ove Office of Evaluation and Oversight

Corporate Evaluation

Inter-American Investment Corporation

Tenth Annual Independent Validation Report

IDB
Inter-American Development Bank
Inter-American Investment Corporation
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ACRONYMS AND ABBREVIATIONS

DEC	Development Effectiveness Unit
DEM	Development Effectiveness Matrix
DIAS	Development Impact and Additionality Scoring system
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
ECG-MDB	Evaluation Cooperation Group of the Multilateral Development Banks
EOM	Early operating maturity
FI	Financial intermediary
FIL	Financial intermediary line (of credit)
GPS	Good Practice Standards
GPS3	Third Edition Good Practice Standards
GPS4	Fourth Edition Good Practice Standards
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
IRR	Real After-Tax Internal Rate of Return
ORP	Office of Outreach and Partnerships
OVE	Office of Evaluation and Oversight
PPP	Public private partnership
PSD	Private sector development
PSU	Portfolio Management and Supervision Unit
ROI	Return on Investment
ROIC	Return on invested capital
SME	Small and Medium Enterprises
TAS	Technical Assistance & Strategic Partnerships Division
XASR	Expanded Annual Supervision Report

EXECUTIVE SUMMARY

This is the tenth consecutive year that IIC has contractually engaged OVE to support it in implementing a standardized system to account for the developmental and financial results of its investment projects. This system - within which reports like the present one serve to record the results of successive annual batches of mature projects - is compliant with the Good Practice Standards (GPS) for Private Sector Operations issued by the Evaluation Cooperation Group of Multilateral Development Banks (ECG-MDB).[1]

Shortcomings in the current GPS methodology have given rise to discussions among ECG members, as well as within IDB, on the possible benefits of increased convergence with the standards for evaluation of public sector operations. These discussions are likely to lead to adjustments in the approach to private sector project evaluation.

Given methodological shortcomings in GPS, results in this report should be considered with caution. The report presents the application of the standards to an annual batch of 24 mature projects, corresponding to a total IIC investment of US$187.9 million. Under the current version of the good practice evaluation standards, 79% of projects (US$165.7 million) rated at least mostly successful in *Development Outcomes*, while *Investment Outcome* was rated as satisfactory for 88% of the projects (US$166.2 million in IIC investment).

IIC Work Quality presented mostly favorable results, with 79% of projects (US$171 million in IIC investment) receiving satisfactory ratings. Finally, from this limited project-by-project evaluation perspective, IIC seems to still have added value to a majority of clients: 63% of projects (US$131 million) rated satisfactory in *Additionality*.

Despite the likelihood of future methodological changes, the discipline brought about by the annual exercises like the one reflected in this report has allowed IIC to strengthen its self-evaluation capabilities over the last decade. In addition, the system has also allowed IIC to identify useful lessons to improve future IIC projects in similar areas, as well as highlight opportunities to increase the reliability of its evaluation system.

Lessons from this report suggest further opportunities to enhance IIC’s project appraisal, structuring and supervision processes by fully leveraging IIC’s financial and non-financial (technical assistance) product offering. These lessons also appeared in prior batches and were the subject of recommendations in last year’s report. Instead, this report has a single recommendation: work with OVE to revamp IIC’s project evaluation system to address the shortcomings of the current one, while seeking harmonization across IDB’s private sector and sovereign guarantee windows. This will likely entail overhauling both IIC’s ex-ante project assessment tools (with a view towards enhancing project evaluability) and IIC’s project monitoring and ex-post assessment approach.

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[1] The Evaluation Cooperation Group (ECG) is made up by the independent evaluation functions, including OVE and analogous counterparts from the World Bank, EBRD, EIB, the Asian Development Bank, the African Development Bank, and similar institutions. At the early behest of common shareholders of the different entities, ECG initially set out to harmonize evaluation metrics so that project results could be compared across entities.

