO invested in two power projects in Bangladesh. During the past 5 years, the economy grew at a steady pace of around 5% to 6% per annum, but further growth is threatened by severe energy shortages. Due to decades of underinvestment in the power sector, Bangladesh's electricity generation per head is among the lowest in the world, leading to frequent blackouts and load shedding. We evaluated our 2002 investment in a 350 MW private power plant near the capital city Dhaka. It was one of the most efficient power producers in the country. By the time FMO joined as a lender, the plant was already operational. FMO refinanced a shareholder bridge loan, freeing up funds for new investments. The refinancing character of the deal meant that FMO's role in the overall project was limited. This also came to light during the plant visit. Apparently, it was FMO's first visit in many years, indicating that FMO's monitoring had been remote. Regardless of FMO's role, the plant was seen to be having a very positive impact. It produces cheap and relatively clean energy, using the country's natural gas as a resource. It also demonstrates that it is possible for a private power producer to operate in a sustainable manner in Bangladesh. Development outcome 'highly successful', investment outcome 'satisfactory', FMO work quality 'partly unsatisfactory'.

The bricks and mortar of development
Another good example of FMO's role in Bangladesh is a large scale cement project, lead-financed by IFC. Because of the very high risks involved and the huge investment size, the project could not be financed without DFIs. The project was set up to produce high quality cement, a very essential product for the country's construction and infrastructure sectors. The new cement plant meant good news for the local economy, as it was located in a remote region with few employment opportunities and little industrial development. As the quality of the cement exceeded that of most imported cement, while the price was actually lower, production would lead to reduced clinker and cement imports. The technologies used in the project were seen to have a relatively low impact on the environment, so the project would act as a best practice example for other cement producers in the country.
As the project was constructed, some of the potential risks that were identified earlier actually materialized, causing significant delays. After a standstill period, the plant recently started production again. With the country's economy growing, and an increasing demand for high quality cement, the project's future looks bright indeed. Because of the implementation delays, it was still too early to evaluate actual outcomes.

Another example of a successful country/regional focus strategy is Latin America's approach to the financial sector in Central America. This strategy was already developed during the second half of the '90s and was further rolled out thereafter. The region (Nicaragua, El Salvador, Honduras, Dominican Republic and Panama) was relatively under-banked (except for Panama) and other DFIs were not yet very active, meaning FMO had a first mover advantage. FMO invested in more than 23 financial institutions in the region. By providing scarce long term capital, FMO strengthened the capital base of these institutions and expanded their lending capacity. Most of the banks have now matured and have grown into solid banks. The sector has consolidated. Some banks have become important regional players while others have been taken over by larger international banks. As access to funding has increased tremendously during the last couple of years, FMO's role diminished and our loans were often prepaid. While these prepayments were not exactly good news for FMO's interest revenues, they actually confirmed that the strategy to stimulate the financial sector in the region had been successful.

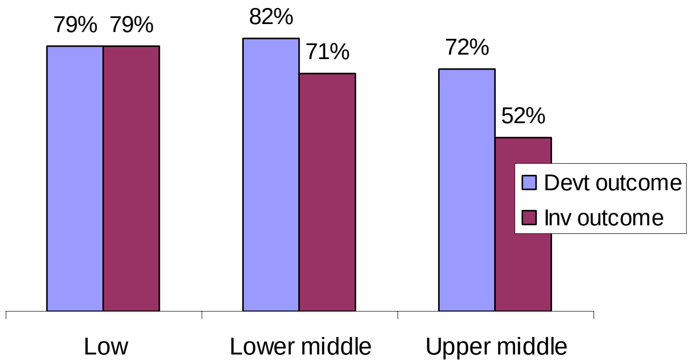
Finally, there is the case of Nigeria which became a FMO focus country in 2000. FMO was a frontrunner when DFIs started to show renewed interest in the country and its financial sector around the turn of the millennium. FMO aimed to set up a new banking portfolio in Nigeria and its activities had a highly pioneering character. As country risk was perceived as being very high, FMO chose to initially target the bigger and better performing banks because of their lower financial risk. FMO was also able to select these banks because other international banks were not interested in providing long term funding. FMO first financed two so called 'new generation banks' which had survived the financial turmoil during the '90s in a very good manner. More transactions followed and FMO's Nigeria portfolio now includes more than 10 banks.

