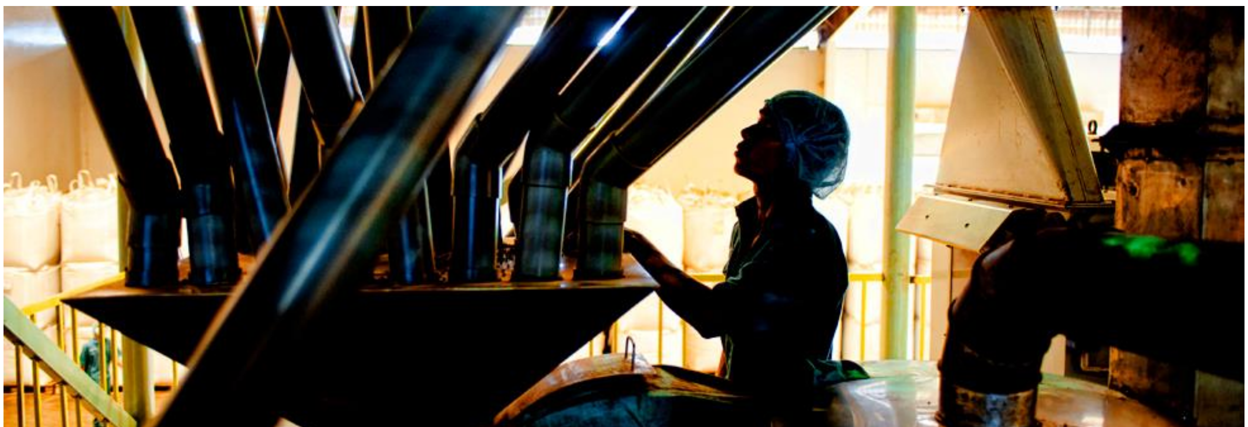
FMO EVALUATION REPORT 2012/2013

Mind the Gap: Expectations versus Realizations of Project Outcomes



Evaluation Unit
Investment & Mission Review
March 2013

Note to the reader

FMO's 2012/13 Annual Evaluation Report is a concise presentation of the findings from project evaluations carried out by FMO's internal Evaluation Unit in the course of 2012.

Any opinions and conclusions contained in this report are those of FMO's Evaluation Unit, and are based on evaluation findings. They do not necessarily coincide with the views of FMO's Management Board.

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

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HIGHLIGHTS AND RECOMMENDATIONS

This is an evaluation of FMO projects committed in 2007. In some instances, we have reported on the evaluations of 2005-2007 commitments to reflect a moving average. Overall, this year's evaluations have led to the following main findings:

- Development outcome is measured across three indicators: a project's business success, its contribution to economic growth and environmental and social outcomes.

- The broad picture observed for investment commitments of 2004 up to 2007 from FMO's own account, is that of a trend towards fewer projects making strong contributions to development, with a historical low in the 2007 commitments (54%). The 2007 investments were made during a friendly economic environment but confronted with the global financial crisis at a very early stage. The decline in development outcomes success rates, illustrates dependence on external conditions including country crises which mostly affected the ECA region (Ukraine, Kazakhstan, Azerbaijan and Russia) resulting in underperformance. The downward post-crisis trend is also observed by other development banks, like IFC.

- Despite the poor development outcomes, evaluation results of 2007 commitments show that FMO played a satisfactory role in 76% of evaluated projects. What this means is that in these projects, FMO was often financially additional, catalyzed funding and positively contributed to standard improvements in any of our clients' environmental and social, business operations and corporate governance aspects.

- Past evaluation results have shown that FMO generates better development returns in the infrastructure and financial sector investments – focus sectors in which it has developed most expertise. Although this pattern still holds for FMO's infrastructure sector, evaluated financial sector investments (banks and Private equity funds) of 2007 have illustrated higher sensitivity towards the financial crisis.

- Projects in which FMO invested in equity in 2007 compared to 2006 vintage year did not perform well from a business point of view, which consequently negated their ability to produce good development outcomes. Among the private equity fund investments that exhibited emerging development results, we lacked information to assess development outcomes at investee company level. The largest equity investment of FMO in 2007 has been TCX; an innovative spin-off of FMO facilitating local currency financing.

- Among the evaluated projects committed in 2007, approximately 46% under-achieved their projections from a business point of view: half of these projects were marginally profitable as a result of which their business success was rated as 'partly unsatisfactory'. The other half clearly declined in performance. Never have gaps between projections and realizations been so large in FMO's 11-years evaluation history.

- Evaluation results of 2005-2007 commitments reiterate the fact that FMO's investments more frequently produced successful development outcomes in low and lower-middle income countries than upper middle-income countries. Projects in upper middle-income countries (particularly ECA) witnessed a combination of contagion effects of the (European financial) crisis and domestic country crises.

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- Despite the crisis, a remarkable proportion of (pre-crisis) FMO investments produced good investment returns. While our loan investments perform very well so far; illustrating improved credit risk management of FMO. Preliminary evidence suggests that 2007 vintage equity investments underperform versus previous vintage years. Almost all of the 2007 vintage equity investments are still in FMO's portfolio, thus evaluation results are based on interim market valuations. Development outcomes and FMO's investment outcomes still shows a sizable correlation but the gap (proportion of projects with good financial returns and poor development outcomes) has increased over the last years.

- FMO remained highly (financially) additional in two-third of the investments committed in 2007. Yet, financial additionality was insufficiently substantiated and/or assessed as limited for the remaining one-third of investments. Additionality came under pressure around 2007 mostly as a result of the influx of liquidity into FMO's markets in the years preceding the crisis and assessment method at the time was less objective. We have indications that additionality has become less questionable post-crisis due to changed market circumstances, and a more objective measurement framework.

- Investments from FMO-managed government funds allow FMO to support activities with a higher development impact potential through clients that are considered high risk. It is not surprising therefore that their investment and development outcomes success rates are lower than FMO-A in 2005-2007 commitments. Among the government funds, Massif fund, focused on MSME financing are by far the best performing in terms of development and investment outcome. Outcomes can be attributed to the diversification of investments in their portfolio which helps maintain the fund's revolving nature. FOM investments produced high failure rates on development outcomes. IDF as well as AEF fund also produced high failure rates although the limited number of evaluated projects does not allow for strong conclusions.

Recommendations:

- Projections vs. realizations; gaps between projects' projections and realizations can be substantial – thus for any result management framework, a feedback loop which takes the actual realized development impact into account is a necessary element, and a pre-condition from an external accountability perspective.

- Over the last years, the reported development results have been heavily influenced by external conditions. We will review the existing methodology in order to mitigate this influence, and at the same time align with best practices available.

- Development outcomes of private equity investments; Investee-level development outcomes are hardly captured, thus difficult to quantify and demonstrate, and hence potentially undermines FMO's external accountability. FMO would benefit from setting up an investee level database to register development indicators, also recommended by an earlier internal evaluation studies on private equity funds.