I. RATIONALE AND SCOPE

1.1 This report presents OVE's independent validation of IIC's self-evaluation results, corresponding to the 24 projects that reached early operating maturity (EOM) during calendar year 2011. EOM occurs when operations meet a set of objective criteria defined by the Good Practice Standards (GPS) of the Evaluation Cooperation Group of Multilateral Development Banks (ECG-MDB).[2] As per these GPS, the projects in this batch were first self-evaluated by IIC (during 2012) and later validated by OVE (during 2012 and 2013).[3]

1.2 This is the tenth consecutive year that IIC has contractually engaged OVE to support it in implementing this standardized system to account for its developmental and financial results.[4] This system - as well as the content, information and types of analyses contained in this report - was designed to be compliant with the Good Practice Standards (GPS) of the Evaluation Cooperation Group of Multilateral Development Banks (ECG-MDB).[5]

1.3 Conforming with GPS, this Tenth Annual Validation Report includes, a rationale for the project sample selection; an explanation of the ratings criteria and benchmarks; a disclosure of any rating disagreements between OVE and IIC; a review of the results, highlighting the proportion of projects falling into each rating category; a discussion of ratings trends over time; and a description of lessons learned and their application to new projects. In addition to these required items, OVE includes a regression analysis linking observed developmental outcomes with ex-ante project characteristics that could be controlled (such as

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2 According to GPS (standard 2.1.3), corporate projects reach early operating maturity when: (a) the project financed has been substantially completed, (b) the project financed has generated at least 18 months of operating revenues for the company and (c) IIC has received at least one set of audited annual financial statements covering at least 12 months of operating revenues generated by the project. By contrast, GPS (standard 2.1.4) defines early operating maturity for financial projects after at least 30 months following the IIC's final material disbursement for sub-loans or sub-investments, i.e., ignoring disbursements for small follow-up investments in existing client companies and disbursements to cover management fees or other expenses of the investment funds themselves.

3 GPS require that each year's project batch be representative of the universe of maturing projects. Since the inception of the system, IIC has exceeded that requirement by evaluating 100% of the maturing projects, leading to a results reporting system that avoids any potential selection bias.

4 Currently OVE has no comprehensive evaluation mandate over the IIC, which is a separate legal entity within the IDB Group. OVE works only under a contractual arrangement with IIC, exclusively for these ECG-GPS validations. As an exception, in 2005 the IIC Board requested that OVE delay the annual validation exercise and conduct instead a thematic evaluation of the performance of IIC's Financial Intermediary Lines. Due to this special request, annual validations by OVE have since been conducted with a one year lag relative to IIC's XASR delivery.

5 Starting in 2000, Private Sector Investment Operations led the way in setting common harmonization metrics that ECG members have since striven to apply. Through a series of compliance benchmarks commissioned by ECG, incremental modifications were adopted into the standards, which are now in a fourth edition. Similar to other institutions, this report uses the third edition, with the fourth one timed to be rolled out with the next annual batch.

work quality, project size, among others), and a discussion of how prior recommendations are being implemented by IIC.

1.4 This evaluation is based on individual project assessments - Expanded Annual Supervision Reports (XASRs) - prepared by IIC Investment Officers for the 24 operations maturing in 2011.[6] OVE analyzes IIC's evidence, the impartiality and consistency in rating judgments, and the appropriateness of the identified lessons. OVE compiles its validation into written comments for each project, and re-engages IIC to obtain further evidence to support the ratings.[7] As in prior years, IIC took into account OVE's comments, to the extent possible procured the additional information required by OVE, and arrived at final self-assigned ratings. After this iterative process, IIC and OVE reached agreement on all rating modifications suggested by OVE for this project batch.[8]

1.5 Each project's performance is evaluated on four dimensions: *Development Outcome*; *Investment Outcome*; *Work Quality*; and *Additionality*.[9] *Development Outcome* is aimed at assessing the project's effects on the client's sustainability and its contributions to the host countries' overall development. *Investment Outcome* reflects IIC's financial returns from the project. *Work Quality* focuses on IIC's role and operational effectiveness. *Additionality* assesses whether the project added further value by catalyzing private sector investments, providing terms not available in the market, or improving the project's design or functioning.

1.6 Each one of these dimensions comprises sub-categories. There are four sub-categories under *Development Outcome* (Project Business Performance, Economic Impact, Environmental and Social Performance, and Private Sector Development); two under *Investment Outcome* (Loan Performance and Equity Performance), three under *Work Quality* (Screening/Appraisal/Structuring, Monitoring/Supervision, and Role and Contribution), and one under *Additionality*. Each project is systematically rated under each one of the sub-categories, and a composite rating is derived for each one of the four major evaluative dimensions.

