

## FMO EVALUATION REPORT 2011/2012

***Good development results despite the crisis-effect***

- *Ten years of FMO's Annual evaluations*



*Evaluation Unit,  
Investment & Mission Review.  
April 2012*

## **NOTE TO THE READER:**

FMO's 2011/12 Annual Portfolio Evaluation Review, the tenth of its kind, is a concise presentation of the findings from project evaluations carried out by FMO's internal Evaluation Unit in the course of 2011. Any opinions and conclusions contained in this report are those of FMO's Evaluation Unit, and are based on evaluation findings. They do not necessarily coincide with the views of FMO's Management Board. Management's position on the Review's findings and conclusions is expressed in the Management Response.

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

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## HIGHLIGHTS: AN EXECUTIVE SUMMARY OF FINDINGS

- For the 10<sup>th</sup> consecutive year, we have completed a program of ex-post evaluations of investments made by FMO five years ago. This year's evaluations confirm many of the findings of earlier evaluation rounds, but have also generated valuable new insights and a wealth of lessons of experience.
- A large majority of supported investments (69% of projects evaluated in the last three years) are found to have made strong contributions to economic growth and development, in a sustainable and responsible manner. Most of the others still produced positive development outcomes but did not quite meet our expectations. Most investments (83% in the last three years) also generated good financial returns to FMO.
- In general, the evaluation report shows that development returns and financial returns are positively correlated. Projects that achieve their business objectives (and hence the expected development results), also deliver favourable financial returns for FMO. Projects supported by FMO from its own capital and evaluated in the past three years did, in 77% of all cases, concurrently realize good development and investment outcomes (win-win), or produced a lose-lose result. A further 19% produced a satisfactory investment return always on loans, but were disappointing from a development perspective, generally because their business performance lagged behind expectations, thus hampering their ability to make a broader impact on development. And only 4%, projects produced good development outcomes despite poor returns to FMO.
- FMO's investments need to be additional to commercially available finance. We are additional and play our role as a DFI by offering products that are not available from commercial parties, and add value to clients' businesses by providing value-added services through improved standards of corporate governance, environmental and social practices, and assistance with business operations, leading to improvements in business success and ultimately good development outcomes. The 2011 evaluation findings are consistent with this theory in the sense that where evaluated FMO's role as DFI and contribution was rated as satisfactory, projects development ratings have also tended to be better (in 85% of cases). In 2 out of every 3 projects that produced poor development outcomes, evaluated FMO role and contribution was limited. These findings highlight the potential of FMO's unique role and contribution for improving development outcomes.
- Evaluation results were negatively influenced by the global economic financial crisis that started in 2008 – particularly through the effects of the crisis on FMO-A clients' business performance, and especially in Eastern Europe and Latin America. Financial institution clients saw their non-performing loans go up as their clients were affected. They had to slow down their (credit) growth to shore up capital, and faced a tough funding environment. In other sectors, clients were more directly affected. On the other hand, outcomes were bolstered by the fact that many investments in Africa and Asia continued to benefit from strong economic growth, an improving business climate, and a strengthening of the financial sector.
- FMO clients in the financial sector and in broad infrastructure more often realized good development results than in 'other' sectors, but investment outcome success rates no longer differ significantly. Projects in these 'other' sectors are often in higher risk sectors and simultaneously outside of FMO's specific sector expertise for which FMO often has limited know-how as to the underlying risks/weaknesses that could undermine financial success of the projects.
- Higher development and investment outcome success rates continue to be observed in Low Income countries, compared to Middle Income countries. Outcomes are strongly linked to FMO's additionality which was generally stronger in the less advanced markets. Part of the explanation also lies in the fact that, in low income countries, we more often provided loans, while in (lower) middle income countries we more often used riskier equity and near equity products. Two-third of investments made in upper middle income countries were in the non-focus/'other' projects, which are generally in higher risk sectors (compared to 21% in Lower middle and 37% in Low income countries), reflecting FMO's move to the higher risk segment in order to remain additional

in its financing in the advanced markets. Also partner transactions contributed to the shift towards non-focus in Middle Income Countries. In general the Financial Institutions, and the Energy Industry are characterized by a high level of regulation, and low default rate. Therefore, other 'non-focus' industries tend to have on average a higher default rate, and subsequently a lower development impact..

- Projects financed out of FMO-managed government funds are meant to take on more risk than FMO can do for its own account, so it is not surprising that, at 61%, their investment outcome success rate is lower than the 83% for FMO-A. As a degree of business success is needed to generate good development results, the percentage of developmentally successful projects is also lower, at 57%. The high risk profile of government fund projects leads to more volatile results. Consequently, if a project is successful, it is more likely that it is highly successful and vice-versa, from both a development and an investment outcome perspective. Where results were good, FMO's role was rated as 'excellent' as well. Massif clients in Asia and Latin America contributed most to good outcomes.
- The government fund outcome pattern can be acceptable if developmentally successful projects generate very strong results (compared, say, to successful FMO-A projects). We have found this to regularly be the case. However, taking on projects that are too risky (and have too small a chance of succeeding) can also threaten the Government funds' revolving nature and their overall development effectiveness (as may be the case with the Infrastructure Development Fund). A thin line needs to be walked by the funds, and closer attention to their developmental and financial risk-return profile appears called for. Projects that fail as a business cannot produce the development results they aim for.
- The Management Board of FMO has taken notice of this years' evaluation report, and agreed upon all relevant observations and conclusions.

## 1.0 ABOUT FMO'S INTERNAL EVALUATION

FMO is a development finance institution that believes that a thriving private sector fuels economic and social progress, and providing financing to entrepreneurs in developing countries helps fulfil that role. The FMO's evaluation unit is charged with the role of assessing the activities of FMO's work in private sector development. The unit operates independently from the front office. The goals of evaluation are to provide an objective basis for assessing the results of FMO's work, to provide accountability in the achievement of its objectives and to improve our work by identifying and disseminating lessons learned from experience which are stored in a *lessons learned database*. In the past we have carried out in-depth evaluations for sample of projects approved five years before. At the beginning of 2011, the management board approved a new evaluation set-up. This new set-up involved a change to; (1) A light evaluation setup for annual program of portfolio-wide evaluations (referred to as Extended Credit Review, ECRs); (2) Sector-based annual evaluation which will involve an in-depth assessment of a sector portfolio within a time period of 5 years.

This report is about the annual program of portfolio-wide evaluations, for projects approved in 2011. It is a lighter version of evaluations which supplements the sector studies, and serves to provide a portfolio-wide (covering 50% of portfolio) accountability of projects committed five years prior to the year of evaluation. This report also summarizes other sector and thematic studies that were carried out in 2011.

In our evaluations, projects are rated on three key areas of performance;

- Development results - assessment of the project's results across three development dimensions; Project business success, contribution to economic growth and environmental and social outcomes. To achieve a successful/highly successful outcome, a project must attain/exceed the set benchmarks in any two (or all) of the development dimensions above. Development outcome ratings are assigned on a six-point scale (highly successful, successful, mostly successful, mostly unsuccessful, unsuccessful and highly unsuccessful).
- Investment outcomes: Measures the extent to which FMO has realized/expects to realize the returns of an FMO loan and/or equity. Loans are rated as satisfactory provided they are repaid or expected to be repaid in full with interest and fees as scheduled (or are prepaid or rescheduled without loss). Equities are rated as satisfactory/excellent if the equity IRR equals 10%-20% / above 20%). Investment outcome ratings are assigned on a four-point scale (excellent, satisfactory, partly unsatisfactory and unsatisfactory).
- FMO's role and contribution – Assessment of the overall quality of FMO's additionality, catalytic role (mobilizing funds from other commercial parties), and FMO's value-adding role in the non-financial aspects of a clients' business such as; improvement in environmental and social activities, business operations, corporate governance in client's business. To achieve a satisfactory role, FMO needs to be additional. And attain set benchmarks by adding value to any two or more of the non-financial aspects of clients business. Ratings are assigned on a four-point scale (excellent, satisfactory, partly unsatisfactory and unsatisfactory).