- FMO's additionality; Additionality was insufficiently substantiated and/or assessed as limited in one-third of 2007 commitments - this pattern was also observed among low(er) income country projects. We note that current definition of additionality can be made more transparent in this regard.

- FMO-managed government fund projects; the high failure rates of government fund projects are understandable given their high-risk mandate. However, taking on projects that are too risky can threaten the revolving nature of the funds, hence their overall development effectiveness.

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INTRODUCTION

Evaluations are essential for accounting for development impact of our investments. By evaluating, we learn of what works and what does not work. By revealing the success factors as well as factors for failure, it helps us understand what we need to do more or, less of, to keep achieving our mission as a Development Finance Institution, DFI. For more on our Evaluation framework, see Annex. 1.

Historic Overview, Global Events 2007-2012

Through increased liquidity, worldwide and economic growth in a number of emerging markets in 2007, many of FMO's 'traditional' target countries attracted commercial finance for lower risk segments- this was a welcome development. As a result, FMO exited some markets (Brazil, Mexico and Russia) and pushed the margins of additionality by moving strategically and purposefully into new markets and specifically into segments that are considered still too high risk by commercial investors. Such segments include: banks providing housing finance to low(er)-income families, underserved market segments and small- and medium, MSME-sized businesses lacking access to commercial financing. The years following the economic boom in 2007 have seen a record crisis that has affected emerging markets, particularly in Eastern Europe and Central Asia ECA. Our portfolio clients in emerging markets have experienced this crisis-effect as well, manifesting itself in a decline in the percentage of successful projects from a business point of view, mostly in business cycle-sensitive sectors; financial and manufacturing sectors.

FMO's 2007 Investment Commitments

In 2007, FMO entered into a record level of new commitments. For the first time, it exceeded its EUR 1bln milestone, by committing EUR 1.3bln (FMO-A: 79%; Government Funds 21%). It was a good year in terms of portfolio growth with local currency financing increasing to 17% (2006:13%). FMO's commitments increased to (36%) in low and (45%) in lower middle-income countries - mostly Africa and Latin America, and 19% in upper middle-income countries. Sector composition included: financial sector (58% - with a record share in Private equity funds), infrastructure (22%), trade and industry and others (20%). Commitments for FMO-managed government funds went up from EUR 229mln to EUR 243mln, consisting of Massif- EUR 160mln; FOM- EUR 33mln; and AEF/IDF- EUR 50mln.

Evaluation Report Sample

A total of 80 projects (50%) of the 161 projects where FMO invested in 2007 were randomly selected into the sample for the 2012 evaluations; 16 of these were not evaluated (9- recently evaluated; 6- cancelled/not disbursed; 1- not completed). We ended up evaluating a sample of 64 projects from the 2007 investments, of which 11 have been repaid/prepaid/exited by YE2012. Overall, this report is based on the 64 projects of 2007 commitments and (previously evaluated) commitments of 2005-2006 totalling 148 projects[1]. FMO-A: 90 and Government funds: 58 (Massif: 35; FOM: 15; IDF: 8 and AEF: 2).

Outline and Structure of the Report

The rest of the report starts with a description of trends and patterns in project development and investment outcome success rates, analysis of the interrelation between development and investment outcomes. This is followed by a discussion of performance by FMO's focus and non-focus sectors and country income levels[2] and the role and contribution of FMO for projects financed out of FMO's capital (referred to as FMO-A). Separate assessments are then made for projects financed out of FMO-managed government funds, since investment objectives vary and may lead to different outcome patterns.

[1] (2007 sample accounts for 43% of the three-year sample - the higher number of projects in 2007 may impact overall results).

[2] Note: The country income segmentation is based on the World Bank country list definitions, as per 2007, For more information on World Bank country list definitions visit http://data.worldbank.org/about/country-classifications

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1. Outcome Trends and Patterns: Investments for FMO's Own Account, FMO-A

Development Outcome:

A project's development outcome is measured across three indicators: project's business success, its contribution to economic growth/private sector development and environmental and social outcomes. Business success is strongly correlated with other development outcome indicators, and overall development outcomes

Development outcome success rates have varied between the 1990s and trends observed for the most recent years – highest outcome success rates were observed in the periods 2001-2003 and have been declining thereafter with a historical low in 2007 (fig. 1a). 54% of the 2007 investments evaluated last year, produced good, i.e. 'satisfactory' or 'excellent' development outcome success rates.

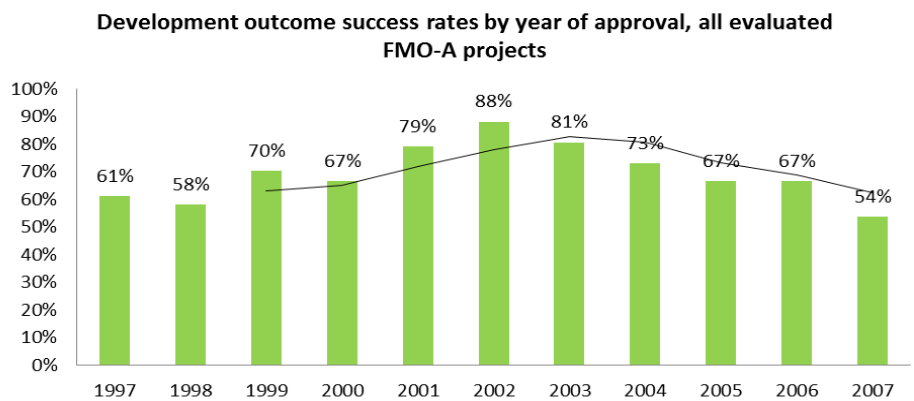


Figure 1 a

This decline is also seen in the three-year moving average consisting of projects committed in 2005-2007 (see line graph above). Factors contributing to this decline may, partly, be a consequence of:

Economic crisis: The 2007 investments were made at the peak of the economic cycle and were confronted at a very early stage with the global financial crisis that erupted in 2008. The direct and indirect effects of the crisis (including country crises in Kazakhstan, Ukraine, Russia and Georgia) affected emerging markets, as well as our portfolio clients in these markets. The financial crisis later manifested itself in a decline in the percentage of successful projects from a business success point of view, consequently resulting in lower development results. Similar patterns were observed by other DFIs[3] (data is not available for FMO) for projects approved just before the 1997-98 Asian-crisis.

Changes in the composition of sector/regions overtime: FMO's sector and country composition has changed over time (2001-03 vs. 2005-07). It could therefore be argued that the balance may have shifted towards regions and sectors with lower likelihood of successful development outcomes - therefore we explored this further. We observed, from the evaluation data (2001-03 vs. 2005-07), a shift towards more

[3] Results from the IFC link , link and European Bank for Reconstruction and Development (link) also show similar trends for pre-Asian crisis investments.

financial sector investments and investments in upper middle-income countries. This might have contributed to higher business cycle sensitivity.