1.7 Projects reaching EOM in 2011 were evaluated based on the Third Edition of the GPS (GPS3). Recent discussions among ECG members, as well as within IDB, are increasingly pointing to shortcomings in the methodology, particularly in providing a solid framework for assessing the developmental effects and

6 The format of the XASRs has been standardized to comply with GPS.

7 See Annexes I and II for the detail about OVE´s examination of each project.

8 Had agreement not been reached, GPS provide that OVE would have proceeded using its own independent ratings, but would have disclosed the nature of any disagreement.

9 See Annexes III and IV for a detailed description of ratings criteria and benchmarks.

additionality of private sector operations.[10] Because of the methodological limitations of GPS3 and the small number of projects covered by this exercise, the results presented in this report must be interpreted with caution.

1.8 GPS3 shortcomings were partially addressed in a Fourth Edition of the GPS (GPS4), which ECG recommends applying to projects reaching EOM as of 2012. However, discussions of possible increased convergence of the standards for evaluation of public and private sector operations are also ongoing, both at the IDB Group and within ECG. The recent convergence of the Development Effectiveness Matrices (DEMs) for public and private operations within the IDB Group is a step in this direction. OVE is working with SCF and the other private sector windows of the IDB Group to develop a project evaluation framework focusing on development results.

Box 1.1 ECG-GPS Methodological Shortcomings

GPS3

- ✓ GPS3 assessment of project Development Outcomes is weak in its analysis of economic development contributions, particularly for financial market projects.
- ✓ GPS3 allows the use of proxies, such as return on invested capital (ROIC) and economic return on invested capital (EROIC), as substitutes for financial rate of return (FRR) and economic rate of return (ERR). The use of these proxies is, however, inadequate as they usually reflect returns for the whole company and not of the project itself. Hence, attribution of business and economic development contributions to specific projects can be difficult, except for stand-alone project companies.
- ✓ GPS3 also generally allows projects to receive a satisfactory rating on its Contribution to Private Sector Development (PSD), even without significant supporting evidence.
- ✓ GPS3 also lacks objective indicators for assessing Non-Financial Additionality, as ratings are usually anchored in subjective inferences about the MDB's contribution to the project.
- ✓ GPS3 Work Quality criteria allow projects to receive satisfactory ratings even when they lack adequate result frameworks or do not track development outcomes during implementation (low evaluability).
- ✓ Since operations are evaluated at maturity, a gap of 3 to 6 years typically elapses between their approval and preparation of the XASRs. Therefore, findings and lessons from each report are not automatically representative of IIC's current operational practices. Yet, XASRs typically incorporate the Investment Officers' hindsight regarding current best practices.

GPS4

- ✓ GPS4 only partially addresses some of these shortcomings. For example, GPS4 recommends the analysis of sub-portfolios to reduce intrinsic attribution problems of ROIC and EROIC for the assessment of a financial market project's contribution to business and economic development.
- ✓ However, GPS4 still has shortcomings, such as the lack of quantitative development indicators for financial market operations, lack of evidence-based criteria for rating project contribution to PSD, lack of objective assessment criteria for MDB Work Quality, lack of focus on the project's evaluability, and overall the lack of a robust approach to measure the projects' development effectiveness.

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10 In particular, the criteria for assessing *development outcomes* place a great emphasis on relatively indirect variables (such as the client's business success). Systematic reliance on these proxies diminishes the pressure to assess projects from a wider perspective (i.e. the logical chain of the intervention). Although in theory the aggregate development outcome rating as per ECG/GPS combines judgments on four underlying factors – Project Business Performance, Economic Sustainability, Environmental Performance and Private Sector Development – these are not treated equally. In practice, the strong emphasis on the first – and more quantifiable – area of the client's business performance, has led to a general lack of objective criteria on what constitutes significant contributions to development in the other three dimensions, as well as on the type of evidence that is considered acceptable.