In addition to the annual program of evaluation, other core deliverables of the Evaluation unit are;

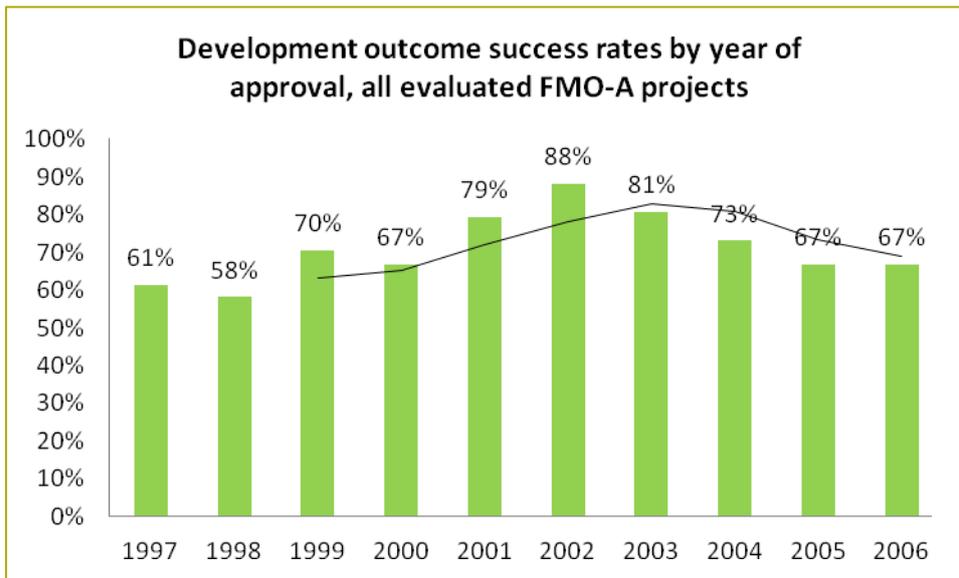
- Undertake policy-relevant sector and thematic evaluation studies for learning.
- Developing and maintaining FMO's processes and tools for ex-ante assessment and monitoring of project's development effectiveness.
- Maintaining of indicator database, ensuring that it meets management and stakeholder demands as well as being compliant with agreements among European Development Finance Institutions, EDFIs on indicator harmonization.
- Managing of the lessons learned database.
- For more on the Project evaluation; selection, methodology and rating see Annex.1 of this report.

## 2.0 EVALUATION RESULTS: DEVELOPMENT AND INVESTMENT OUTCOME TRENDS AND PATTERNS

### 2.1 Development outcome rates by year of approval, FMO-A investments<sup>1</sup>

Aside producing good financial returns to FMO, evaluated projects often made positive contributions to development by attaining set benchmarks in any two (or all) of; project's financial performance (project business success), environmental/social outcomes and positive economic growth and development. Although investment outcomes success rates held up at 83% (compared to last year's evaluation results) for sample of projects evaluated in 2011, development outcome success rates (figure 1)<sup>2</sup> stabilized at 67%. A similar result was observed in IFC's Annual Portfolio Review FY11, both in terms of level and trend. Business success is a necessary, albeit not sufficient, condition for good development results and is closely associated with the other development aspects. The remaining one-third of the projects that have not produced good development results were not necessarily a failure, but more was expected on business (financial) success and/or the other development aspects.

Figure 1.



Where projects produced poor development outcomes, these were often due to the crisis effect. Markets were affected, leading to sales decline in clients' businesses. Portfolio growth and quality deteriorated and inadequate risk management surfaced for financial institutions. A combination of the latter affected the ability of projects to attain their expected financial benchmarks, nor make expected contributions to neither economic growth nor environmental and social requirements (nevertheless, loans were mostly repaid). This was mainly observed among clients in the ECA region. Investments outside FMO's sectors of expertise more often produced lower than expected development outcomes; apart from these investments being largely in the higher risk sectors, FMO is less specialized with underlying risks that affect business success of these types of projects.

As much as possible, FMO seeks to differentiate itself (as a Development Finance Institution, DFI) from commercial investors when we invest. This, FMO (DFI) role and contribution is achieved by being financially additional to our clients in taking on risks that would otherwise not be taken by commercial investors, as well as catalysing other

<sup>1</sup> Outcomes are based on number of projects and not weighted by volume of commitments. All other results in the report use the same approach

<sup>2</sup> The line graph on figure 2., is the development outcome success rate on a three-year moving average.

commercial parties and providing value-added services to clients through improved standards of corporate governance, environmental and social sustainability and assistance with business development and operations. The importance of our role and added-value shows up in terms of the project's financial (project business success, a core component of project development performance), this should in theory act as a facilitator of project development results. Consistent with our financial additionality, when FMO provides needed assistance in areas such as business operations, risk management, as well as improving company standards in corporate governance and labour standards, leading to improvements in business success, this should in theory, ultimately lead to good development outcomes. The 2011 evaluation findings are consistent with this theory in the sense that **investment projects more often produced good development outcomes where FMO's role and contribution was rated as satisfactory; in 85% of cases** (a similar result was observed using data for 3 years' time-period). Conversely, in 2 out of every 3 projects that produced poor development outcomes, evaluated FMO role and contribution was low. These findings highlight the potential of FMO's role and contribution in increasing development outcome success rates.

## Box 1. Examples of projects with high and low development outcome ratings

### High:

The project involved an FMO loan to a new mobile telecom company in the Caribbean for the expansion of existing capacity and development of mobile infrastructure in two countries in the region, previously not covered by client's network. At the time, these countries had low mobile telecom penetration with a monopolistic mobile telecom provider who provided low quality mobile services. And the market was frustrated eagerly awaiting a competition. Developmentally, the project was expected to contribute to the availability of telecommunication services and hence improve the mobile telecom penetration rates in the countries, consumer prices will drop due to competition, and employment will be created during the roll-out of network and with independent distributors of phone cards. Our client had a strong competitive advantage with their quality GSM coverage and provided value for money.

FMO's returns for this financing have been satisfactory and expected development effects have been achieved to a great extent, hence a satisfactory development outcome rating. The project was a commercial success, exceeding financial expectations (excellent business success rating). Subscriber base increased from 1.5million in 2005 to nearly 7.2million in 2011 driving up revenues. And average revenue per user, ARPU has been declining. Project produced good returns to the local economy in the form of taxes, positive employment effects (through small and medium-sized distributors of phone cards) and especially access to more affordable mobile phone services - all of which led to a satisfactory rating on project's contribution to economic growth and development. Client was classified as a low risk client with regard to environmental and social risks and quality of reporting on the latter have been good. The client was also involved in community development activities and provided support to disaster-affected areas in the region.