Business success ratings are often based on comparing actual results to projections[4]: Among the projects committed in 2007, approximately 46% underperformed vis-à-vis their projections from a business point of view. Half of these clients reacted relatively (financially) well to the crisis in absolute terms but business success was rated as ‘partly unsatisfactory’, while the other half clearly declined in performance. Because project’s business success shadows and continues to largely drive overall development outcome success rates, these projects in turn, less frequently produced good development returns. Gaps between projections and realizations can be substantial – this reiterates that any result management framework requires a feedback loop of ex-ante assessment and monitoring and evaluation.

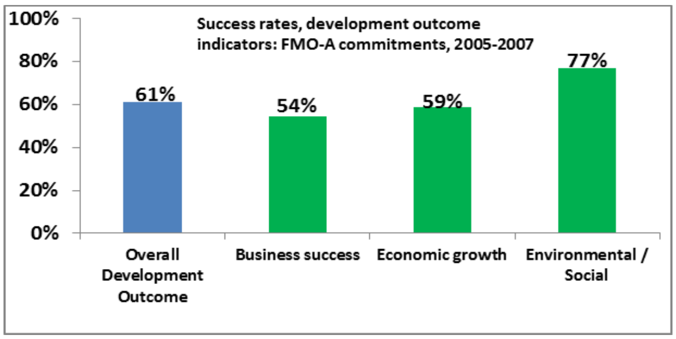


Figure 1 b

Proportion of 2005-2007 evaluations scoring positively (satisfactory, excellent) on each determinant of overall development outcome is illustrated in fig. 1b: business success (54%) has demonstrated to largely drive overall development outcome success rates at 61%. Strikingly, projects’ E&S outcomes were often very successful at 77%, which is partly attributed to a ‘satisfactory’ rating assigned to a few low E&S risk (C) projects[5]. Since 2009, FMO increased attention to sustainability – although this may have played a role, we did not explore it further for lack of evaluative evidence. In few cases where business success was rated ‘partly unsatisfactory’, the projects still managed to generate good development returns - this was mostly observed for telecom projects[6].

Investment Outcomes

Despite the crisis, investment outcome success rates of projects committed in 2007 remained relatively stable at 77% (fig. 1c) - often reflected FMO’s choice for loan products that generally come with a downside protection for investors. The better loan outcome illustrates FMO’s increased banking expertise.

Project investment outcomes assess the extent to which FMO has realized or expects to realize the loan/equity returns expected at approval

[4] Regardless of how the projections measure up with time and internationally accepted standards), yet performance ratings would be best assessed against an objective measure of performance such as a benchmark rate of return.

[5] Low E&S risk clients (category C) are in principle rated ‘satisfactory’ on E&S outcomes except there is any material reason not to.

[6] This is due to a combination of the low E&S risk (C) ratings, as well as the direct and potential multiplier effects on economic growth of telecom projects (see Ajiboye O.J et al (2007) http://www.jiti.com/v07/jiti.v7n2.131-144.pdf).

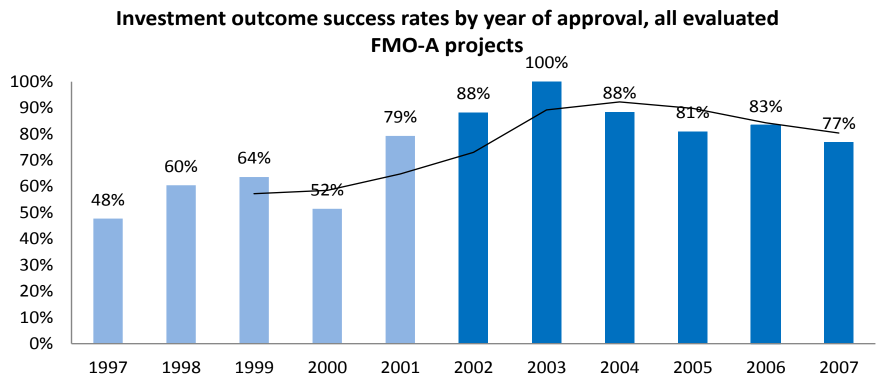


Figure 1 c

Preliminary evidence suggests that 2007 vintage equity investments show poor investment outcomes. This is due to lower equity valuations in Emerging Market stock markets (fig. 1d). This mixed reversal in (unrealized) returns manifests itself in a drop in the percentage of successful equity investments from a business success point of view and lower returns to shareholders. Most of the 2007 vintage investments are still in our portfolio, so evaluation assessments are based on interim market valuations. Usually on a portfolio basis, it is normal that a few highly successful equity investments compensate for less successful ones.

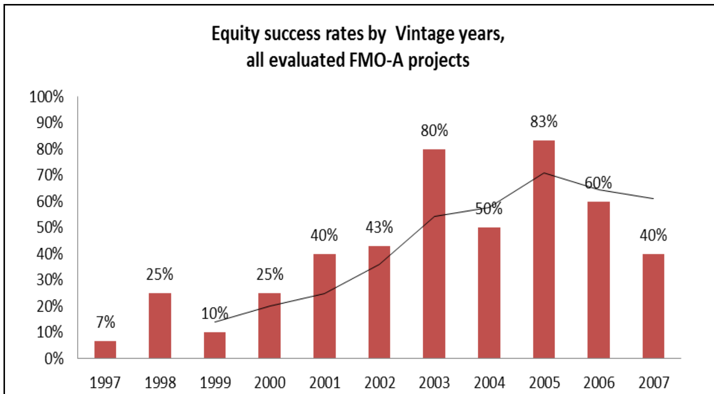
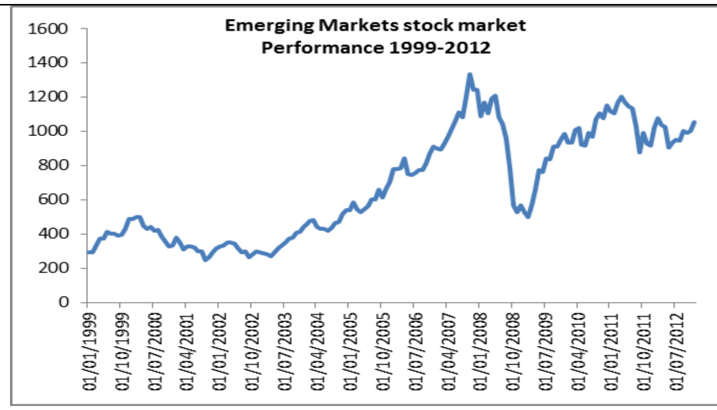


Figure 1 d



Source: MSCI Emerging Markets Index, Bloomberg

2. Interrelations between Development and Investment Outcomes, FMO-A

Having described the trend of FMO's development and investment outcome success rates, we now refer to the correlation between them. The graph below (fig. 2) shows the results of project evaluations based on the three-year moving average (2005-2007). Among the projects committed in this period, 57% (2011: 65%) realized a win-win outcome (simultaneously good development and investment outcomes) and 16% (2011: 13%), lose-lose outcome. In other words, development outcomes and FMO's investment returns still remain closely associated, with 73% (2011: 78%) of the evaluated projects producing either a win-win or lose-lose outcomes. Development outcomes and FMO's investment returns always go hand-in-hand as long as clients are selected on their potential for good contributions to development as well as financial sustainability. In that case, projects that succeed in reaching their expected business objectives contribute to development and are able to meet financial obligations to financiers. Nevertheless, we are beginning to see an increase in the gap between them (i.e. proportion of projects with good financial returns and poor development outcomes).