II. PROFILE OF THE 10TH ANNUAL BATCH OF MATURE PROJECTS

2.1 **This annual batch involved US$187.9 million in aggregate IIC disbursements, predominantly to Financial Intermediaries (FI).** FI operations constituted 64% of disbursements (US$121.2 million) via 46% of the projects (11 operations). In contrast, the 13 corporate projects in this 10th batch accounted for US$66.7 million in disbursements (36% of the total). The batch included only one equity investment (combined with a loan) to a FI located in an A country. All the other projects consisted exclusively of loans.

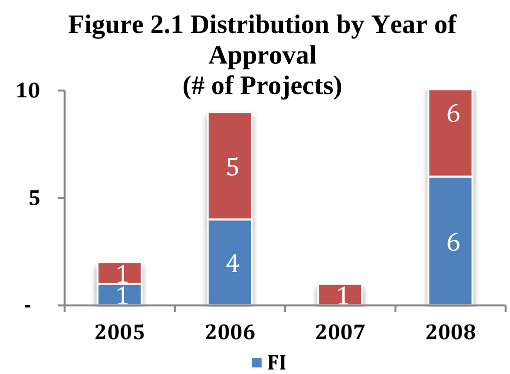
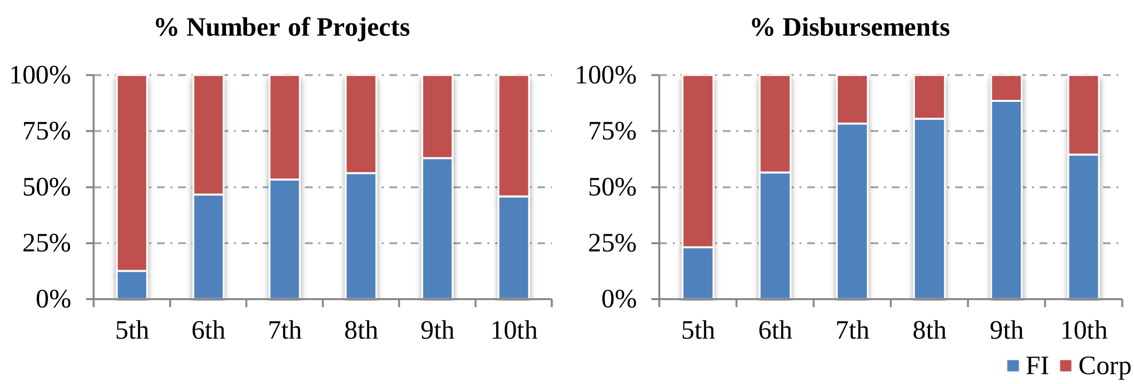
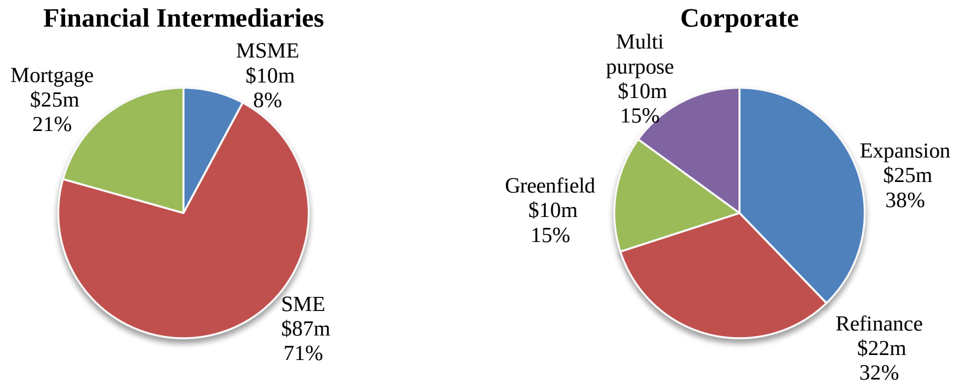