### Low:

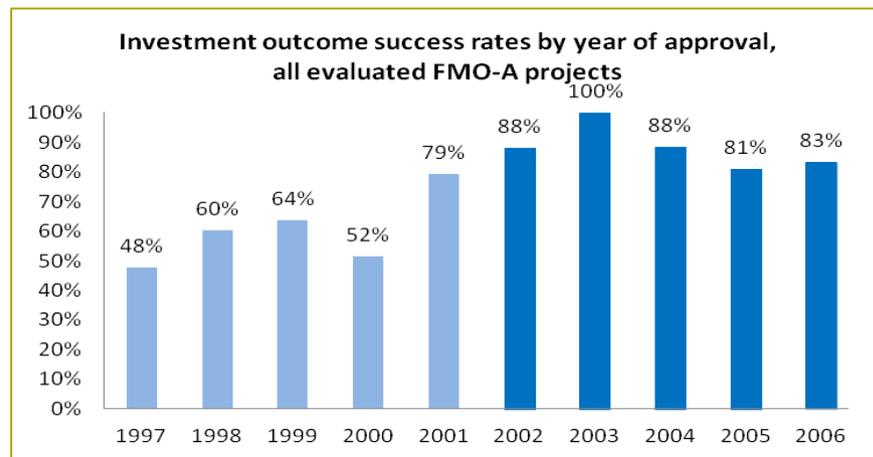
The project was a long term financing to a young and rapidly growing regulated mortgage bank in Ukraine. As the country had just recovered from the financial turmoil sparked by political crisis in 2004, in addition to improvements in the legislative base for mortgage lending, demand for financial services grew rapidly - hence, a need for FMO's loan. Purpose of the FMO's funding was to finance residential mortgage loans with a tenor of up to 15 years to this growing mortgage bank. Our financing was additional by providing an alternative source of scarce funding which was not readily available from commercial parties. Expected development objectives of this project were; to enable our client offer low priced and transparent, mortgage in a country where such opportunities were still limited. This would allow client to subsequently grow their mortgage loan portfolio.

Financial returns to FMO for this loan financing have been satisfactory. The project development outcome was rated as unsatisfactory because it failed to produce the expected development benchmarks. This is because the project's business (financial) success was below expectations, mostly affected by the 2008 economic crisis which hit Ukraine more than other countries in Eastern Europe. The crisis effect resulted in substantial devaluation and a collapse in the real estate prices. In addition, the National Bank of Ukraine put a stop to hard currency lending to individuals, effectively wiping out mortgage business. As a result of the above, our client started to focus less on mortgage lending and more on retail/consumer lending. Consequently, project's contribution to economic growth came out low since the mortgage business did not grow as envisaged and expected development effects were far-fetched. Although FMO's presence in this financing was expected to give a positive environment to actualizing expected development objectives, the crisis (external) effect made this less possible. Client was classified as a low risk client with regard to environmental and social risks and quality of reporting on the latter have not proved otherwise.

## 2.2 Investment outcome rates by year of approval, FMO-A investments

Investment outcomes (return to FMO) is essential to FMO's sustainability and to achieving its mandate. It measures the extent to which FMO has realized/expects to realize the returns of an FMO loan and/or equity<sup>3</sup>. In recent years, evaluation results show most clients have generated good investment outcomes for FMO. Concurrently, FMO have had good financial results in these years. In 2011 project evaluation sample which includes investment projects approved in 2006 from FMO's own capital, referred to as *FMO-A*), outcome success rates held up at 83% as shown in figure 2<sup>4</sup>.

Figure 2



**Investment outcome success rates held up well despite the crisis effect. This is partly due to product type/concentration and their related risks.** In 2011, out of the 30 clients in the evaluation sample to whom FMO provided financing from its own capital, 24 were provided with loans (in 2010: 16 clients were provided with loans out of 21 clients in the evaluation sample), 5 clients with equity/mezzanine and 1 client with both loan and equity products. The loans generated good returns to FMO in 88% of the cases. Where FMO provides a loan, it has a ranking claim on assets/cash flow for loan servicing as well as security packages, which provides some downside protection. Hence, clients have the obligation to make payments when due, even though their underlying financial results (financial/business outcomes) may/may not be in line with expectations. Given their lower financial risks, loans more often meet their expected success (evaluative) benchmarks and achieve good FMO investment return ratings than equity investments. Investment outcome success rates for equity investments on the other hand were lower at 33% (2010:83%; 2009:50%)<sup>5</sup> - results are however based on very small sample size. Equity investments are highly volatile and face subordination risks, yet with potential upsides. And factoring out evaluative benchmarks, equity investments have been an important driver of FMO's overall financial performance in recent years (refer to: *Evaluation study of FMO-A Private Equity investments on page 16*).

The remaining 17% where investment outcomes were rated as '(partly) unsatisfactory' were often as a result of a lower than expected investments returns to FMO (i.e. FMO received/expects to receive sufficient interest income to

<sup>3</sup> Loans are rated as satisfactory provided they are repaid or expected to be repaid in full with interest and fees as scheduled (or are prepaid or rescheduled without loss). Equities are rated as satisfactory/excellent if the equity IRR equals 10%-20% / above 20%.

<sup>4</sup> Figures for 2002 and later are not comparable to those for earlier years. In the past, following IFC's evaluation rating methodology, - we assigned a 'partly unsatisfactory' rating to prepaid loans, where significant amounts of margin income were foregone without being compensated for by prepayment fees. Following a change also made by IFC, we now rate such investments as 'satisfactory', recognizing that they produce a good return on capital and make a positive contribution to FMO's profitability, also by enabling profitable and developmentally-relevant re-investments.

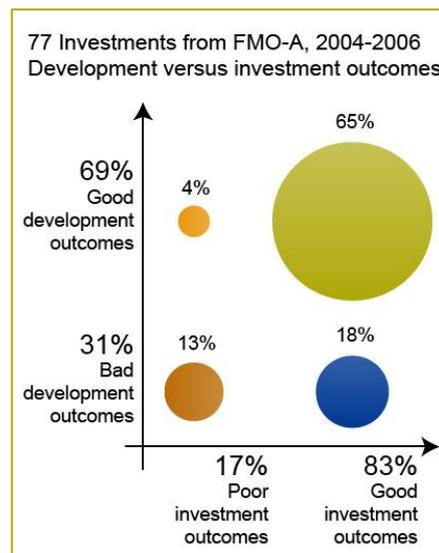
<sup>5</sup> The relatively poor returns on equity investments made in 2006 (i.e. vintage 2006) are also caused by the fact that in 2006 equity markets in emerging markets were about to peak just before the credit crisis. The years 2006/07 are with the benefit of hindsight recognized by the height of the boom period in equity markets worldwide and in emerging markets in particular. If compared to the previous years, investments made in 2006-7 are characterized by higher entry valuations, and hence pressure on returns.

recover all of its funding cost but less than the full dollar margin originally expected or made losses, provisioning/impairment in place, negative IRR).

### 2.3 Outcome trends- Interrelation between development and investment outcomes, FMO-A Investments 2004-2006 periods (3- year moving average)

Results in figure 3. below are based on 77 project evaluations taken from all investments made in 2004-2006 for projects financed through FMO's own capital. Evaluation results, once again show that FMO has in general not supported projects where there was a significant trade-off between development outcomes and project's returns to FMO. **More often than not, projects that realize good development outcomes concurrently realize good investment outcomes and vice versa.** In this sample of investment projects made 2004-2006, 65% (2010: 74%) of projects realized a win-win outcome (good development and good investment outcomes) and 12% (2010: 10%) realized a lose-lose outcome. In other words, in 77% of projects supported by FMO in the period, there was a direct correlation between project development outcomes and investment outcomes (returns to FMO). We can thus deduce that FMO's development outcomes and financial returns go hand-in-hand (results also comparable with IFC's).

Figure 3.



