FMO

EVALUATION SUMMARY | EVALUATION RESPONSIBLE EXITS

INTRODUCTION

This evaluation assesses FMO's approach to responsible exits for the period 2018 to 2024. As codified in internal policy commitments and confirmed through support for relevant international standards, FMO seeks to exit its investments in a responsible manner.

FMO's Sustainability Policy defines its approach to responsible exits in terms of balancing impact and financial returns: "*FMO considers the effect of an exit on ESG risks and seeks to preserve positive impact and avoid negative impact as much as possible*".[1] In addition, FMO is also a signatory to the key set of international standards on this issue: Principle 7 of the Operating Principles for Impact Management (OPIM- 'Impact Principles') states that signatories[2] should: Conduct exits considering the effect on *sustained impact*. Specifically, *the Manager shall in good faith and consistent with its fiduciary concerns, consider the effect which the timing, structure, and process of its exit will have on the sustainability of the impact*[3], which FMO also publicly acknowledges.

The above definitions succinctly capture the essence of what makes an exit "responsible": The investors' Environmental and Social (E&S) commitments continue into the exit process by considering how the nature of the exit shapes long-term impact. This requires focus on four core elements: Timing of the exit, how the deal is structured, to whom equity shares are sold (if applicable), and the way the process is managed. When considering these four elements, a responsible

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1 https://www.fmo.nl/l/library/download/urn:uuid:c4d8ec12-9257-464f-8154-bf111ea07ce6/sustainability+policy.pdf?redirected=1758792528

2 The OPIM has 185 signatories, managing assets of more than US$500mn., accounting for a third of the impact investment market. As well as private impact investors, all major MDBs and DFIs, including FMO, are signatories.

3 https://www.impactprinciples.org/

exit also requires attention to the "do no harm" side of the equation: the potential adverse environmental and social impacts that may result from the decision to exit and from the way the exit is implemented, including on affected communities, workers, and other stakeholders (for example, where an exit could exacerbate existing E&S issues or reduce leverage to address them). Together, these elements provide a clear and practical framework for thinking about what a responsible exit should entail.

THE STUDY

The objectives of the evaluation are threefold: First, to understand how FMO defines and manages responsible exits. Second, to compare this to international standards and the approaches taken by peers. Third, assess what is working well, what challenges remain, and identify areas where improvements can be made.

The evaluators - ADE S.A. - collected evidence through a combination of literature review and document review, portfolio analysis of a sample of exited investments between 2018-2024, interviews with FMO staff and sector experts, staff and client surveys, case studies, as well as a comparative study of FMO's peers. [4]

ABOUT RESPONSIBLE EXITS

Although some international organizations offer a definition of responsible exits, there is no single, universally accepted formulation in Development Finance. FMO itself, like many of its peer Development Finance Institutions (DFIs), does not explicitly define responsible exits. In practice, a responsible exit for FMO is an exit that has been concluded in line with relevant FMO policies and internal guidelines.

WHAT ARE FMO'S PEERS DOING?

The peer review revealed quite some variation in the approach to responsible exists between DFIs. Whereas all DFIs seek to balance the maintenance of high Environmental, Social and Corporate Governance (ESG) standards post-exit with the continuation of strong financial performance, there exist different emphases and a variety of operational practices.

Norfund for example, places greater emphasis on financial performance and the need to recycle capital by pursuing exits in a timely fashion. It has established an Exit Committee to promote such timely exits. In addition, Norfund also conducts regular post-exit surveys of former investees, which is an important way of understanding whether the goals of a responsible exit – i.e. to see positive impacts maintained over the longer-term – have been achieved. So far, it is the only DFI conducting such surveys.

The peer review also showed that British International Investment (BII) is the closest to FMO in its approach to responsible exits, with a similar emphasis on balancing positive financial return and maximizing impact. While both are at the forefront of DFI practice, BII has a more formalized framework for balancing these goals. For example, BII requires a 'responsible exit dashboard' to be completed for all actively managed exits.

[4] These are two bilateral DFIs (British International Investment and Norfund), two multilateral institutions, and two private financial institutions.

FMO'S APPROACH TO REALIZING ITS RESPONSIBLE EXIT COMMITMENTS

The type of exit largely determines how FMO seeks to realize its responsible exit commitments. In the absence of a common definition, the World Bank Group's Compliance Advisor Ombudsman[5] (CAO) offers a useful typology of exits, distinguishing between active or passive exits and planned or unplanned exits. In practice, a planned, passive exit is the maturing of a five-year loan for example. For equity investments, the investor can, in theory but not always in practice, choose when to exit and to whom. Also, passive exits can be unplanned in different ways. A loan may be paid early by the borrower or cancelled by the lender, if the borrower fails to honor the terms of the loan on ESG commitments, for example. For active exits, an equity investment may be exited earlier than planned due to the emergence of major commercial or ESG risks such as political upheavals, e.g. a coup, that make some investments untenable, or abruptly obsolete.