Figure 2.2 Share of Financial Intermediary Operations



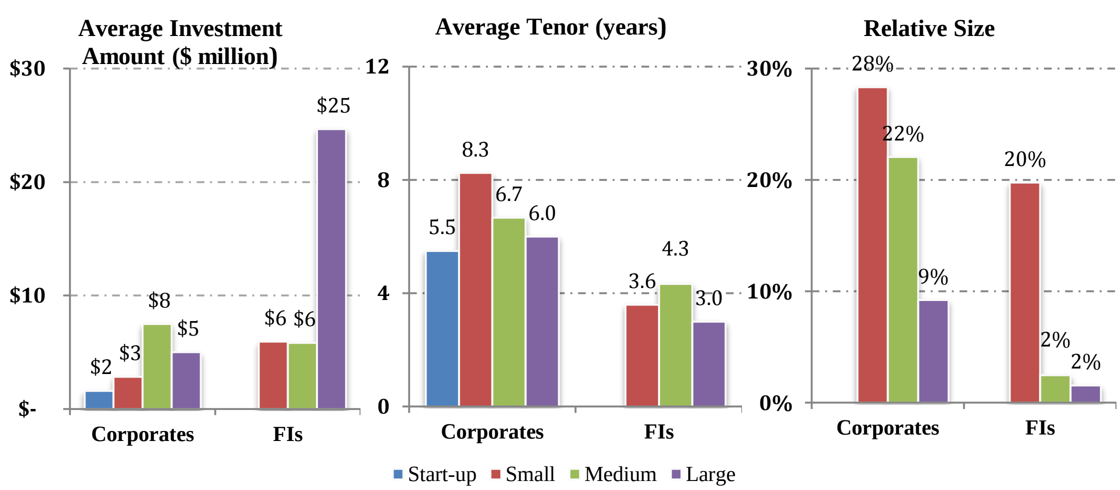
2.2 **Most Corporate operations were aimed at supporting capacity expansion and refinancing existing debt; while FI operations focused mostly on supporting SME financing.** Manufacturing was the most prevalent sector among corporate projects (4 projects, 22% of disbursements), while commercial banks represented the largest group among FIs (5 projects, 37% of FI disbursements). Among the corporate operations, there were also two projects with retailers and two with river-shipping companies.

Figure 2.3 Distribution by Use of Funds – 10th Batch



2.3 **The average investment size in corporate operations was $5.1 million, while the average size with FIs was $11.0 million.** By contrast, IIC offered longer tenors to Corporates than it did to FIs (6.4 years vs. 3.6 years, respectively). On average, IIC investment represented 16% of its corporate clients' total assets and 10% of the FIs' lending assets. Within the latter group, there was a very substantial difference in the relative size of the IIC loan between small and large FIs: IIC loans averaged 20% of small FIs' assets, while they only averaged 1.6% of the large FIs' lending asset base. In turn, average IIC lending tenors tended to be shorter for larger corporate clients.

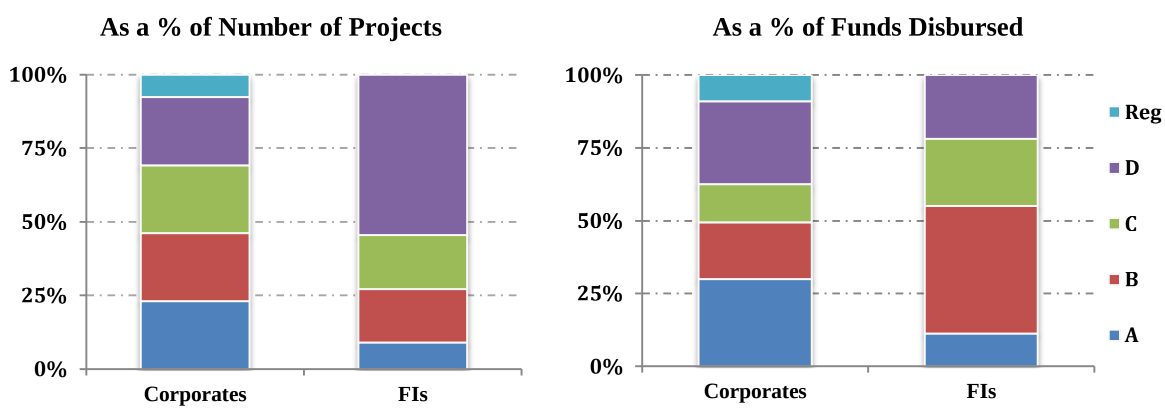
Figure 2.4 IIC's Contribution Relative to Size of Client - 10th Batch[11]



[11] For Corporate projects, relative size of IIC's financial contribution is measured as % of Total Assets. For FIs, it is measured as % of the total outstanding portfolio. The relative size of IIC's contribution to Corporate start-ups projects is not reported in the graph because one of the firms' total assets was too small at the approval date.