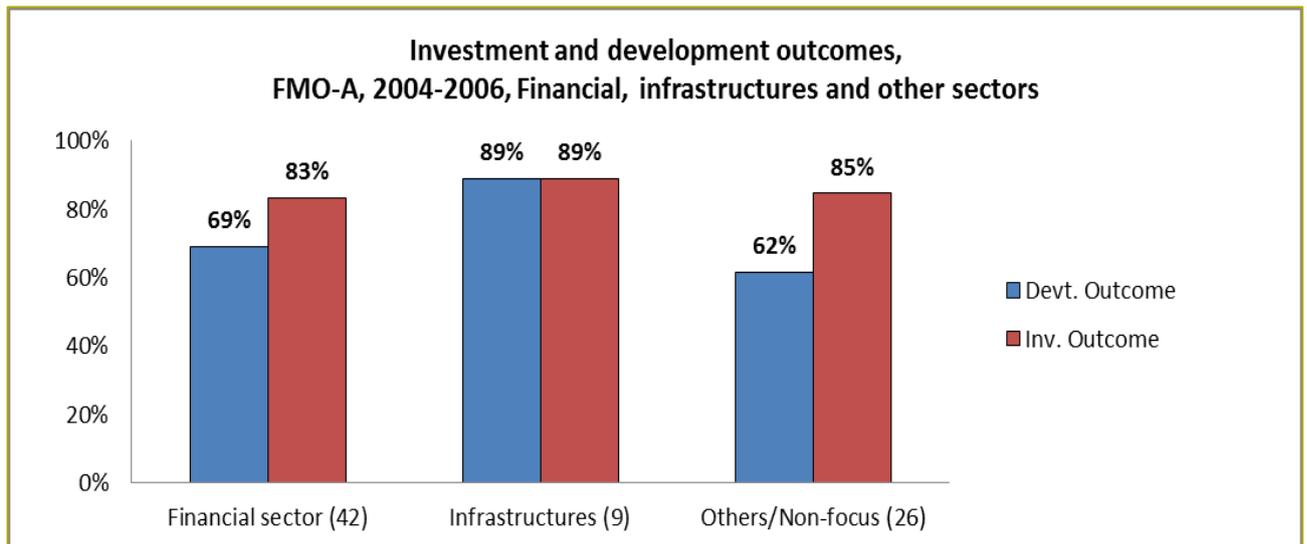
**Where disconnect was observed between development outcomes and investment returns (outcomes) to FMO, this often reflected product type and/or clients' poor business success.** The 19% of evaluated projects, with poor development outcomes and good investment outcomes, mostly involved loans with underlying projects' business success often rated as '(partly) unsatisfactory -the latter was often associated with the crisis effect. Due to clients' poor business success, projects could hardly make positive contributions to economic growth nor undertake E&S improvement actions, however, managed to service their loans to FMO (based on the same reasoning above on loan products) - hence, unsuccessful development outcomes despite good returns to FMO.

In the remaining 4%, projects produced good development outcomes despite poor returns to FMO. This small percentage clearly shows how rarely it could happen that a project can produce positive development outcomes while making poor returns to FMO. This comprises of 3 investment projects; a fund<sup>6</sup>, a trade facility in Nigeria and a telecom project that contributed positively to end-users of mobile services in Tanzania despite making poor financial results. Again re-establishing the concept that projects can hardly make substantial contributions to development while investment returns to FMO is poor.

## 2.4 Performance by financial, infrastructures and ‘others’ sectors, FMO-A, 2004-2006 periods (3-year moving average)

In the 2009 – 2012 ‘Moving Frontiers’ strategy, FMO sharpened its sector focus with the financial, energy and housing sectors as main focus sectors for FMO’s business. Prior to 2009, FMO had a region-based organization. Within these regions, there was a focus on specific countries and/or financial sector<sup>7</sup> and broad infrastructures<sup>8</sup> in addition to ‘other’/non-focus sectors<sup>9</sup>. Results below are based on these sector definitions as used before the 2009 strategy. Figure 4. shows that FMO projects in the financial and broad infrastructures realized better outcomes than projects categorised as ‘others’ (hereafter referred to as non-focus sector). An average of 79% development outcomes (average of 69% and 89% for financial and infrastructures respectively) and 86% investment outcome success rates than projects categorized non-focus. Reason for good outcomes in financial sector and broad infrastructures include; high level of regulation, low level of cyclicalit, and sector specialization/knowledge. For an external validation of highly succesful operations in the energy industry we refer to a summary of the Dalberg study: *EFP Joint-EDFI evaluations on Energy Infrastructure projects confirming strong development results in page 19 of this report*). Other sectors tend to be less regulated, some of them have a higher level of cyclicalit, and have in on average a higher default rate (and hence a lower development outcome).

Figure 4.



<sup>6</sup> Fund acquires farms in South Africa, operates them and links them to the market by a strong market and distribution network, bringing long term benefits to the farms. The fund also has a social responsibility component that is of benefit to farm employees and the rural community.

<sup>7</sup> Financial institutions (including NBFIs and private equity funds)

<sup>8</sup> Broader infrastructures include projects such as telecoms, ports, in addition to access to energy and access to housing.

<sup>9</sup> Others include investment projects such as logistics, food, water, agriculture and other investments outside the financial and broad infrastructures).

## **Financial sectors and broad infrastructures:**

**A sample of 42 financial sector projects were evaluated for the 2004-06 period; of these, 69% had successful development outcomes ratings, however with projects in ECA and LAC often less successful.**

ECA and LAC are the two developed regions where FMO invests. Pre-crisis, the ECA region was characterized by a 'boom and bust' in the financial sector. Loans (consumer and housing) grew rapidly, often denominated in foreign currency with disregard for currency risks, and funded by short term, external borrowings. The bubble burst and the sector was confronted with severe liquidity and solvency problems. This led to an accumulation of macroeconomic and other sector-specific vulnerabilities. Pre-crisis, the financial sector in LAC was highly liquid and competitive (banks relied on short-term capital flows) due to the presence of large international banking groups and borrowing increased. With often lower leverage and less opportunity for additionality, FMO sometimes moved to the higher segment in order to remain additional. In the heat of the crisis in 2008/09, the subprime mortgage market collapsed, with a disproportionate share of bank insolvencies associated with financial institutions with loans concentrated in residential real estate. Borrowers defaulted on their loans and real estate values fell, leading to a decline in bank funding. Additionally, institutional weaknesses became uncovered. FMO clients were not left out. A combination of the above factors contributed to a weakening of clients' financial returns and in turn poor development outcomes success rates.

**A high portion of evaluated infrastructure projects financed out of FMO-A, were assessed to have contributed to economic growth and development.** Eight out of the nine evaluated infrastructure projects had successful development outcomes, half of which were telecom projects.

## **'Others' (Non-focus sector):**

Non-focus projects realized a development outcome success rate of 62%. While this success rate is low (compared to an average of 79% for infrastructure and financial sector projects), their investment outcomes held up at 85%, especially for Asia and LAC. There is now, hardly any gap in the investment outcome success rates of non-focus sector versus the average of financial sectors and broad infrastructures (i.e. 85% vs. 86%). Development outcome success rates for 'others' were lower due to clients' poor business success outcomes. These non-focus sector investments are generally in higher risk/less regulated sectors and the projects are outside of FMO's area of expertise. Additionally with limited FMO knowledge/expertise with the underlying risks/weaknesses that could undermine the financial success of businesses (but clients were often able to repay loans without losses to FMO).