We can conclude that focusing on specific countries, and on specific sectors within these countries, has much helped our effectiveness. It enabled us to pro-actively support clients that could make good use of our investments, and to better get to know our clients' playing fields and needs. It also helped us (1) to better monitor our clients' performance (partly because we also got to know their peers), (2) to, at times, put them in touch with useful business partners and (3) to more effectively provide support, e.g. through regional or country level banking courses and environmental and social training and advice. FMO is thus advised to avoid spreading itself too thinly, and to keep working with selected countries and selected sectors within countries.

Country income

In earlier evaluation reports, we have shown an unexpected inverse relationship between a country's income level and projects' developmental and financial outcome success rates. This still holds for the evaluations carried out in 2005-2007. In particular, good investment outcomes were much more prevalent in lower income countries than in upper middle income countries.

Development and investment outcome success rates by country income class, FMO-A approvals 2000-2002



This pattern is partly explained by 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 more often made in upper middle income countries, as these economies are seen as more attractive (in terms of fund raising opportunities, regulatory environment and exit opportunities). Interestingly, however, among evaluated equity investments, excellent equity returns were relatively more frequently realized in low and lower middle income countries than in upper middle income countries. At the same time, loans also frequently performed less successfully in the more advanced markets. In such markets, the financial sector is typically more developed, and FMO thus has to move to higher risk activities if it is to remain additional. The higher number of (often equity financed) clients in upper middle income countries that experienced business failures explains the lower development outcome success rate. We note, however, that also in the relatively more advanced markets the bulk of FMO's investments generated good development outcomes. At the same time, FMO typically was still able to play a good role as DFI here.

Evaluation experience to date thus suggests that there is no basis for the sometimes voiced opinion that FMO should balance its investments in high risk low income countries with low risk volume transactions in relatively higher income, 'safer' countries, in order to adequately spread its risks. It would be even less correct to say that FMO earns (or should earn) its money here, in order to cross-subsidize operations in the poorest countries.

GOVERNMENT FUNDS

Government funds have in recent years become an increasingly important part of FMO's activities. They intend to help FMO support investments that are highly relevant to development, but carry risks that FMO cannot (yet) prudently take on for its own account. In the first part of this report we reported on the outcome of 33 SEF- and SC-funded projects. We have also seen the first NIMF and LDC Fund investments pass through the evaluation process. And we have carried out an evaluative review of projects financed out of FOM.

In general, we can conclude that projects financed out of FMO-managed government funds make good contributions to development, and to the respective funds' specific development objectives. We also see that the former Seed Capital Program and FOM, aimed at relatively small start-ups with often less experienced sponsors and managers, have financed relatively many clients that have proven not to be economically and financially sustainable, and are thus unlikely to make a lasting development impact. FMO could not have served these clients economically for its own account. The Small Enterprise Fund has successfully channeled investment finance to small enterprises - in a manner that burdened neither the intermediary financial institutions nor the ultimate clients with foreign exchange risk. FMO could not prudently have taken on this risk. Meanwhile, quite some former clients of the fund have graduated to FMO-A, particularly since FMO has been able to arrange exchange risk cover through KOF and TCX.

We have also noted that relatively smaller clients (with relatively small investment amounts) typically require more support and closer supervision than more established and experienced clients. As such, they often received insufficient attention from FMO's staff. Amongst Seed Capital clients, for example, expectations about FMO support beyond the investment itself (in terms of active board involvement, technical assistance, etc.) were at times quite high. But FMO could not always deliver. If FMO does want to take on this type of project for developmental reasons, investment staff needs to be incentivized to devote the necessary time and attention to them.

To assure sufficient attention to higher risk government fund clients, FMO may wish to consider devoting more dedicated staff to managing government fund investments - both for new business and for monitoring and supervision.
This could also help to remedy another weakness that we have often noted in fund financed projects: poor monitoring of the achievement of fund objectives. With quite some SEF-financed clients, for example, it was hard to find out to what extent our housing finance or SME-loan had led to increased SME-lending or mortgage financing for intended target groups. In funds – with explicit development objectives – it is all the more important to monitor not just the client's credit risk, but especially also progress towards achieving the investment's expressed development objective.

PRODUCT CHOICE AND INNOVATION

In recent years, FMO has aimed to increase the proportion of equity and mezzanine investments in its portfolio. This was motivated (a) by the wish to better serve our markets and clients with scarcer types of finance (and thus to retain and increase additionality), (b) by the fact that such investments can have strong catalytic effects and thus a high degree of development effectiveness, and (c) by a desire to improve FMO's returns.