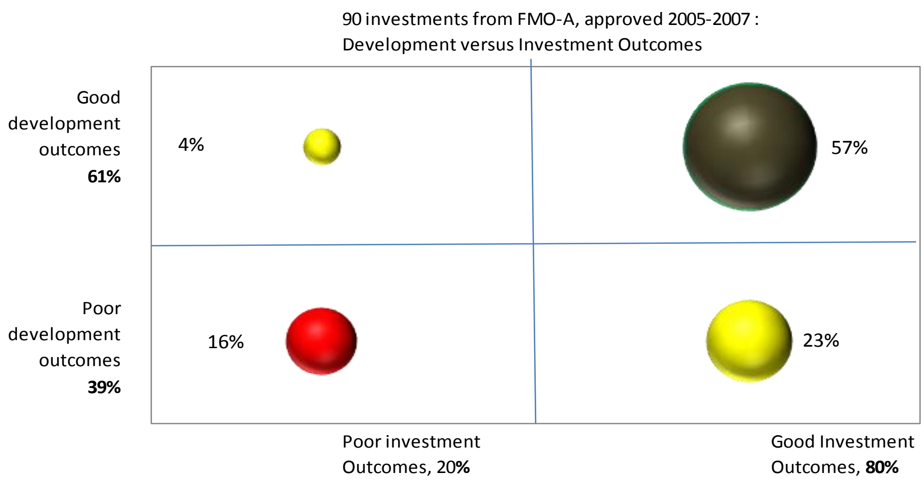


Figure 2

The rise in the proportion of projects producing poor development outcomes but good financial returns to FMO occurs because clients show weak business performance and low profitability, but still managed to service their loan obligations. The marked increase to 16%, in the proportion with lose-lose outcome on both dimensions (which is often expected in an economic downturn) consists mostly of risky equity and near equity investments in FMO's portfolio.

Poor Development vs. good Investment outcomes: Manufacturing	Poor Development vs. good Investment outcomes: Bank
FMO provided a USD funding to an Asian company that manufactures garments and sportswear for premium brands worldwide. 100% is exported, 90-95% to USA. The funding was to be used for building a new (and refurbishing existing) factory. It was expected that the project would lead to increased jobs, foreign currency earnings, taxes and additional off-take from local suppliers. At approval, main risks identified were competition and export country concentration risks. Although currently completed, client experienced construction delays during which they outsourced production at a higher cost to other companies in order to cope with orders from off-takers. Due to the economic crisis, client witnessed a decline in global demand for garment products, as a result of which they increased supplies to the local markets. Following the depreciation of the local currency and the absence of a hedging policy, our client incurred foreign currency losses, which in turn affected business success. The latter culminated into a weaker financial performance and subsequent inability to deliver on expected development objectives. Nevertheless, client managed to repay loan with the help of additional capital injections from shareholders which resulted in satisfactory' rating in investment outcomes.	A rapidly growing bank in ECA region to which FMO provided a long-term mortgage facility. Client was mostly focused on mortgage loans and slightly on consumer loans (at approval of our loan, their mortgage/consumer loan portfolio stood at a ratio of 70:30). But over time, the intended mortgage portfolio growth was hardly achieved as a result of the Central Bank prohibiting hard currency lending to individuals, effectively wiping out our client's mortgage business in addition to the global financial crisis that particularly hit Ukraine in the ECA region. There was substantial devaluation and decline in real estate prices and profitability deteriorated significantly. In order to counter these developments, our client changed its strategy and increased its focus on short-term retail/consumer lending, next to the attention it had to pay to successfully workout its mortgage portfolio that was suffering from the effects of the crisis. As a result of the latter, the client barely performed in line with initial financial and developmental expectations, resulting in 'partly unsatisfactory' ratings. Furthermore, FMO indicated support for client to launch an SME credit line but client abolished this intention to launch SME as a full business line. FMO's loan was later prepaid in 2011, which resulted in 'satisfactory' ratings on project's investment outcomes.

3. PERFORMANCE BY SECTORS: FOCUS AND NON-FOCUS SECTORS, FMO-A

In 2007, FMO was a region-based organization and within the regions, focus was on financial sector (a combination of financial institutions/banks and Private Equity funds PEFs), broad infrastructures and 'other' (non-focus sectors). For the purpose of these evaluations, we have applied sector definitions[7] as used in the 2005-2007 period. In the past, evaluation results have shown that FMO generates better development returns in focus sectors in which it is specialized and has developed expertise. This pattern still holds for infrastructure sector projects but is no longer the case for financial sector projects (fig. 3).

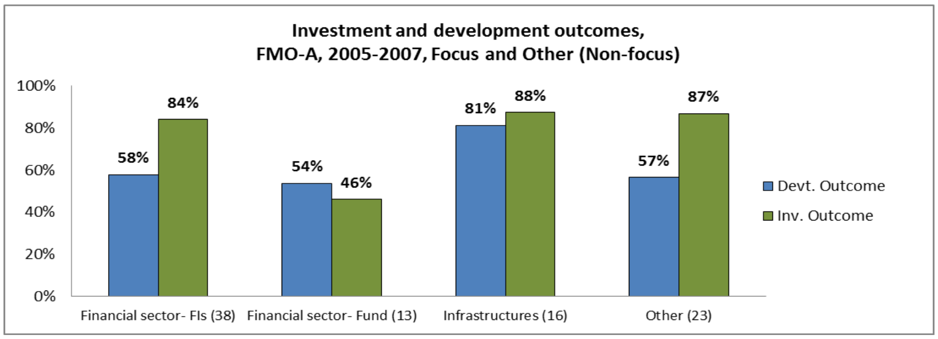


Figure 3

Infrastructures:

The infrastructure sector continues to be one of the strongest performing sectors with 81% of projects rated developmentally successful. While performance might be a reflection of stronger government regulations and improvement in business climates in project countries, infrastructure projects are also generally less susceptible to market forces and often operated locally in markets that have not seen much economic downturn (especially in Africa). The role of Independent Power Providers, IPPs (in power projects) in enabling infrastructure development cannot be overemphasized. Dalberg (2012)[8] has shown a similar finding.