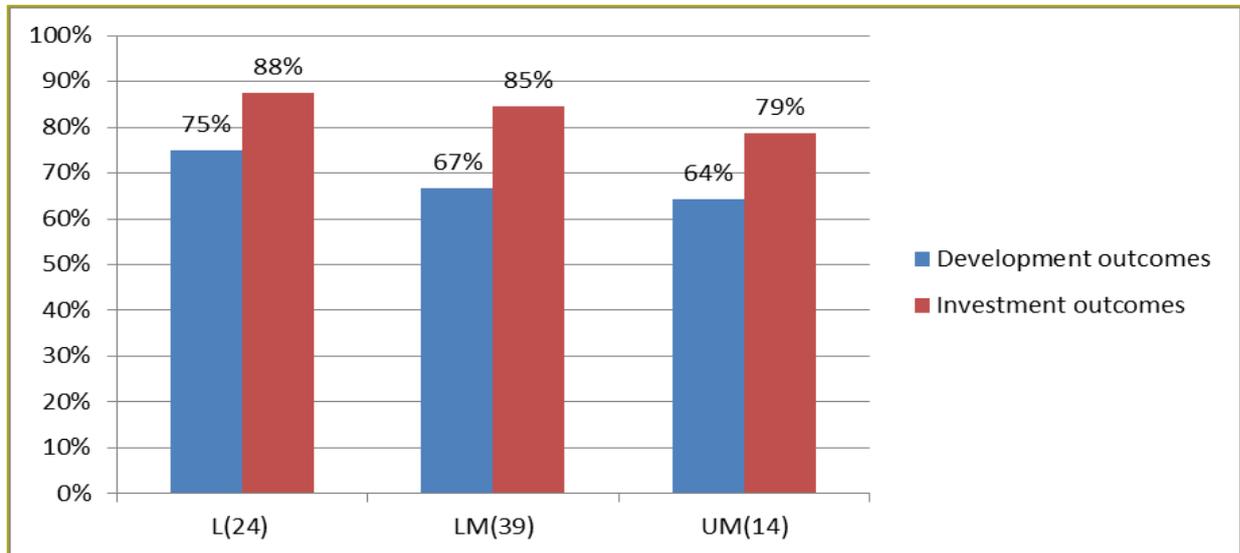
FMO's sector focus has been sharpened since the 2009-2012 strategy in financial institutions, energy and housing (and recently, agribusiness, food and water). For projects outside these focus sectors, we invest alongside experienced partners to make up for our lesser expertise. We expect that with this partner approach, evaluation results for investments contracted from 2009 and beyond, should more often demonstrate concurrently, high development and investment outcomes success rates, reflecting a trusted-partner choice. Notwithstanding, a project's industry-type can potentially play a role on overall development outcome.

## **2.5 Performance by LIC vs. Non-LIC countries, FMO-A investments 2004-2006 period**

In the past, evaluation results per country income category have shown an inverse relationship between a country's income level and a project's development and investment outcome success rates, with the highest success rates for projects in lower income countries and lowest success rates for projects in Upper Middle (UM) countries. The summary at that time was that lower country risks in UM countries was often in practice more than outweighed by the higher client plus product risks as compared to Low (L) and Lower Middle (LM) income countries. It is worthwhile examining if past evaluation results still hold with the current project evaluation.

Figure 5.

## Development and investment outcome success rates of 77 investments By country income level, 2004-2006

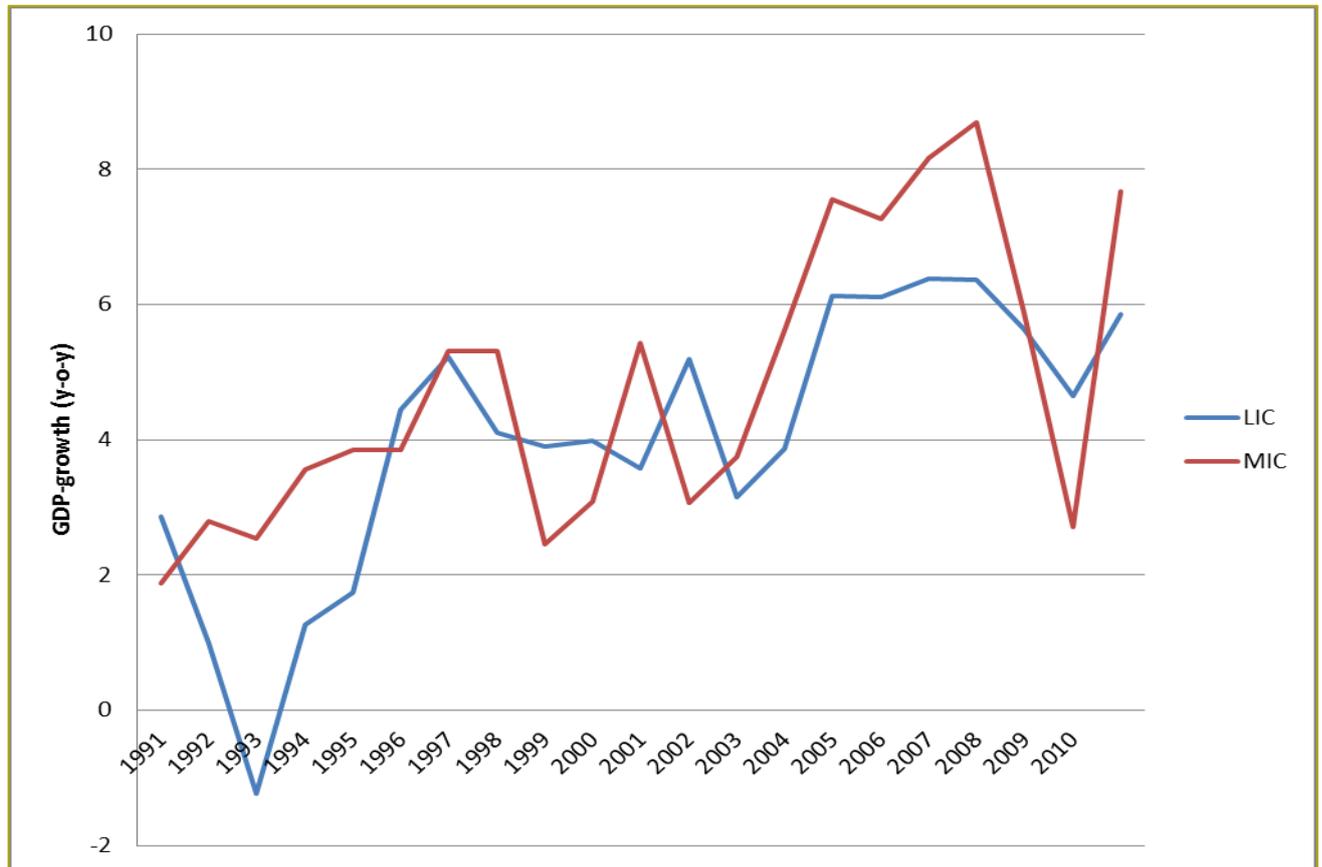


Using the World Bank country income level classifications of 2004, 2005 and 2006 (consistent with project's year of approval), **results show an inverse relationship between a country's income level and a projects developmental and financial success rates, with highest success rates for low income countries, mostly in Asia and Africa.** The higher development outcome success rates observed for low income countries further supports FMO's focus on Low income countries<sup>10</sup>. This success rate is partly explained by the economic growth and lower volatility in these markets. The crisis effect in LM and UM has been much larger (Ukraine/Mexico) than in low income countries (see figure 6. below, which represents an average GDP-growth over country income categories) - this is in particular the case in ECA, the region worst hit by the crisis. The recent financial crisis has had a larger impact on Middle Income Countries (vs. LICs, as opposed to the crisis in the early 1990s), which tend to rely more on volatile external capital flows, and tend to be more integrated with the OECD economies. The difference in investment outcomes success rates by country income class is also striking, and is partly explained by a higher concentration/success rates of loan investments in low income countries than in LM and UM countries where we more often used riskier equity and near equity products (88% of the clients in lower income country class were provided with loans compared to 64% and 71% in LM and UM income countries respectively). Loans, however, were often less successful in advanced markets; these markets are typically more developed and FMO often moves to the higher risk segment if it is to remain additional.

We further analyzed the country income levels classifications by sector and found that two-third of investments made in UM income countries were in the non-focus/'other' projects, which are generally in higher risk sectors (compared to 21% in LM and 37% in Low income countries). This partly reflects a number of partner transactions in Middle Income countries (with a more diverse character than FMO originated transactions), and the fact that FMO moves to the higher risk segment to remain additional in its financing in these advanced markets.