In contrast to our equity experience in the second half of the nineties, the above purposes have been achieved by the equity investments made five to seven years ago. Most have generated good development returns and demonstrate that FMO played a good role in serving its equity clients. FMO's profits were boosted in recent years by the returns on equity investments that we made in years when commercial investors were quite reluctant to venture into our markets. Investments benefited from the fact that FMO's equity investment staff had gained experience and learned its lessons from the often poorly selected investees and poorly structured equity investments of the nineties. But equity returns have equally benefited from the good performance of many of our markets in the years following the 2002 recession, which has meanwhile led to a booming emerging market private equity industry and vastly improved exit opportunities in quite some countries.

Well before we 'discovered' mezzanine finance as a strategic initiative, we had already started providing finance of a hybrid character: to ensure that, when providing a loan, we were not only accepting downside risk but could also share in the upside, or to mitigate the risks of providing straight equity. In the box below, we highlight some findings with respect to this early FMO experience with mezzanine finance.

FMO's early experience with mezzanine

Mezzanine finance is an increasingly important product for FMO, but what exactly is mezzanine? As defined by FMO, mezzanine capital is the layer of financing between a company's senior debt and its equity capital. For a financial product to qualify as mezzanine, we use the following characteristics:

- It ranks after senior debt and before equity; it is usually unsecured or formally subordinated;
- There is a self-liquidating element (either redemption of the loan/preferred shares or - in exceptional cases - equity with a put option on a creditable party at fixed price) AND
- It has an upside linked to the financial performance of the borrower/investee company (warrants, dividend, EBITDA linked interest etc.).

Among 2005-2007 evaluations, 11% of all the investments were mezzanine finance, with structures varying from subordinated loans with a variable margin to convertible loans[6]. Of these, 57% were funded out of FMO-A and 43% out of MASSIF. The financial return for mezzanine is determined by the interest margin on the one hand and the upside on the other. The higher the risk, the higher the total required return. The financial success rate of FMO's mezzanine deals was around 70%. In total, four deals had negative, or lower than aimed for, returns. The losses from these transactions were more than compensated for by the good returns in others. Three of the unsuccessful mezzanine deals were small start ups, financed from Seed Capital. In these latter transactions, we essentially took high equity risk while attempting to limit our downside.

When comparing the outcomes of mezzanine transactions with those of all 2005-2007 evaluations, certain issues become apparent. First of all, the quality of FMO's front end work is rated higher for mezzanine transactions: 79% score satisfactory or higher in case of mezzanine, against 63% overall. Mezzanine transactions also more frequently score excellent on work quality: 21% compared to 10% overall. A possible explanation is that the potential complexity of mezzanine products almost forces an investment officer to perform its due diligence very accurately, resulting in a good deal structure with a proper risk return.

Mezzanine structures can become quite complicated indeed. Some of the structures we evaluated were so complex that staff had difficulties calculating the returns to which FMO was entitled, especially as FMO's ICT systems were not suitable to administer certain structures. In one instance, we saw that a variable margin was not billed for two consecutive years. Due to staff changes and handing over of supervision responsibility, monitoring staff wasn't aware of the upside. In another case, FMO almost forgot to execute its warrants. These shortcomings were reflected in the lower score on monitoring quality, where mezzanine deals scored unsatisfactory in 36% of the deals, compared to 29% in total.

This clearly illustrates that there is significant room for improvement in the quality of monitoring mezzanine transactions. Mezzanine structures require very well informed project managers. Special attention should go to the handover of a mezzanine deal from the originating investment officer – who knows the ins and outs of the construction - to the project management department. During the handover, all the details of the complete structure (upside calculation, conversion rights, warrants etc.) need to be explained carefully. And last but not least, the Mid Office needs to be informed right from the start in order to make sure that the structures fit within FMO's systems, therewith securing the correctness of future invoices.

Mezzanine has proven its value, and FMO has learned from weaknesses in early transactions. Whereas, in the early years, we were quite pleased when we had negotiated 'some upside', we are now more carefully assessing the product's position on the loan-equity spectrum, in order to get pricing right. Administration of such products has also improved – for example by ensuring that warrants are administered as a separate product, and not as a characteristic of a loan -, thereby helping adequate monitoring and supervision. But our observations on monitoring weaknesses still give reasons for concern. While staff dealing with new transactions has acquired more knowledge of these products, the development of project management staff may not have kept pace. And there remains a clear risk that knowledge of the ins and outs of complex products is insufficiently imparted on portfolio management staff when project responsibility is handed over to them. FMO should thus ensure more careful handing over of project responsibility, provide

[6] For our purpose, we have excluded plain subordinated loans and tier 2 facilities where the return on our loan was not performance related.

more training to project management staff as well, and apply closer scrutiny to mezzanine transactions in the annual credit review process.