2.4 **This year's batch had a large number of projects in D countries (38% of total operations), but the majority of the funds was directed towards clients in B countries (35% of total disbursements).**[12] This can be explained by a disparity in the average investment amounts for FIs. Although 55% of the FI clients were in D countries (6 projects), the average loan size for those clients was $4.4 million. By contrast, in B countries operations averaged a much higher amount of $26.5 million. This led to 44% of all FI funds ($53 million) being disbursed through only two FI operations in this latter group.

Figure 2.5 Distribution by Country Group - 10th Batch

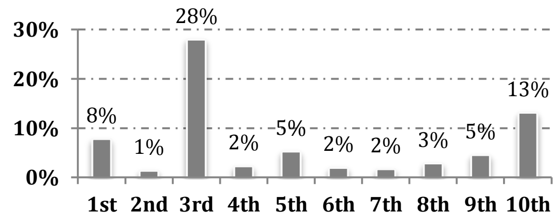


A. Project Ratings - 10th Annual Batch

2.5 **This section consists of three parts: the first one presents aggregate results for this 10th annual batch, followed by sections with more detailed analyses of the performance of *corporate projects* and *financial intermediary lines*.** Each part contains rating information for the current batch of XASRs on the four evaluative dimensions (*Development Outcome, IIC Investment Outcome, IIC Work Quality, and Additionality*).

2.6 **For this annual evaluation cycle, OVE suggested 38 downgrades (13% out of total ratings).** After revisions, IIC agreed to modify all of these ratings.[13] The high share of downgrades can, in part, be

Figure 2.6: Rating Downgrades (% of Total Number of Ratings)



[12] Projects in A countries: Argentina (4); in B countries: Chile (3) and Colombia (2); C countries: Costa Rica (2), Jamaica (1), Panama (1) and Uruguay (1); D countries: Bolivia (1), Ecuador (3), Guatemala (2), Panama (1), and Paraguay (3). The regional project involved Brazil and Argentina.

[13] In compliance with GPS 3.3.6, OVE informed IIC regarding these changes through a ratings validation variance memorandum addressed to the responsible senior operations manager, with copies to the relevant XASR teams and their managers. This memorandum is reproduced in Annex V.

explained by OVE's own stricter evidence requirements in the assessment of *IIC Additionality* (which accounted for 21% of the total number of downgrades).[14] As discussed before, under the current GPS methodology the assessment of *Additionality* was mostly based on qualitative descriptions, often lacking objective supporting evidence.[15] In the past, OVE's approach to the validation of those ratings was to accept the XASRs added-value claims unless evidence of the contrary was found, in which case ratings would be downgraded. In this 10th exercise, OVE has moved to increase the burden of evidence: unless IIC was able to provide evidence corroborating its value added claims, ratings were downgraded.[16]

1. Project Ratings - Complete Batch

Table 2.1 Share of Favorable Ratings
(All 24 Projects in this year's batch)

Dimensions and Sub-categories	% of Number of Projects	% of Funds Disbursed
1. Development Outcome	**79%**	**88%**
Project business performance	83%	94%
Economic impact	50%	36%
Environmental effects	83%	89%
Private sector development	88%	94%
2. IIC Investment Outcome	**88%**	**88%**
Loan	92%	96%
Equity	0%	0%
3. IIC Work Quality	**79%**	**91%**
Screening, appraisal, structuring	71%	65%
Supervision, administration	100%	100%
Role and contribution	88%	93%
4. IIC Additionality	**63%**	**70%**

2.7 **In terms of number of projects, 79% (19 projects) received a favorable rating in *Development Outcome*, while 88% (21 projects) had satisfactory *Investment Outcome* ratings.** In terms of disbursements, 88% ($166 million) received favorable *Development Outcome* ratings and also 88% of investments ($166 million) received satisfactory ratings in the *IIC Investment Outcome* category.