<sup>10</sup> Committed portfolio per income group, FMO 2010 annual report on <http://www.fmo.nl/reports>

Figure. 6 Average GDP-growth over country income categories\*



\* LIC corresponds with FMO's low income countries classification and MIC refers to middle income country classification.

## 2.6 Performance by region, FMO-A investments 2004-2006 period

Within FMO's investment regions a high proportion of successful development outcomes were observed for Africa (81%) and Asia (73%); Africa and Asia are the fastest growing regions and FMO's investment portfolio in these regions have been growing in the last three years<sup>11</sup>. The latter, in addition to improvements in business environments, strengthening financial sectors in the regions all contribute to successful outcomes. Furthermore, FMO's role was also, often rated as 'satisfactory' for successful projects in these regions (emerging markets are relatively more prone to market imperfections and additionality and consequently development impact potential is higher where market inefficiencies exist).

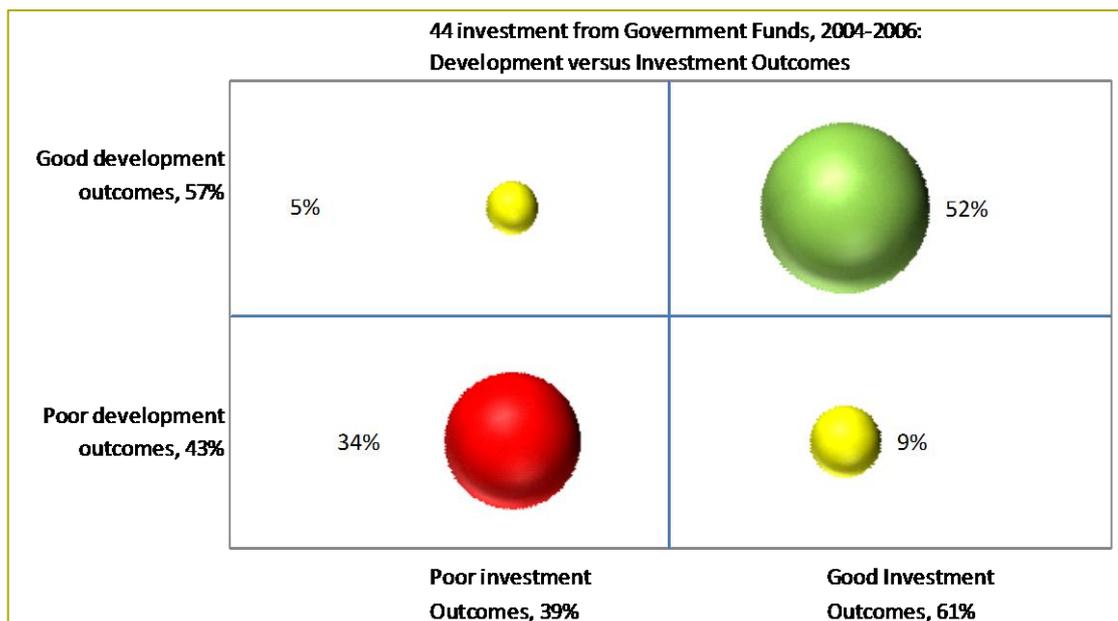
Despite 84% successful investment outcomes of evaluated projects in ECA region, only half of the evaluated projects realized good development outcomes. Six out of the nine unsuccessful cases were in the financial sector. Due to the crisis, liquidity dried up in these markets, institutional weaknesses became uncovered as portfolio growth, and portfolio quality deteriorated subsequently affecting financial results and ability to make expected contributions to economic growth in turn. Projects evaluated just at the onset of the crisis in 2009 had better outcomes than in the current year, implying that the crisis effect appears to be more evident in recently evaluated projects. A similar result was observed for LAC (69% versus 85% success rates in development and investment outcomes respectively).

<sup>11</sup> Committed portfolio per region, FMO 2010 annual report on <http://www.fmo.nl/reports>

## 2.7 Performance by type of government funds

FMO manages several funds<sup>12</sup> on behalf of the government. Through these funds, FMO is able to support investments with high development potential, which would otherwise be too risky to take on from FMO's own capital. Figure 7. below shows that in general, investment outcomes success rates at 61% for government funds, have improved over the last three years (still lower when compared to 83% for FMO-A). Successful outcomes are driven mostly by Massif clients in Asia and LAC. Development outcomes success rates declined, 57% (63%:2010) mainly due to poor financial (business) success. Overtime, evaluation results in the past have shown that business success is a necessary condition for clients to produce good development outcomes.

Figure. 7



**In figure 6, direct correlation between development and investment outcomes for government funds was more strongly than in previous evaluations.** With 52% of a sample of 44 projects approved between 2004-2006 realizing win-win outcomes and 34% realizing a loose-loose outcomes. This implies in other words, an 86% direct correlation between development and investment outcomes— and as expected for the government funds projects, profits have not been sought at the cost of development success. The 34% of projects with lose-lose outcomes points to the risky nature of projects financed from the government funds. This was mostly observed for FOM projects in ECA and IDF projects in Africa. Given their higher risk profile, losses are part of the funds' programs but should not be accepted too easily as failure rates are increasing (32%:2010; 25%:2009) which is also reflected in poor development results. Taking on projects that are too risky can threaten the success of the funds and projects that consequently fail financially hardly produces the development results they aim for. Characteristics that were predominantly shared by projects in this percentage include start-up risks, with some likelihood of failure/default especially in bad times, inexperienced management, project delays and lower diversification.

**Again, similar to what was observed in FMO-A projects, where correlation between development and investment did not hold, this mirrored product choice and their related risks.** The 5% projects with good development and poor investment outcomes were two equity investments, while the remaining 9% with poor development and good investment outcomes were loans, hence the observed outcomes.

<sup>12</sup> During 2004-2006, FMO made investments out of the Seed Capital Fund and the Small Enterprise Fund (predecessors of what now is Massif), and finally the Netherlands Investment Matching Fund (NIMF) and the investment facility Emerging Markets (FOM) and finally the LDC Infrastructure fund.

Not only do government fund projects have lower success rates than FMO-A projects, the high risk profile also leads to more volatile results. This means that if a project is successful, it is more likely that it is highly successful and vice-versa, from both a development and an investment outcome perspective. FMO-A projects on the other hand, tend to be more concentrated in the moderately successful classes. In the last three years, 11% of all evaluated government fund projects scored 'highly successful' for development outcome, for FMO-A projects this was 7%.

Analysis of outcomes by type of government fund show similar trends as in previous years; investments funded via Massif are by far the most successful ones with 75% and 79% development and investment outcomes success rates respectively. Main drivers of successful outcomes include; '*cherry picking*' of investments in a way that helps maintain the revolving nature of the fund, professionalism in the banking sector, in addition to satisfactory role by FMO and good success rate of Massive equity investments. Success rates are lower for FOM with 40% development and 53% investment outcome success rates. A sample of four out of the five IDF projects evaluated all produced unsuccessful outcomes (however, careful not to generalize results considering the small sample size). The poorly performing IDF projects ranges from power, gas, energy and water projects suffering from either poor structuring and/or, weak sponsor/management, liquidity constraints, construction delays (leading to a postponement of profitability), political and off take risks. These related risks and consequently failure rates, needs to be taken into account to the extent that the fund is required to be revolving.

## 3.0 HIGHLIGHTS ON THEMATIC STUDIES

<sup>1</sup> *“The strategy and FMO-A investments of the Private Equity department (PAR), covering the period 1996 to 2010”.* Assessment was based on effectiveness from a wide range of angles. The study is summarized as follows:

PAR’s choice for a private equity fund and co-investment strategy in 2001 has helped FMO to develop into a significant and experienced private equity fund investor. For FMO-A alone, PAR has invested in 74 funds since 2001. With most of these funds, FMO was targeting to realize co-investments. Co-investments are direct equity investments in investee companies alongside funds. Up till now, 31 co-investments have been contracted. The number of direct equity investments done without involvement of a fund is 21. Out of these 21 investments, 12 were done with clients with whom FMO had earlier experience as a lender.