At FMO, the following typology can be applied for exits from debt and equity transactions:

- Active – planned (mainly equity exit).
- Active – unplanned (irregular ending, non-performing exposures at Special Operations).
- Passive – planned ('normal ending' debt).
- Passive – unplanned (pre-payment by clients, debt).

Specific guidance for responsible exits is available for FMO's Special Operations (SO) and Private Equity departments, i.e. for 'active' planned and unplanned exits. Guidance is currently also being developed for Venture Capital (VC) investments. **In each case, separate guidance is required because of the distinctive features of each investment type**. Despite their differences, all relevant FMO documents provide guidance on how to realize the stated commitment, including balancing ESG and financial considerations on a case-by-case basis.

SO manages non-performing exposures arising from financial and/or ESG-related issues. The department tries to recoup as much of FMO's capital as possible, while simultaneously aiming to ensure existing ESG commitments are honored, and ideally continued in the future. In case of a sale, the selection of buyers who are likely to maintain, or ideally build upon existing ESG standards is therefore an important element. Exits from direct equity investments also seek to balance FMO's financial return and the long-term sustainability of ESG commitments. VC investments are similar, except for the much higher failure rate (up to 70%) which creates issues that are far less frequent in standard equity investments.

The OPIM Principles stress the importance of *sustaining* impact. However, lasting impact ultimately depends on clients maintaining a minimum level of financial performance. Without financially viable clients, impact cannot be sustained. To properly assess how FMO seeks to realize its commitments, therefore, we need to look beyond its formal responsible exit guidelines and examine how it supports strong performance both financially and concerning ESG.

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5 Julia Gallu and Sadaf Lakhani, Responsible Exit: Discussion and Practice in Development Finance Institutions and Beyond (Washington, DC: Office of the Compliance Advisor Ombudsman [CAO], January 2023)

On the financial performance side, both debt and equity investments are assessed continuously for which periodical reports are generated. In case FMO's clients face financial difficulties, enhanced monitoring and interventions are triggered to improve their financial performance. If clients accumulate arrears, they are transferred to SO as described above.

For ESG, all new investments are assigned an ESG Risk Category. High-risk clients are automatically assigned a dedicated ESG Officer, who engages regularly with the client, negotiates on Environmental and Social Action Plans (ESAPs) and regularly reviews progress. For lower risk clients, ESG issues are assessed by Investment Officers during annual reviews. FMO's exit guidelines are applied to high-risk investments.

PORTFOLIO INSIGHTS ON TYPES OF EXITS AT FMO

The table below provides a detailed account of the sample of FMO's 211 exits during 2018-2024. Most exits concerned debt (178), compared with 33 equity exits. In addition, most exited investments were funded by FMO's own balance sheet (FMO-A) rather than Government Funds and had therewith a relatively lower risk profile. In sectoral terms, more than half of the exits took place in the Financial Institutions (FI) sector.

FMO exits by type, region, sector, and fund

Category	Equity	Debt	Totals
Total	33	178	211
Africa	10	46	56
Asia	15	36	51
ECA	1	19	20
LAC	7	65	72
Global	0	9	9
No region	0	3	3
AFF	5	31	36
Energy	11	40	51
FI	17	107	124
BP	4	7	11
EVO & IA	20	154	174
MASSIF	9	11	20
AEF	0	6	6

Most of these exits included in the sample were '**planned and passive'**: 120 loans were paid back on time with no major ESG issues. 36 loans were passive unplanned exits, meaning the client paid back the loan early, while 17 loans were active-unplanned exits, meaning problematic enough to be transferred to the Special Operations (SO) department and eventually exited. Once transferred to SO, these non-performing exposures become actively managed from a recovery and restructuring perspective, including an exit process where applicable.[6] Finally, the sample includes a total of 33 active-planned exits from PE.