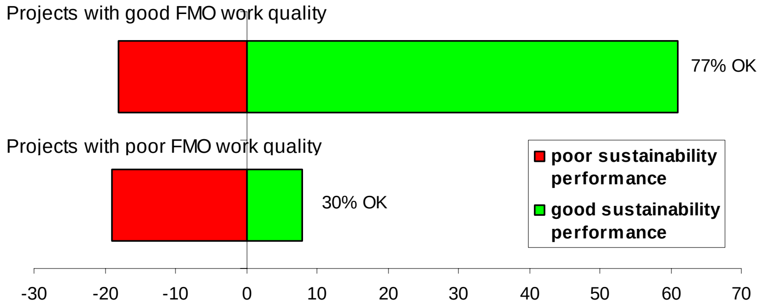
Going forward, product choice and focus are important strategic issues. FMO will have to let itself be guided by the requirements of its clients, tailoring its offered products to demand, and thus ensuring continued additionality. Mezzanine solutions can have clear advantages to both FMO and its clients, and equity finance – despite the recent boom in emerging market private equity – is still a scarce product in many of our markets.

SUSTAINABILITY

One of the development outcome dimensions that we evaluate is a client's environmental and social performance. We noted in earlier reports that clients with good business performance tend to 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. Paying attention to sustainability is thus typically not at odds with profitability. On the contrary, it is likely to be good for business, especially in the longer run.

Another relationship that we have been able to establish – as may be seen in the graph below – is that FMO's overall work quality is an important determinant of environmental and social outcomes.

Environmental and social performance, projects with good and with poor FMO work quality, evaluations 2005-2007



While this may partly be explained by autocorrelation[7], the relationship is still striking. Poor compliance with environmental and social standards or insufficient follow-up to E&S action plans can often be linked to inadequate due diligence of a client's a priori commitment to comply or to improve performance. Monitoring quality – whether we do or not we chase up on environmental and social reporting, and whether we pay monitoring visits to environmentally or socially sensitive clients – has an influence on outcome. And even FMO's role and contribution may be evaluated as having been unsatisfactory if, for instance, FMO promised to assist the client to establish good environmental and social management systems, and if such assistance is subsequently not provided.

Environmental and social outcomes of a project can be more than just good if clients serve as an example for others in their sector – as was the case with some evaluated financial sector clients – or if they make a direct and strong contribution to the environment or to social development. Examples of the latter were FMO's first forays into renewable energy (see Box below) and a number of investments in microfinance low income housing finance.

Renewable energy: hydropower in Central America

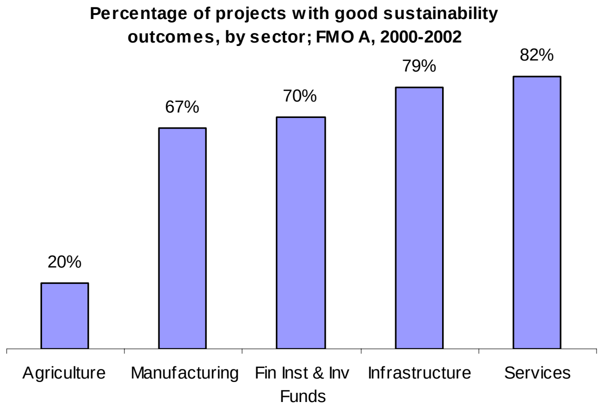
FMO was pleased to co-invest, alongside a multilateral DFI, in a Central American hydropower project, sponsored by a European multinational. The project showed a very strong financial and macro-economic performance, and contributed excellently to reducing carbon emissions.
The project was, at the start, difficult to finance from commercial sources alone, given its pioneering character. However, the financial success was such, that DFIs were no longer needed for the sponsor's follow-up investments in the country and the region. In fact, our additionality in the project itself was reduced shortly after project completion, when strong cash started to be generated.

[7] Environmental and social monitoring is, for example, one of the elements of work quality assessed, and inadequate reporting can lead to an unsatisfactory score on environmental and social outcome.