The alignment of PAR’s strategy with FMO’s overall strategy and mission is satisfactory; over the last few years, PAR has turned into a frontrunner in terms of lower income country focus, while FMO’s role (mainly (financial) additionality) in equity investments can be considered adequate. Furthermore, there is increasing attention within PAR for investments in FMO’s focus sectors, particularly in Financial Institutions and Energy. With a 22 percent average Internal Rate of Return (IRR) over the last ten years, FMO-A equity investments have been an important driver of FMO’s overall financial performance in recent years. Particularly co-investments have led to outstanding returns (average IRR 33 percent). Furthermore, FMO outperformed IFC in terms of PE fund performance, which indicates that financial results can definitely be considered satisfactory.

In the following areas there is still some room for improvement:

- The number of co-investments realized; for several reasons, the number of co-investments closed has not developed in line with the growth of the fund portfolio. Focusing on early involvement in first time fund managers (as anchor) and introducing key account management will not only increase potential for closing co-investments, but can also enhance FMO’s overall (financial) additionality.
- Quantifying development impact; evidence of the (plausible) development impact of PE fund investments is insufficiently captured by FMO, and is thus difficult to quantify and demonstrate. The introduction of investee level quantitative indicators is recommended.
- Cooperation with FMO’s sector departments; development of a joint market strategy and a shared client approach of high potential debt clients with equity possibilities, could strengthen the relationship between PAR and the sector departments and therewith help better meeting the needs of our clients.
- Financial reporting; PAR’s current methodology for capturing FMO’s equity cash flows to produce IRR results is too complex and elaborate. With FMO’s fund management ambitions in mind, this set-up have to be professionalized and consequently transferred to an independent department that will be responsible for data management and reporting.

2. *A review was undertaken of the effectiveness of FMO's sustainability (E&S) approach with financial institution clients. FI E&S study (expected).*

This review followed up on the 2009 evaluation of the effectiveness of FMO's E&S approach with FI clients, which brought out that efforts made until that time had not been very effective in improving FI clients' E&S risk management. Based on this evaluation, the FI department formulated and implemented a new sustainability strategy. We were requested to assess how the strategy was executed by the department, how it evolved, what issues had been encountered, and what results were achieved on the ground, at our FI clients.

The 2009 recommendations were, initially, fully embraced in the strategy adopted by the FI department. Significant steps were made to implement these recommendations and, as a result, more than half of the clients where FMO had a role to play have meanwhile adopted good E&S risk management practice. This is a significant improvement compared to 2009 when the evaluation found that it was 'exceptional for our FI clients to comply with FMO's requirements'. Additionally, sustainability has, to large extent, become mainstreamed in the work of the FI department. Gradually, however, the initial focus on high risk clients appears to have become more diffuse, as the department has adapted its E&S strategy.

Increased focus on and assistance to ESMS implementation by category- A clients has borne fruit. Seven out of eight clients, where FMO steered the implementation process, have rolled out or upgraded their ESMS. In addition, increasing numbers of category B clients are seen to be willing and able, and also make progress on ESMS implementation. Thirteen out of twenty-one clients where FMO was actively involved had rolled out or enhanced their ESMS. Worth mentioning is the increasing trend in offering clients pricing incentives and capacity development assistance, which have been critical in stimulating ESMS implementation.

A novelty in FMO's approach, unforeseen at the time of the 2009 evaluation, is country-wide financial sector sustainability initiatives. Efforts went beyond individual clients to enhance sustainable banking practices in the whole financial sector in Nigeria and Bangladesh. The great achievement of these events was the impulse given to financial institutions to take ownership of and collaborate in developing a sustainability agenda for the entire sector. The translation of this momentum into improved E&S practices is the next step, which we expect to demonstrate that sector-wide engagement can be a powerful complement to our one-on-one E&S efforts with clients. The success of FMO's approach was found to derive from the fact that it is relationship based. Where sustainability was placed at the core of the relationship, FMO has been most effective in engaging clients on E&S. This is different from the transaction-based approach taken by (most) other DFIs, which limits the involvement to enforcing contractual requirements, often linked only to utilization of their own credit lines. The most articulate examples of FMO's approach are the sector wide initiatives and the way of working prevalent in the FI LAC team.

Although significant progress has been achieved, we noted that there is scope to further improve FMO's effectiveness in E&S at FIs. Looking at the experience to date, having interviewed FI IOs and managers, and having observed the practice of ESMS implementation at some clients, we identified a number of factors that, if addressed, could increase effectiveness:

- Coordination and prioritization at Department level;
- Management information on E&S at FIs;
- A clearer common understanding of what we expect from category B clients;
- Simplification of the E&S categorization of clients; and
- Further development of the 'opportunity' side, now the risk side is quite well dealt with.

The FI department has, meanwhile, outlined plans to take our recommendations on board.

### 3 *EFP Joint-EDFI evaluations on Energy Infrastructure projects confirming strong development results*

A first external evaluation of joint EDFI transactions<sup>13</sup> (all of them with active FMO involvement) has been performed by Dalberg consultants ([www.dalberg.com](http://www.dalberg.com)), a respected international expert in the area of international finance with local presence in emerging markets. The report clearly demonstrates FMO's leading role as impact investor in the energy industry in Sub Sahara Africa.

The evaluation study has analyzed three large energy projects (Rabai, Olkaria III, CEC) in energy constrained countries Kenya and Zambia. The energy situation of Low-Income Country Kenya is in particular characterized by load shedding, and the use of relatively expensive emergency capacity. Furthermore, overall installed power capacity in these countries is still rather low, while the two evaluated projects together contribute to app. 10% additional capacity on a national level. This clearly illustrates that FMO/EDFI can make a substantial difference by investing in energy projects. All of these projects have delivered very positive economic impact on the economies (additional electricity capacity, sizable cost savings due to low-cost character, lower emission levels, and induced employment) and the local communities, and also contributed to a more sustainable local energy industry. Of the range of outcomes (1-6), all projects have been scored as 1 ('very good project'). Results have been confirmed both by desk research, educated calculations, and by field research/interviews.

The evaluation research has used a variety of methods:

- Cost-benefit analysis: with help of a counterfactual analysis ('what would have happened if the project would not have been financed by an EDFI-partner/FMO?'), the cost-benefit (annual savings during the lifetime of the project) of a project has been calculated. Such a counterfactual analysis is by definition arbitrary, but serves well as an illustration of the ultimate impact of a project.
- With a scorecard methodology the ex-post impact of projects have been calculated and compared with the ex-ante calculations.
- An economic rate of return (ERR) has been calculated for each project based on the cost-benefit analysis.
- For every project the direct, and indirect jobs have been calculated, and the number of jobs which has been 'supported' by the project.
- For every project the number of electricity connections has been calculated.
- For every project a 'theory of change' framework has been designed (input => output => outcome => impact => goals), which connects the various financial inputs to the aimed impacts/goals.
- The role of FMO/EDFI-partners has been in all cases clearly additional (i.e. there would be no alternative financiers at the financial close). In particular, in the case of Kenyan situation at the moment of financial close (local elections, financial crisis), financial additionality has been significant, and FMO roles as arranger has been very beneficial.

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<sup>13</sup> EDFI: European Development for Finance Institutions, a cooperation between 14 different bilateral DFI's, which also finances joint projects under the EFP-program (European Financing Partners). Together with Proparco, and DEG, the French and German DFI's, FMO is the largest EDFI-institution.