FMO follows a risk-based approach to responsible exit. The focus of FMO's exit guidelines is on those investments that are actively managed, i.e. the equity investments[7] as well as non-performing exposures transferred to SO that are categorized as high E&S risk. The evaluation considered the absence of ESG issues, such as outstanding ESAP items, upon exit an indicator of a successful exit in which financial performance and E&S issues are balanced. No major ESG issues were found in the case of passive exits, both planned and unplanned. This was also the case with equity exits, though it should be noted that, of the 33 investments included in the sample, only five had been deemed high enough risk to warrant intensive ESG monitoring, including the allocation of a dedicated ESG Officer and the development of an ESAP. At the time of exit, the implementation of these ESAPs was almost entirely completed. On the financial side, equity returns

CHALLENGES TO RESPONSIBLE EXITS

The evaluation revealed several challenges to responsible exits, both of a general nature and more specific to debt and equity investments. Poor commercial performance was found to be the most important general barrier to the achievement of a responsible exit. Next to jeopardizing the long-term sustainability of a business, poor commercial performance makes it less likely that investments will be made to improving ESG standards and therefore to the impact of a business. Furthermore, struggling borrowers will find it more difficult to honor their loan obligations under such circumstances. Finally, it will be more difficult to find a buyer who is aligned on ESG issues for an equity stake in a struggling company.

Other general challenges that apply to both debt and equity are:

- **Adverse changes in the investment context**. In most extreme cases, such as the outbreak of a major violent conflict, most or all responsible exit commitments will become impossible to achieve, highlighting the limits of what DFIs can achieve upon exit. Other -less extreme- shocks, such as the damage to assets through natural disasters or major shifts in investee prospects because of volatile commodity market developments, can impair (but not destroy) the value of FMO's assets, and make it difficult (or even impossible for a certain period) to achieve an exit of any kind. Given the markets in which they operate, DFIs such as FMO are more exposed to such shocks than other types of investors.

- **Business risks materializing**: Customers with underlying vulnerabilities in their business models may carry a higher risk of underperformance or failure, regardless of the support provided. When such risks materialize, this can constrain available options later on and add complexity to achieving a responsible exit.

[6] There was insufficient data available for a complete assessment of five loans, due to the transfer of a new internal system at FMO.
[7] These concern direct equity investments rather than equity funds, where the issues relating to responsible exit are outsourced to the fund managers. There are some very limited exceptions.

- **Limited leverage**: Encouraging engagement from a customer on E&S topics may require a combination of incentives and agreed expectations. This can take the form of 'carrots' (like the prospects of a future investment from FMO) or 'sticks' (like contractual obligations linked to loan disbursals). Leverage is highest when contracts are being negotiated, when it is seen as essential to build in 'carrots and sticks' that can be used at later stages of the relationship. As a financial relationship nears its close, leverage is limited. Where relations have also broken down it can be non-existent.

- **Weak national regulations/standards**: The broader regulatory environment can also play an important role. In contexts where ESG standards are more firmly embedded in national legislation and practice, it may be relatively easier to support their consistent application. Conversely, in settings where such frameworks are less developed, customers may face additional challenges in adopting and maintaining higher standards, particularly where there are perceived implications for their competitive position.

Aside from these general challenges, there are also some **challenges specific to achieving responsible exits from non-performing exposures** transferred to SO:

- **Balancing financial and ESG/impact objectives**: When a company is in financial survival mode, its management and shareholders are often forced to focus purely on the business and may trim down E&S budgets and human resources.

- **Limits to human and financial resources**: SO's engagement with clients is often intensive and time-consuming. Hence, FMO must triage which clients are most likely to recover with support and focus their efforts there.

- **Lack of buyers, particularly aligned buyers:** FMO has hard limits on who to sell its assets from a Compliance/ Know Your Customer (KYC) perspective, but beyond that SO may have little ability to 'pick and choose' buyers of assets based on ESG alignment because the asset is often not financially attractive.

The evaluation also identified **equity-specific challenges** preventing responsible exits:

- **Lack of potential buyers**: Finding a buyer for FMO's equity stake that is prepared to pay a fair price is often a key challenge in FMO's markets. This limits FMO's ability to weigh options and select the most ESG-aligned buyer, particularly in very challenging markets.

- **Compliance/ KYC constraints**: FMO precludes selling assets to organizations that do not comply with FMO's standards, for instance concerning KYC and anti-money laundering (AML). Because it is time-consuming to screen potential buyers, such assessments are only conducted once negotiations reach a more mature stage. This can potentially complicate sales considerably when compliance issues are discovered at a later stage. A further constraint are compliance issues arising at the level of the investee. Where this is the case, FMO would typically have to sell its related assets, though the compliance issues would make this exit process difficult.

- **Misaligned shareholders**: Because FMO takes only minority stakes in its partners, ESG improvement depends very much on the willingness of the other shareholders to cooperate. While a misaligned majority shareholder can block change, misaligned minority shareholders can also prevent FMO from creating sufficient pressure for reforms. In a similar way, in selling its minority stake, FMO is dependent on the cooperation of the other shareholders.