This case illustrates that FMO can play a good role in facilitating environmentally beneficial investments, but that a project's environmental impact alone is insufficient justification for FMO's financial support. As in other types of investment, in environmentally beneficial projects also we have to venture where private capital is in short supply. Environmentally and socially beneficial investments are likely to see underinvestment – as positive externalities can not be captured by the investors and because many such investments are innovative and (technically or financially) unproven – and may thus qualify for strategic targeting. Like any other sector or field of activity, this would require FMO to build relevant networks and expertise.

Projects with direct environmental and social benefits contribute to development in more than just the economic realm, and are thus worth pursuing (on the condition that they are also financially sustainable). In future, this will be encouraged by taking expected environmental and social impacts into account when assessing a project's development relevance. Because such projects generate positive externalities that cannot be captured by shareholders and financiers, there is likely to be underinvestment from a societal or global perspective, implying the possibility of strong additionality for DFIs. The latter is, however, still to be assessed on a case by case basis.

FMO differentiates its environmental and social efforts by projects' inherent environmental and social risk intensity, which is determined in part by the sector in which a client operates. Below, we show environmental and social outcome success rates by sector.



Only one of the five agriculture-related investments made in 2000-2002 managed to achieve a satisfactory level of environmental and social performance. In the others, agreed action plans were insufficiently carried out; in one case, the client's lack of willingness to carry through agreed improvements even led to termination of FMO's financing (see Box below). If FMO were to make a strategic choice to, in future, do more in agriculture, this would likely bring along significant challenges on the environmental and social side.

Growing and manufacturing sugar in East Africa

In 2007, we evaluated FMO's support to an integrated sugar grower and manufacturer in East Africa. Over time, FMO supported various investment rounds of this client, to increase production capacity and to consolidate the company's funding and, most recently, to improve fuel efficiency and to generate electricity – also for outside use - using the bio-mass left over once sugar has been extracted from the cane.
The company's activities are highly relevant to the country's development, it being one of the largest private sector employers and one of the largest – if not the largest – tax payer in the country. During due diligence, various areas were identified where the company would need to improve, in order to comply with World Bank guidelines on environmental performance (use of chemicals, water treatment, environmental health and safety) and with the ILO core labor standards (protective equipment, provision of drinking water, workers' representation).
As formalization and acceptance of an environmental and social action plan was not conditioned as a condition of first disbursement, follow-up was slow and insufficient (on the side of the client, but – to be honest – on FMO's own side as well, e.g. in responding in a timely manner to draft mitigation action plans). Although FMO had been given the impression that the client was sufficiently committed to meet our requirements, progress was slow and, in some areas, the client's willingness to comply became increasingly questionable.
Eventually, FMO cancelled the final disbursement of its loan, as disbursement conditions were still not being complied with. In 2007, we demanded / encouraged prepayment of the outstanding facilities because of lack of compliance. The client was able to attract means to refinance our loans – although of shorter tenors – allowing FMO to disassociate it from the company.

This case shows the importance of ascertaining a client's full commitment to required improvements well in advance, and of agreeing – where essential - on a well-defined, highly specific action plan (including a firm timetable) at the earliest possible stage: if not before signing the investment agreement, then at least before first disbursement.

Manufacturing clients also relatively frequently performed below agreed expectations, but the relatively high number of financial institutions with less than satisfactory environmental and social performance is maybe more surprising. 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 intensified in later years through the Netherlands Government funded Financial Institutions Program (FIP), which supplements FMO's own efforts to actively assist financial sector clients in improving their social and environmental management systems.

DEVELOPMENT IMPACT ASSESSMENT AND MONITORING

A sound project monitoring and evaluation system ensures that our evaluations are aligned with what we set out to do, and that the outcomes to be evaluated are also monitored. Moreover, an evaluation system that serves both the functions of accountability and of institutional learning ensures that lessons of experience emerging from evaluations are fed back into the organization's new operations. In the course of 2007, FMO has instituted several changes that serve to strengthen the project cycle, ensuring that the outcomes that we want to be held accountable for form the basis of our assessment in the project selection and approval process, that such outcomes are more systematically monitored (to enhance evaluability), and that lessons are more effectively incorporated in new transactions.

FMO's Development Impact Team has reviewed and revised the scorecard section that is used to assess – on the basis of a stakeholder analysis - the expected development outcomes of the investments that we support. Indicators for the expected impact on shareholders and financiers have been refined (introducing forward looking indicators, rather than taking the client's at approval risk profile as a predictor of the financed activity's profitability), and a new scorecard was developed for assessing the expected development outcomes of infrastructure investments (which typically affect different stakeholders than investments in other productive enterprises). These changes strengthen the incentives to select projects that, if successful as a business, make a strong contribution to economic development. Work was started to also bring the assessment of environmental and social performance in line with the new Performance Standards, and to incorporate expected environmental and social outcomes in the overall impact assessment and targeting process. This is expected to be completed in 2008.