Financial Sector:

Development outcome success rates for evaluated financial sector investments were lower (fig. 3) compared to previous years. While the sample of evaluated financial sector projects increased during 2005-2007 periods, compared to 2001-2003, the decline in development outcomes is mostly ascribed to the crisis (including country crises) that confronted clients in the years following 2005-2007 (especially in ECA – hit hard by the crisis). Outcome patterns are different for banks (and non-bank financial institution, NBFIs) vs. private equity funds; hence we have analysed them separately.

[7] Financial sectors: financial institutions (including private equity fund and leasing); infrastructures: refers to broader infrastructures such as power, housing, transport and telecom infrastructure. 'Others': any other investments outside financial sectors and infrastructures.
[8] Dalberg (2012) "EDFI Joint evaluation on three EFP Energy infrastructure projects" Website link

Banks saw a decline in asset growth as a consequence of declining credit demand and deleveraging, even in regions that were mildly affected by the crisis. Pre-crisis, there was abundant global liquidity, leading to an influx of foreign investors and real estate bubbles. But when the crisis hit in 2008, banks witnessed portfolio (mortgages dominated in hard currency) deterioration following sharp depreciation. The latter manifested itself in a number of projects where business success was rated as '(partly) unsatisfactory' and less frequently generated good development returns. Despite the lower business success rates, our MSME-focused financial institutions often responded relatively well to the financial crisis, often with FMO's support and good management. Investment outcomes were relatively stable.

Projects in which FMO invested in equity in 2007 did not perform well from a business point of view, which consequently negated their ability to produce good development outcomes. Private equity fund investments rarely produce substantial development returns five years after it is set up. Yet, when there are indications that a fund's investment has produced positive development outcomes, we often lacked information to assess the development effects of investee companies. FMO would benefit from setting up an investee level database for measuring development effects of private equity fund investments - this has been recommended by an earlier study on private equity funds.

Other (Non-Focus Sectors)

Non-focus sectors also witnessed a decline in development results at 57% (2011: 62%) for the 2005-2007 committed investments. The proportion of projects producing poor development outcomes may be ascribed to a combination of factors. Business cycle sensitive sectors like manufacturing were confronted with falling domestic and international demand on the one hand, in addition to project-specific challenges, resulting in overall decline in performance. We further explored, but did not find any significant variation within regional performance for the non-focus sector portfolio that explains the decline.

4. OUTCOMES BY COUNTRY INCOME LEVELS: FMO-A 2005-2007

Development and Investment Outcomes Success Rates,

Country income level, 2005-2007 FMO-A approvals

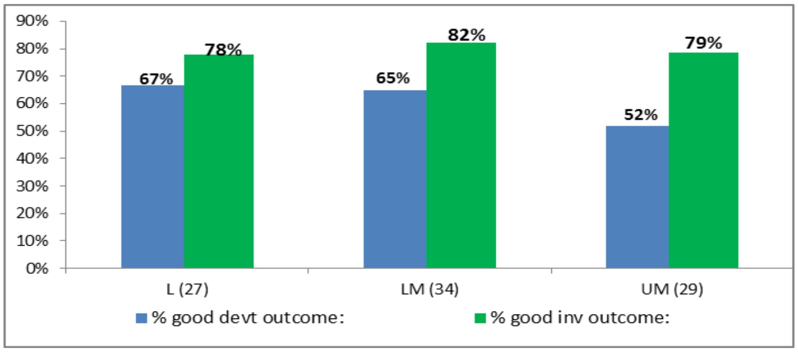


Figure 4

Among the evaluated projects committed 2005-2007, investment returns to FMO by country income classifications remained relatively stable (fig. 4). Evaluation results show that FMO's investments in low (67%) and lower-middle income (65%) countries more frequently produced successful development outcomes than upper middle-income countries (52%). Within the low and lower income countries, development outcome success rates differ by regions - while outcomes in Africa, Asia and LAC held up, ECA (particularly Ukraine) underperformed. Africa and Asia seem to have been less sensitive to global business cycles and capital flows, they also benefited from improved regulatory/business environment.

In general, the poor development outcomes in lower and upper middle-income countries were negatively affected by projects in ECA (Ukraine, Azerbaijan, Russia and Kazakhstan). These countries suffered from a combination of contagion of the (European financial) crisis and domestic country issues.

5. ROLE AND CONTRIBUTION OF FMO, FMO-A

Role and contribution FMO by year of approval:

All evaluated FMO-A projects

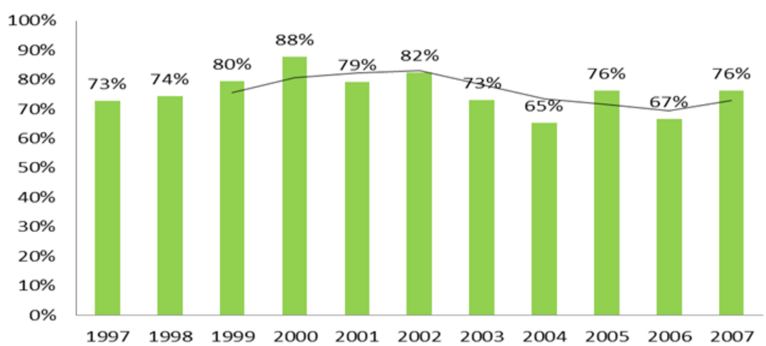


Figure 5 a

The role and contribution of FMO is an overall indicator combining ratings on financial additionality[9], catalyzed funding and non-financial contributions of FMO (such as value added in improving standards in clients' corporate governance, environmental and social aspects and business performance). In 2007, FMO was rated as having played a good role in 76% of evaluated projects (fig. 5a). The latter is often a reflection of the additionality scores.

Additionality

FMO remained clearly financially additional in two-thirds of the investments made in 2007 - we still managed to take on risky projects that commercial investors were not ready to take. In the remaining one-third of investments, additionality was insufficiently substantiated and/or assessed as limited.

FMO additionality score by year of approval: All evaluated FMO-A projects

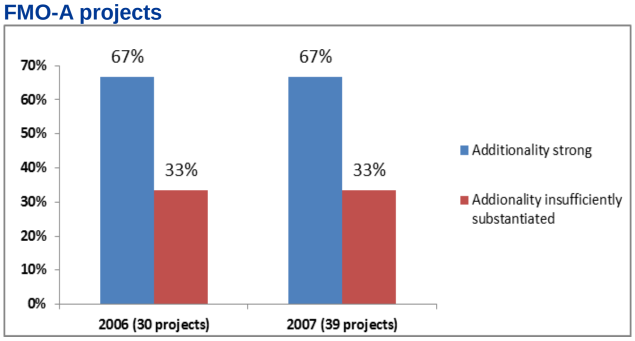


Figure 5 b

Emerging Markets Risk Premiums 1998-2012

Source: EMBI Spreads Bloomberg

9 Role of FMO is rated satisfactory as long as FMO is financially additional and or contributes to any two of the non-financial aspects of clients' business. Additionality carries a higher weight.