CONCLUSIONS AND RECOMMENDATIONS

The evaluation finds FMO's approach to responsible exits to be logical, well integrated into its general procedures and policies, and broadly understood by relevant staff. It also compares well with its closest peer DFIs. FMO seeks to balance strong financial performance with high impacts and ensures as much as possible that both are maintained post exit and not put at risk by the exit itself.

The evidence stemming from FMO's ESG interventions and financial performance suggests that FMO is doing well on maintaining this balance. The analysis of the loans included in the sample showed that only two loans were non-performing to the extent that they were written off by FMO. In addition, for the 70 borrowers with an ESG category that requires an ESAP, virtually all ESAPs were completed. Furthermore, less than 10% of loans were transferred to SO, only one of which was written off, and there is no evidence of major outstanding ESG issues in these cases. For the 33 equity investments, the evaluation revealed that most investments generated positive returns and performed well on ESG. Five investments almost fully completed their ESAPs at exit. However, while these figures are certainly positive, it should be noted that most of FMO's clients included in the sample, particularly equity investees, did not have ESAPs owing to their ESG-risk classification.

Furthermore, FMO compares well with its peers in its approach to responsible exits, with the most similar DFIs being IFC and BII. Its approach is also compatible with the principles from international organizations to which FMO is a signatory.

There are, however, some areas where improvements could be made. FMO's responsible exit guidelines has evolved over time. Originating in SO to address the specifics of non-performing exposures, FMO's responsible exit guidelines then later gained focus in the PE Department, with application to actively managed investments. More recently, guidelines are being developed for Venture Capital (VC) investments.

Given the differences between regular debt, non-performing exposures, equity investments and VC, it makes sense that there are separate guidelines. The result, however, is a segmented approach, where the understanding of, and approach to, responsible exit differs across FMO. There is value in improving communications on this issue in our view, so that staff, peers and investees have a shared understanding of FMO's approach to the issue, including how it seeks to uphold the commitments that have been made in different contexts and different types of investments, limitations to what can be feasibly achieved, and the balance it has to strike with other commitments. Relatedly, there is also a dispersed and formally unconnected pool of expertise on the subject within FMO, which could be used more effectively to pool and share learning on the subject.

The evaluators propose three recommendations:

i. FMO should strengthen internal and external communication on its commitments to responsible exits and how these are operationalized in practice, so that staff, peers and investees have a clear and shared understanding of FMO's approach. This includes clarifying what a "responsible exit" means across different exit situations (e.g. passive loan maturities, prepayments, planned equity exits, and SO-managed irregular endings), what trade-offs and constraints can limit what is feasible and how future practice may be improved.

ii. There is potential value in creating 'institutional memory' on responsible exits at FMO that staff can access and learn from, by enhancing FMO's internal collaboration and sharing of knowledge and lessons on implementing responsible exit across, and within, various teams with relevant expertise, considering restrictions on the sharing of commercially confidential information.

iii. While responsible exit is adequately addressed for high-risk clients, there is a risk that ESG issues may emerge at the time of exit for clients classified as lower risk. The evaluators therefore recommend that FMO assess how responsible exit considerations can be applied to such clients where latent risks may be present. Given the importance of initial ESG risk categorization, and the possibility that previously unidentified ESG issues arise over time, FMO should periodically reassess clients with a lower ESG risk rating and adjust monitoring and intervention approaches where necessary.

As the third recommendation is viewed sufficiently addressed in FMO's existing risk-based ESG approach and annual investment review, only the first two recommendations are actively further acted upon.

KEY LESSONS ON DELIVERING RESPONSIBLE EXITS

The evaluation revealed two **general lessons**, thus valid for both debt and equity, and two equity-specific lessons based on the practices at FMO and peer DFIs on how challenges can be navigated, and responsible exits made more likely:

- **A 'responsible entry' is key to a responsible exit**. FMO's leverage and effectiveness of its interventions to sustain impact after exit are highest early in the investment process. This includes client selection and ESG interventions (ESAP) in the early stages.
- **Embedding ESG standards in clients' DNA is crucial**. While protections need to be built into contracts, in many markets these can be enforced only to a limited extent. Embedding high standards in clients' 'DNA', where they want to drive and maintain progress, including post-exit, is often the best protection of a responsible exit.

There are also **equity-specific lessons**:

- **Shareholder Agreement** that protects minority rights, FMO's financial interests, and veto rights on buyers, are essential. Even if enforcement is hard as discussed above, robust Agreements can serve the valuable function of bringing parties to the negotiating table.
- **Exit plans must be genuinely revisited annually** and changed as needed, including on timing.