As of 2008, FMO has also started recording, for all new commitments, base line and monitoring data on a number of general (employment, government revenue generation, effects on the balance of payments) and sector-specific quantitative indicators. This brings FMO in line with other members of EDFI, the association of European Development Finance Institution, and is meant to serve the same purpose as, say, IFC's Development Outcome Tracking System, DOTS: to, in future, be better able to report on specific development outcomes on an ongoing basis, and for the portfolio as a whole, and to strengthen the basis for evaluations. To date, evaluations have, at times, been hampered by the fact that monitoring and annual credit reviews have often focused almost exclusively on client risk, while insufficiently tracking progress towards investments' expressed development objectives.

Finally, the feedback loop from evaluations to new transactions has been strengthened by having Evaluation Unit staff sit on the Finpre-committee, the committee that clears early leads for further due diligence. The role of the Evaluation Unit's representative is to ensure consistent development impact and additionality assessment at the earliest possible stage, and to be sufficiently acquainted with newly proposed transactions to provide the deal team with a number of relevant lessons of experience – from Evaluation's Lessons Learned Database or otherwise – to be addressed during due diligence and in the final investment proposal.

To : FMO Supervisory Board
From : FMO Management Board

Re : **Management Board Reaction to the Annual Evaluation Review**

We are pleased to present to you the report "Informing Policy and Strategy" – the Annual Evaluation Review 2007/8 – from our internal Evaluation Unit. As Management Board, we welcome the conclusions and findings, which to a large degree provide support to the strategic choices that have been made in the past and provide valuable lessons and recommendations. These form valuable input for the currently ongoing new strategy formulation for the period 2009 – 2012.

It is very gratifying to see that the 2002 vintage of projects financed by FMO, has generated the highest development outcome success rate ever. This in part reflects the favorable timing of these investments within the economic cycle, but also a further improvement in FMO's quality of work, confirming that the investments in the further professionalization of FMO's staff and organization are bearing fruit.

When reading and interpreting the findings of the evaluations, it should be kept in mind that these are based on individual project findings and a specific evaluation methodology, that do not necessarily cover all relevant aspects of our operations. For example, when calculating the financial returns for FMO, transaction costs are not taken into account, creating to a certain extent a relative bias. Furthermore, important portfolio aspects such as risk diversification and dynamics over time are not considered.

With respect to the specific recommendations for improvement in FMO's operations, we would like to comment as follows:

i) "***room for improvement in the management and supervision of mezzanine transactions"***: The Management Board recognizes this for this relatively new and complex type of product. One of the steps recently undertaken to remedy this, has been the setting up of a separate so called Knowledge Community for mezzanine, to further develop and disseminate the knowledge of this product within the organization;

ii) ***"monitoring of social and environmental performance … often shows shortcomings and should be strengthened"***: To improve the effectiveness of our E&S work, last year most of the previously centralized E&S experts within the Investment and Review Department (IMR) were transferred to the front-office with the aim to improve the cooperation with the front-office staff, thereby truly integrating E&S aspects within our core business. The remaining 2 E&S experts within IMR are, next to E&S policy development, responsible for checking the work quality of the front-office, thereby creating a clear functional separation of responsibilities. We expect this new organizational set-up to gradually improve our E&S performance in the coming years. Notwithstanding, we note that the level of our E&S activities is a continuous balancing act between ambition and costs. At the same time it is good to realize that among its peers, FMO is a front-runner and closest behind standard setter IFC.

As in previous years, we very much appreciate the work of our independent Evaluation Unit as it helps us improve our effectiveness as a development bank and to be accountable to our stakeholders.