This has been ascribed to a number of reasons; first, additionality came under pressure due to the influx of liquidity into our markets in the years preceding the 2008 crisis (further evidenced by the Risk Premium graph in fig. 5b). FMO also experienced substantial prepayments in 2007, reflecting the high liquidity increase in our markets at the time. Secondly, the assessment method used at the time was less objective. The 2009-2012 strategy ‘Moving Frontiers’, formulated in 2008, addressed this mounting pressure on additionality. Liquidity squeeze during the global crisis also helped. With the 2009-2012 strategy, a stricter policy on additionality was introduced: FMO exited some markets and pushed the margins of additionality by moving strategically and purposefully into new markets and specifically into segments that are considered still too high risk by commercial investors. Simultaneously, FMO’s client scorecard application used to assess additionality was modified to strongly reflect and document sources of FMO’s additionality.

Projects where additionality was insufficiently substantiated cut across all country income levels - considering that this pattern is also observed for low-income (i.e. high risk) country projects, it appears that while (high) country risks usually equated for high FMO’s additionality it may not give the overall picture. Although one of the best among DFIs, the current assessment tool which FMO currently uses to measure additionality can be made more transparent in this regard.

6. Outcome Trends, FMO-Managed Government Funds, 2005-2007

The FMO-managed government funds reflect the Dutch government's priorities in private sector development. FMO manages four funds on behalf of the government to allow FMO engage with clients and offer products that would generate high development effects, but too risky to be prudently taken on by FMO's own capital, thus allowing us to cross boundaries and take on projects that are otherwise un-bankable even by DFIs. Each fund has specific investment criteria alongside explicit objectives, which are assessed during evaluations. And they take on specific risks such as – local currency risks in the case of Massif, product and high project risks especially for FOM, IDF and AEF. The fund analysis is based on a sample of 58 projects approved 2005-2007 consisting of Massif- 35; FOM- 15; IDF - 6 and AEF- 2.

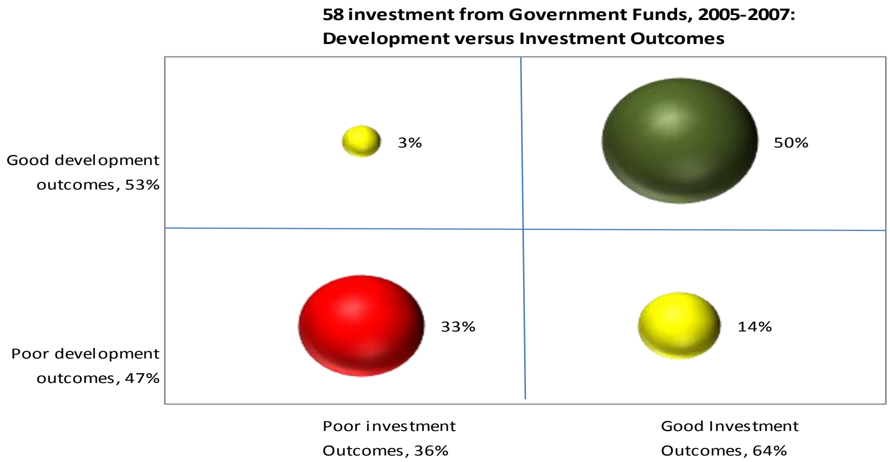


Figure 6 a

The government funds projects do not only have lower success rates, their high-risk profile leads to more volatile results (fig. 6a). The higher risk is evident from the proportion of government fund projects that resulted in good investment outcomes: 64%, as compared to 80% for FMO-A. Outstanding investment returns for some projects that generate (at times very) good returns compensate for others with disappointing outcomes. In line with the high business risks of government fund projects, the proportion of developmentally successful projects are also lower at 53%, but clients whose business turn out to be finally successful usually produced good to excellent development outcomes.

Performance by Fund Type

Among the government funds, Massif fund projects, focusing on providing local currency financing for financial institutions focusing on MSMEs, are by far the best performing on outcomes (fig. 6b). The diversification of investments in Massif portfolio, in a way helps maintain the revolving nature of the fund. This lends it to a development success rate of 66% for evaluated 2005-2007 commitments. Additionally, the ECA-effect was minimal on Massif investments as Massif was hardly allowed to operate in the ECA during 2005-2007. The result thus demonstrates, that assisting MSME financiers via Massif thus offers good developmental and business opportunities.

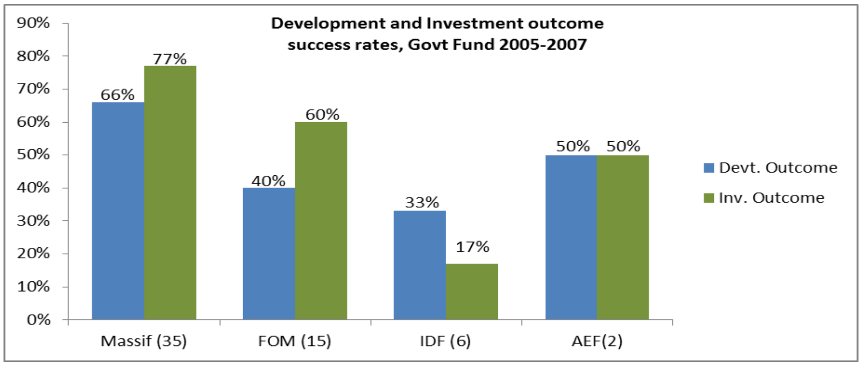


Figure 6 b

Clearly, Dutch SMEs with green field or brown investments in emerging markets (FOM's main target group), pose a higher risk: their target investments were mostly characterized by poor management and start-up risks that often led to poor business success and consequently poor development outcomes. Nevertheless, approximately one-third of the projects still produced good development outcomes while accepting high risks. One of the FOM project evaluations in Ukraine showed that when FOM invests alongside a well experienced, financially strong sponsor with good local knowledge, the likelihood of project success is high and indeed FOM can effectively help Dutch SMEs expand their businesses in emerging markets. We are careful not to generalize results for IDF Infrastructure fund and AEF, considering the limited sample size of 8 projects in total: two, of the six projects evaluated for IDF produced good development outcomes, while one of the two evaluated AEF projects was developmentally successful.