The main results are summarized in the table below:

Project	Rabai	CEC	Olkaria III
Country	Kenya	Zambia	Kenya
Type of project	Thermal (dual) power plant (90MW IPP), 7% of total Kenyan capacity	Management buy-out of transmission company (incl. expansion)	Geothermal Power plant (52 MW IPP)
Total investment	111mIn EUR	135mIn USD	183mIn USD
FMO investment	29mIn EUR (arranger, equity + sr. debt)	22 (equity + debt)	15 (debt)
Financial close/operation	2008/2010	2006	2009-2012
Main impacts	<ul style="list-style-type: none"> <li>• Additional MW capacity</li> <li>• Cost savings (i.e. lower price)</li> <li>• Demonstration effect (local IPP market)</li> <li>• Lower emission levels</li> </ul>	<ul style="list-style-type: none"> <li>• Zambian ownership of transmission line, which supplies electricity to Zambia's mining region</li> <li>• Supports further expansion</li> <li>• CSR investments</li> </ul>	<ul style="list-style-type: none"> <li>• Additional MW capacity</li> <li>• Cost savings (i.e. lower price)</li> <li>• Demonstration effect (local IPP market)</li> <li>• Lower emission levels</li> </ul>
Impact: local/national	High/very high	Medium/High	Very high/medium
Overall Rating of the project	Very good	Very good	Very good
No of beneficiaries	522,000		302,000
No of direct & indirect jobs	105	350	80
Number of jobs supported	183-433 thd	50 thd	136-322 thd
Government revenues (annual)	3mIn EUR	1.5mIn EUR	7mIn USD
Savings on USD-imports			57mIn
Estimated annual savings	20-234mIn USD		59-274 MLN
Calculated ERR	16-112%	15-19%	27-89%

Note that in the case of Rabai, the benefits will increase as the current dispatch rate is still relatively low, but expected to increase as additional transmission capacity will become available in the short-term.

The underlying reason why the estimated cost savings and ERR show a very wide range is the 'what if' assumption of the electricity price in the counterfactual analysis. In the one low cost savings case, the price of emergency power is used, while in the high cost savings case it has been assumed that there would have been very costly unmet demand (i.e. no available capacity), which would have generated high opportunity costs.

Although less visible, the CEC project (management buy-out) also delivers substantial secondary effects: larger domestic ownership, more focus on domestic development (i.e. growth in other industries, capital market development via IPO), and CSR-investments.

Main recommendations to FMO/EDFI's are:

- For every project the intended impact logics should be made more clear/transparent (i.e. results in higher accountability),
- Indirect network effects (cost savings, higher reliability, jobs supported) should be given a higher weight in the scorecards and/or project selection criteria (at the expense of direct employment effects, in particular for energy projects).

The overall conclusions of the evaluation are that:

- All analyzed power projects have delivered their expected development output. Some of them outperformed expectations, due to larger network effects, or due to higher than expected annual savings and/or annual government revenues (both via dividends and via tax revenues), and CSR aspects of the underlying projects.
- The external research confirmed the very high development impact of energy projects in energy constrained Low/Middle Income countries.
- Furthermore, energy projects reach a very high number of ultimate beneficiaries, and contribute significantly to improvement in the business climate, and therefore to indirect job creation. Via its network effects, the ultimate impact of access to energy is much wider.
- Annual cost savings and government revenues are large, and deliver a high economic rate of return (ERR) for all underlying projects.

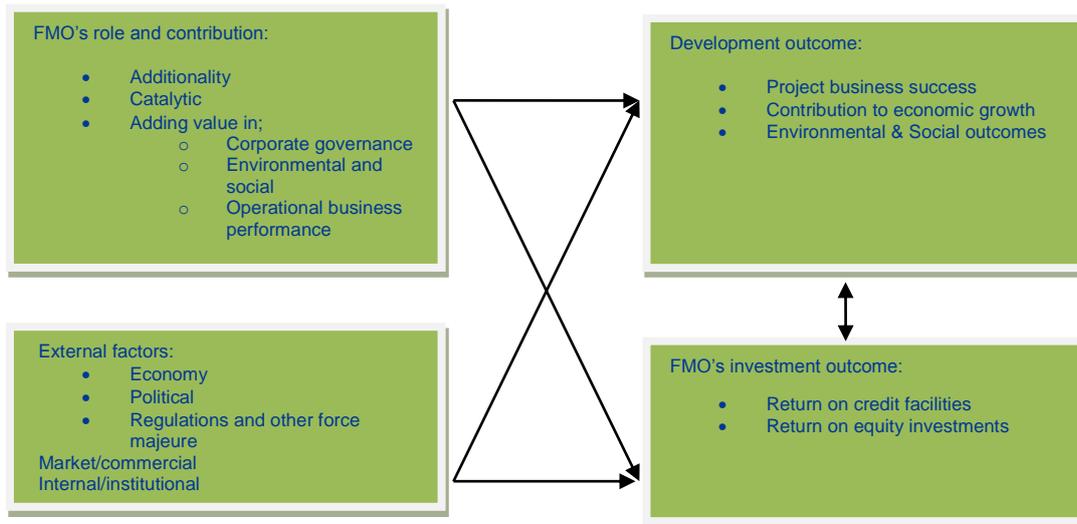
Finally, via the role of equity provider and/or arranger FMO has played (and will continue to play) a leading role in financing Africa's future sustainable energy generation. This external research report clearly supports FMO strategic choice for energy as one of its focus industries.

## ANNEX.1

### 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 2011, we evaluated a 50% representative stratified sample of projects contracted in 2006. 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<sup>14</sup> 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.

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

<sup>14</sup> Our current methodology for portfolio-wide evaluations differs slightly from GPS; although we do not assess work quality in this evaluation program, we make up for that in the sector studies.

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 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](mailto:evaluation@fmo.nl))

## b. Sample representativeness: Project evaluations 2011

### By region:

	2006 Approvals – total number of projects	Sample evaluation, 2011
<b>Region</b>	<b>125 (100%)</b>	<b>61 (100%)</b>
Africa	30 (24.0%)	15 (24.6%)
Asia	28 (22.4%)	14 (23.0%)
ECA	39 (31.2%)	18 (29.5%)
LAC	28 (22.4%)	14 (23.0%)

### By sector:

	2006 Approvals – total number of projects	Sample evaluation, 2011
<b>By sector</b>	<b>125 (100%)</b>	<b>61</b>
Financial institutions	80 (64%)	39 (64%)
Infrastructures	17 (14%)	9 (15%)
Other	28 (22%)	13 (22%)

### By source of fund:

	2006 Approvals – total number of projects	Sample evaluation, 2011
<b>By type of fund</b>	<b>125 (100%)</b>	<b>53 (100%)*</b>
<b>FMO-A</b>	<b>77 (62%)</b>	<b>30 (56%)**</b>
<b>Of which, clients provided with;</b>		
Loan		24 (80%)
Equity/Mezzanine		5 (17%)
Loan + equity		1 (3%)
<b>Government funds:</b>		
FMO-A / MASSIF	4 (3%)	2 (4%)
FMO-A / MOL	1 (1%)	0 (0%)
FMO-A / NIMF	1 (1%)	1 (2%)
IFOM	13 (10%)	5 (9%)
MASS	22 (18%)	11 (21%)
MOL	5 (4%)	3 (6%)
NIMF	2 (2%)	1 (2%)

\* Out of these 53 project evaluations, 6 projects were prepaid, 7 have been repaid, 40 is not fully repaid (amounts still outstanding).

\*\*Although 37 projects were initially in this sample for 2011 evaluations, 7 of these clients' projects have been evaluated one or two years ago (that is with earlier facilities with repeat clients). To avoid repetitions, these have been excluded from this sample, therefore arriving at the 30 FMO-A sample of projects 2011 evaluations.