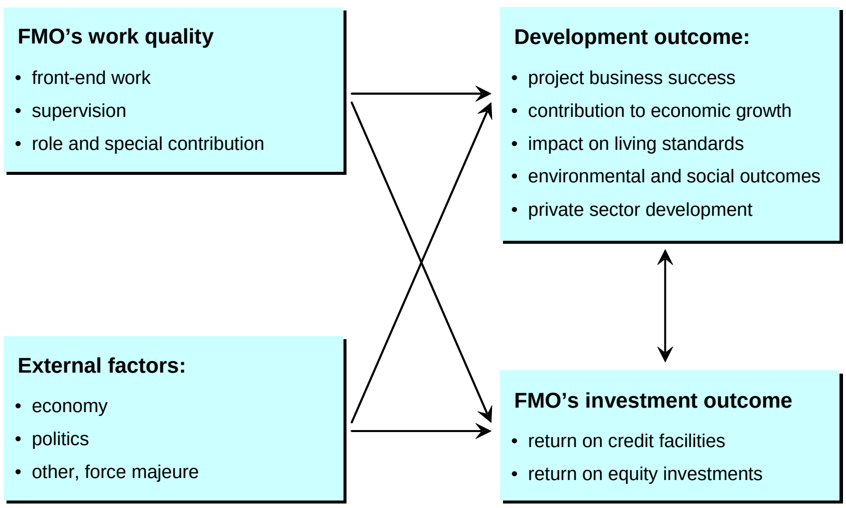
Annex 1. FMO's Project Evaluation Framework

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.



The graph shows the elements that we look at in each of the three evaluation dimensions. Evaluation standards for each of these elements are laid out in detailed evaluation guidelines.

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.

Annex 2. Impact assessment versus Evaluation

Ideally, outcome evaluations are fully aligned with how an institution like FMO assesses, ex-ante, what outcomes it expects to achieve with its investment activities, as well as with monitoring the realization of such outcomes. When the evaluated projects covered in this report were approved, FMO did not yet have a systematic approach to ex-ante impact assessment. Investment proposals included a paragraph on the perceived developmental merits of the investment and on FMO's role in the project, but this could be phrased in very general terms. Around 2001 a project scorecard was introduced, initially focusing primarily on client and investment risk assessment and monitoring, but already with a rudimentary section to assess a project's 'financial-economic impact', or FEI. No processes were, as yet, in place to guard correct – or at least consistent – scoring, and the FEI contained a somewhat arbitrary list of potential development benefits.

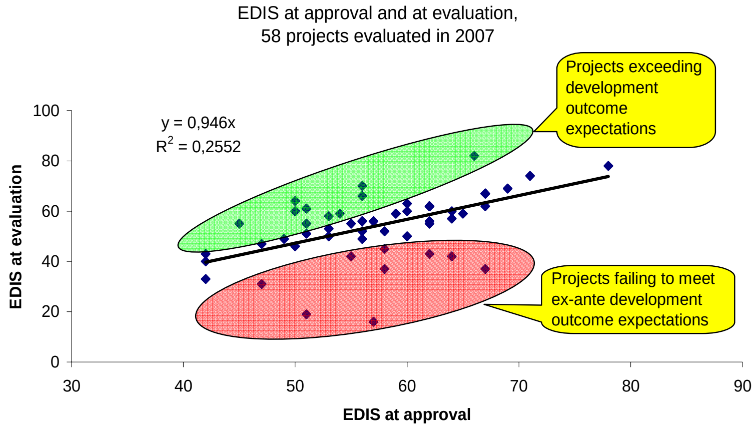
Only in 2005, FMO developed its Economic Development Impact Score or EDIS, a tool to assess expected economic benefits by going through a full (economic) stakeholder analysis (specific to how investments typically produce external benefits, so differently for financial institutions, productive companies and investment funds). Proper procedures – applying the four eye principle – were introduced to ensure quality and consistency. The impact assessment framework continues to evolve, economic impact assessment having been further fine-tuned in a revised scorecard introduced for 2008, while environmental and social impacts are planned to be integrated with economic impacts later in the year[8].

We have, last year, applied the EDIS section of the scorecard to all evaluated projects (both from FMO-A and from government funds), reconstructing the 'ex-ante' score by retroactively scoring on the basis of information in the investment proposal[9], and scoring the same projects 'ex-post', on the basis of outcome information available at the time of evaluation. Using these data, it has been possible to answer two important questions:

- To what extent have projects approved in 2002 realized the economic development effects that they were expected to achieve; and
- Is FMO's development impact assessment framework in line with its evaluation methodology?

Expectations versus outcomes: did projects achieve what they set out to do?

The graph below plots the reconstructed ex-ante EDIS against the EDIS at evaluation, for all projects evaluated last year.