Evaluation results have regularly shown that government fund projects, if developmentally successful, often produce strong results, however, taking on projects that are too risky (with limited chance of succeeding) as reflected in the high failure rates above can threaten the revolving nature of the government funds and their overall development effectiveness. A typical example of how start-up risks can lead to poor development outcomes is shown below:

An IDF infrastructure Fund investment where we provided a Euro loan and equity funding to a client who operates composting units in Asia. The purpose of the project was the creation of three composting units - the composting units will be used to convert organic wastes to compost which will be sold locally. The facilities will have an initial capacity of 100-130 ton/day and 700 ton/day when proven to be successful. The nature of the industry allows client to generate carbon credits (CERs). At approval, FMO was deemed highly additional and main development objectives were employment, market development and import substitution for expensive fertilizers as well as reducing pollution. To date, only one of the three composting units have been constructed, the project experienced poor management, several delays from obtaining permits, local funding and operational issues that have limited production capacity. Financial performance in turn, has been poor and both loan and equity are fully provisioned and impaired by FMO and it is doubtful if FMO will receive the expected returns from this investment. Despite our high financial additionality and initial assessments, project has not performed in line with expectations due to factors mentioned above, hence the unsatisfactory ratings on development and investment outcomes.

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7. The Currency Exchange Fund (TCX): Largest FMO Equity Investment (70mln USD)

Introduction

In September of 2007 The Currency Exchange Fund (TCX) was established in order to provide innovative solutions for hedging FX risks from emerging market transactions.

Development Impact

TCX offers financial derivatives to financial institutions, and therefore enables counterparties to offer local currency financing. Local currency financing is preferred above hard currency lending due to the avoidance of Foreign Exchange risk at clients level (banks/MFI's) or end-user levels (local micro borrowers, SMEs). In particular for local currency earnings businesses (SMEs) and retail clients (mortgages) which earn predominantly local currencies and hence become less FX-sensitive if they are financed in local currencies. This so-called primary portfolio has grown significantly during the last 2 years to a level of 784 mln USD. The majority of the portfolio is allocated to Africa and Eastern Europe. The business model of TCX has proven itself during the last 5 years, given the professionalization and growth of the institutions and its track record of profitability, in a difficult period. Given the current level of capital, TCX can still grow its local currency portfolio significantly in the coming years. In particular outside the microfinance sector and outside of Eastern Europe there is still a huge market potential for TCX. The portfolio is still much smaller than projected at approval, also due to the financial crisis which has negatively influenced the new production in 2008/9.

Financial Result

TCX has been considered as a strategic investment by FMO. It offers FMO the opportunity to hedge its FX-risks outside its own balance sheet and to broaden its product range with local currency products. The expected returns in the baseline (Libor + 3%) have not been realized so far (also due to the lower than anticipated portfolio level, which resulted in a lower leverage), but the IRR (based on fair market values) has been positive (Q2/2013: IRR 2.3%). Indirect benefits to FMO by providing local currency derivatives have not been taken into account by the calculated returns on the shares in TCX.

Role of FMO/Additionality

FMO clearly played an innovative and catalyzing role. First of all, the objective of TCX is to offer financial products in developing countries which don't exist. This is financial innovation which facilitates underlying real transactions of end-users. As TCX has been a spin-off of FMO with ultimately 23 shareholders and a total capital base of 676 mln USD (Q2/2012, including sub-debt) the initial effort of FMO clearly catalyzed other investors. As started as a 100% internal FMO activity, FMO currently has a 15% share in TCX, and remained the largest client of TCX. In the majority of the countries where TCX is active, they offer financial derivatives with longer maturity than the existing financial markets. In other words, TCX offers clearly a financial service which is additional to the existing markets, and thereby play a very relevant role in developing local financial markets.

To summarize, the investment in TCX of 2007 has been the largest single investment of FMO and combines a few of FMO key targets: innovative, catalytic, and a favourable development impact with the financing of products which are clearly additional. Furthermore TCX has become an independent, professional and profitable financial institution, which survived the first difficult first 5 years of existence. Given the high level of capital TCX and the lower than projected production in particular during 2008/9, TCX has ample room to grow its primary business: offering local currency solutions for end clients in emerging markets.

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8. HIGHLIGHTS ON IMPACT EVALUATIONS: STRATEGIC AGENDA FOR FMO

The annual portfolio-wide evaluation of a sample of five year old projects – whose findings are the subject of this review – has, for the past ten years, formed the backbone of how FMO seeks to be accountable for the development results achieved by the projects it supports. Together with other policy studies – and other tools developed and maintained by FMO's Evaluation Unit, including those for ex-ante effectiveness assessment and outcome monitoring – they have helped steer FMO's investment selection and policies towards greater development effectiveness. Nevertheless, in particular the current methodology of development outcomes measurement is still heavily influenced by external conditions, and hence the reported trend is difficult to link to FMO's role & contribution. Therefore a review of the current methodology, and a comparison with best practice within the DFI's is on the agenda.

But, though helping us to learn a lot about what works and what doesn't, these ex-post evaluations – based, as they are, on partial evidence at the level of FMO's clients - do not constitute hard and conclusive evidence of projects' effects on those who are intended to developmentally benefit from the project activities. It is part of FMO's strategic agenda to increasingly show these 'hard evidences' going forward through:

Impact evaluations; encouraged by the Protocol for Results Achievement in Private Sector Development issued by the Ministry, FMO has, last year, developed an evaluation plan for the funds that FMO manages on behalf of the Dutch Government. Based on the evaluation plan, we aim to annually commission a number of high quality impact evaluations.The first studies are expected to be commissioned in the first half of 2013.

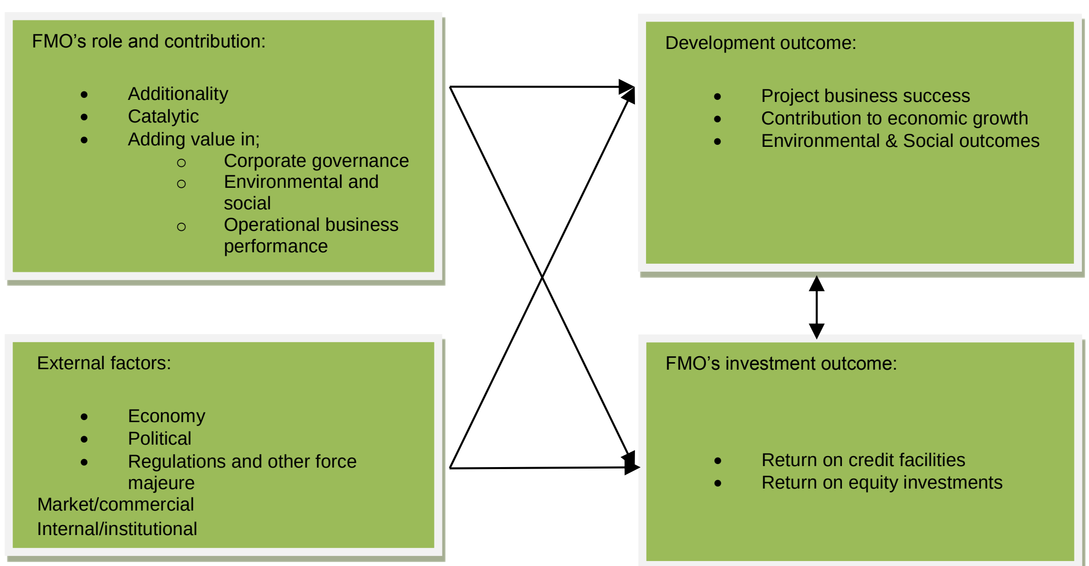
Strategic goal; FMO intends to become a leading impact investor by doubling its impact and halving its footprint by 2020. FMO's 2013-2016 strategy period will be guided by this goal of 'doubling impact and halving footprint'. This 'big audacious goal' will require a shift in the way we work in relation to the logical framework (result chain) underlying the investments we make. The Strategic Horizon for Impact and Footprint Transition (SHIFT) project has been put together in order to further develop and implement the new strategy. And part of the aim of SHIFT is to implement a new framework for impact measurement, including a set of clear indicators.