The graph shows that many projects just about generated the development outcomes that they were expected to achieve, while projects failing to meet ex-ante expectations were largely balanced by projects where initial development impact expectations were actually

[8] While no annual monitoring system for such benefits has been set up (as, for most types of investments, outcomes typically only become visible after several years) FMO is currently introducing a set of general and sector specific quantitative indicators, to be annually monitored (employment created, government revenues generated, etc.) in order to substantiate claimed development effects.
[9] At times, this involved a degree of conjecture, as development outcome objectives were, in 2002, not always systematically and explicitly stated in the proposals.

exceeded. There is a fair degree of correlation – confirming the predictive value of the EDIS as an assessment tool. The slope of the regression line shows that the projects realized, on average, 95% of their expected development impact (as measured by the EDIS). Because projects exceeding expectations were, on average, larger than underperforming projects (which include, for example, some poorly performing small investments from the Seed Capital Fund), the projects' combined development impact (EDIS times Euros disbursed) was as high as 99% of original expectations.

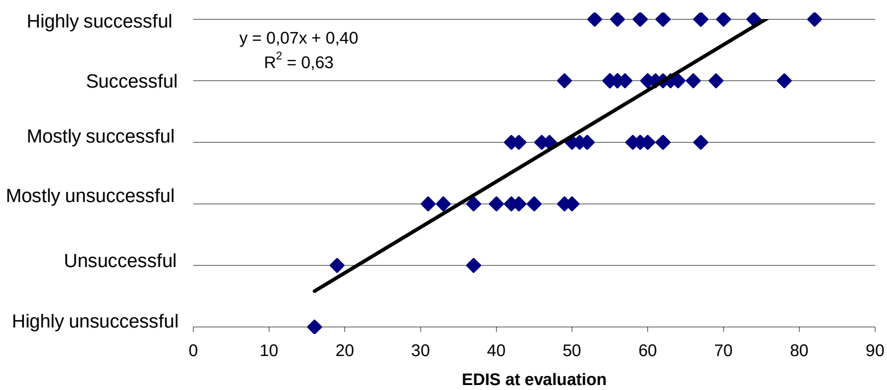
Clearly, such a high degree of achieving expected impacts is exceptional, and is largely due to the favorable economic climate in emerging markets in which the 2002 investments bore fruit. Normally, and given the risky environment in which FMO operates, realizations would be well below expectations, as a proportion of project fails as a business proposition, while exceeding the 'as planned' expectations would be exceptional.

Our 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 projects with high impact potential, while avoiding those with a very limited expected impact. FMO has begun doing this in a systematic way in 2006.

Are ex-ante impact assessment and evaluation aligned?

It is important to establish how the scorecard way of evaluating realized economic development impact compares with the development outcomes as measured by our evaluation methodology. The graph below compares the EDIS at evaluation for 2006 project evaluations with each project's development outcome evaluation rating.

EDIS at evaluation and Development Outcome Rating, projects evaluated in 2007



It is encouraging to see that the two approaches to development outcome evaluation show a very high correlation. The EDIS largely measures what is also assessed at evaluation: a project's contribution to economic growth, which consists of the project's business success (impact on shareholders and financiers) and the effect on living standards (impact on other economic stakeholders). Even the outcome on broader private sector development is captured in de EDIS (through items like the impact on suppliers or the impact on financial sector development). What the evaluation methodology does take into account – and the EDIS doesn't – are a project's outcomes in the environmental and social domains. As the assessment of environmental and social impacts will, in future, also be dealt with in a more integrated manner, the scorecard appears to be developing into an ever better tool for future ex-post evaluations as well. This tool will gain further in strength as it is going to be complemented by monitoring of quantitative indicators of macro-economic effects (employment, government revenues and balance of payment effects) and sector specific development outcome data (e.g.: numbers of small enterprise or mortgage loans provided, numbers of households connected to the power grid or provided with piped water).

Annex 3. Supporting documents and data

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

1. FMO's project evaluation process and procedures in 2007: a description
2. FMO's 2007 evaluation instruments: evaluation form and detailed guidelines
3. Determinants and characteristics of the 2007 evaluation population
4. Statistical analysis of the 2007 evaluation outcomes
5. Combined analysis of the 2005-2007 evaluation outcomes

Previous evaluation reviews:

AER 2002: "Every project tells a story" (in Dutch; summary in English available)

AER 2003: "Resultaten in Ontwikkeling" (in Dutch; summary in English: "Results in Development")

AER 2004: "Looking back, moving forward" (in Dutch; summary in English available)

AER 2005/06: "Targeting development"

AER 2006/07: "Going for results in private sector development"