ANNEX

a. Project Evaluation: Selection, Methodology and Rating

When FMO makes new investments, the Economic Development Impact Score is used to determine the expected economic development effects per euro invested. Additionally, environmental and social aspects are assessed and possible areas of improvements are identified and included as a condition in the contract documents.

It is of utmost importance to not only assess these subjects ex-ante but also establish whether expected effects and improvements were actually realized. This is the basis for the systematic portfolio-wide annual evaluation program where projects committed five years earlier are selected for evaluations. Selection is based on a stratified sampling of projects. In 2012, we evaluated a 50% representative stratified sample of projects contracted in 2007. The evaluation performance indicators, which allow the evaluation unit to assign the overall performance (development and investment outcomes and FMO's role) ratings are based on FMO's mandate and is in line with the Multilateral Development Bank's Good Practice Standards for Private Sector Investment Operations[10] developed by the Multilateral Development Banks' Evaluation Cooperation Group- MDB-ECG. As illustrated below, FMO's project evaluations assess; (1) Projects' development outcomes, (2) FMO's investment outcomes and (3) FMO's role and contribution in relation to the project.



All three drivers of development and investment outcomes allow us to investigate to what extent the various drivers are interrelated, and to learn how we can further improve development results. As much as we expect our projects to succeed, some projects may fail, as a result of the high-risk environment in which FMO operates, leading to poor development and/or investment outcomes.

[10] Our current methodology for portfolio-wide evaluations differs slightly from GPS; in the sense that we do not assess work quality in this evaluation program, but we make up for that in the sector studies.

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For these three dimensions, sub elements are scored on a four-point scale (from unsatisfactory to excellent). Investment outcome is rated as satisfactory or unsatisfactory when FMO has realized/expects to realize for the remaining investment life, the loan returns that were initially expected at the time of approval or vice versa. Equity is rated as satisfactory/excellent if the equity IRR equals 10%-20% / above 20%. The overall development outcome is a combination of three aspects that assess the project's overall contribution to host country's development by meeting or exceeding project's financial and environmental and social benchmarks and making positive contribution to economic growth and development. It is rated on a six-point scale (from highly unsuccessful to highly successful).

In assessing the role and contribution of FMO, the following are the main points considered. Was FMO in particular, additional at the time of approval? Did FMO play a catalytic role during the project's life (i.e. mobilize commercial funding) and, if so, to what extent? Also, FMO's value adding in non-financial aspects of clients' business is assessed (FMO's contribution to improvements in clients' corporate governance, environmental and social activities and business operations).

Draft project evaluations are prepared by the investment staffs/Analysts using project evaluation guidelines, which help strengthen objectivity. The drafts are critically and independently assessed by staff of the evaluation unit, who finalizes the evaluations after discussing them with the relevant investment staff member.

For more on the evaluation guideline, methodology, outcome ratings, please contact the evaluation unit at evaluation@fmo.nl

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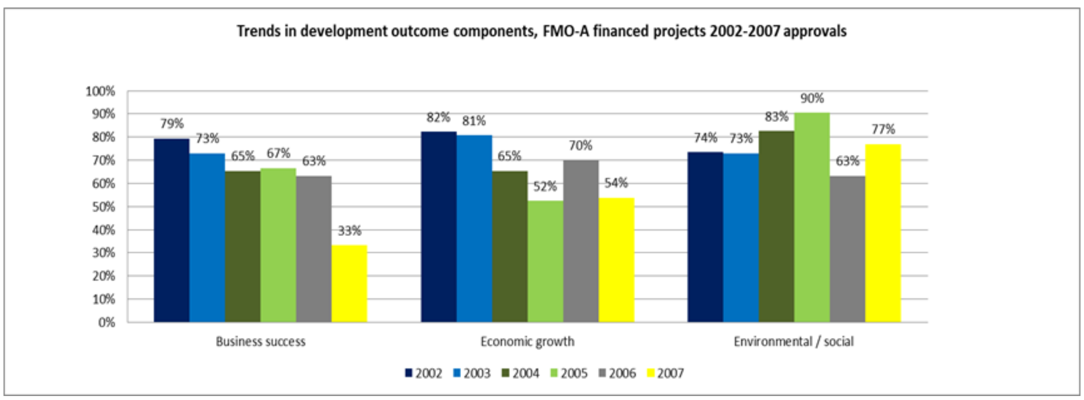
MANAGEMENT RESPONSE

Main Findings

Last years' annual evaluation review (2010/2011) from FMO's evaluation unit for the first time showed that the economic crisis had a real impact on financial and development success rates. This impact has become more pronounced in this year's evaluation of investments made in the year before the global financial crisis erupted.

This is best reflected by the historic low percentage of 2007 projects that had a positive development outcome (54%). The graph below reflects the changes over time of the three factors that define development outcome (Business Success, Economic Growth and Environmental / Social). It visualizes the effects of the financial crisis on the projects Business Success, which had a strong negative effect on the overall development outcome. Business Success is driven, amongst others, by the growth of investee companies, the level of profits and for financial institutions the quality of their portfolio. All these factors were negatively influenced by crisis. As noted in the evaluation review, EBRD and IFC (2011) had similar findings with lower development outcomes.



FMO's role remained strong, with a score of 77% added value for our clients in terms of providing needed long term finance, catalysing funds, improving standards in environmental, social, corporate governance or business aspects.

The investment outcome of also 77% was comparable to the previous years where 4 out of 5 projects proved financially successful. This reflects FMO's ability to select and support strong clients also in adverse circumstances. Although based on a small sample, the 2007 private equity results seem challenging as could be expected of a higher risk product in an unfriendly economic environment, combined with relative high valuations pre 2008.

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The report does make it clear that it is important that any ex ante development impact expectations must be verified by ex post measurement. As recommended, we will take this into account in the design of our new impact framework. We therefor support the evaluation unit’s proposal to review the current methodology of measuring development outcome. This also goes for the evaluation unit’s wish to increase transparency in the measurement of additionality.