14 There were also several downgrades in *Screening, appraisal and structuring* (15% of the total).

15 In most cases, XASRs argue that IIC added value by helping meet SMEs' demand for longer tenors. Similarly, in most of the FI projects, the XASRs argued that IIC added value by helping the FI clients themselves improve their financial position through terms not available in the market. In addition, several XASRs also reflected IIC's influence on improving the FI's capabilities to monitor the environmental practices of their clients. Nonetheless, since objective parameters for what constitutes *Additionality* are not clearly defined, performance in this category tended to be rated favorably in past reports even when the value-added by IIC may had been hard to quantify.

16 This changed approach was anticipated in the 9th Annual Validation Report, which stated that "[i]n future batches, OVE will work with IIC to increase the requirements for evidence, seeking indicators to support the value added described in XASRs".

2.8 **IIC *Work Quality* ratings were favorable in 79% of projects (19 projects or 91% of funds), while only 63% of projects (15 projects or 70% of disbursements) performed favorably in *Additionality*.** There was a significant share of projects with favorable *Development Outcome* ratings, but low *Additionality*: 29% of the projects (26% of disbursements).[17] The fact that IIC and OVE could not substantiate any significant value added in many of these "financially successful" interventions suggests uncertainty as to the incremental development results had the IIC not provided funding to those clients. Investments in larger, safer clients seem to have kept IIC from having a more substantive role in improving the course of the client's developmental effects.

2. Project Ratings - Corporate Operations

Table 2.2 Share of Favorable Ratings
(All 13 Corporate Projects in this year's batch)

Dimensions and Sub-categories	% of Number of Projects	% of Funds Disbursed
1. Development Outcome	**77%**	**86%**
Project business performance	77%	86%
Economic impact	62%	74%
Environmental effects	77%	81%
Private sector development	85%	88%
2. IIC Investment Outcome	**85%**	**88%**
Loan	85%	88%
Equity	0%	0%
3. IIC Work Quality	**62%**	**74%**
Screening, appraisal, structuring	62%	74%
Supervision, administration	100%	100%
Role and contribution	77%	81%
4. IIC Additionality	**46%**	**34%**

2.9 **As per the XASRs in this batch, IIC's clients mostly achieved their business objectives and provided at least some basic evidence of positive development contribution.** The share of IIC disbursements to corporate projects with favorable *Development Outcome* ratings was high, reaching 86% ($58 million).

2.10 **Six out of the 13 corporate projects (58% of funds) were associated with "successful" *Development Outcome* ratings[18].** Operations rated as "successful" included one Greenfield project in a C-country that came to IIC through an Agency Line; two loans to help improve clients' debt profiles, two operations supported clients' expansion plans in D-countries and a project that combined

[17] This issue is more evident among Corporate projects: while for FIs 18% of projects (6% of disbursements) had high *Development Outcome* and low *Additionality* ratings, this share reached 38% of the Corporate investments (or 54% of disbursements to that group of clients).

[18] *Development Outcom*e ratings were largely driven by favorable business results and - relatively easy to reach - favorable *Private Sector Development* ratings. By contrast, contributions to economic development were relatively lower.

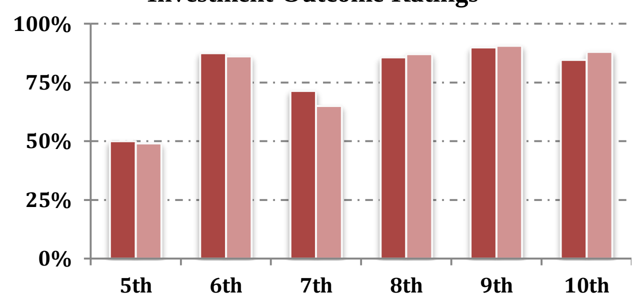
debt refinancing and support for the expansion of an international container facility concession in an A-country. Two corporate projects in this batch were rated as outstanding in terms of *Development Outcomes* (see box 2.1). By contrast, two other corporate projects had negative results, rating “highly unsuccessful” in *Development Outcomes*. The first one was a Greenfield project, where higher than expected start-up costs, lower demand, and a substantial increase in raw material costs led the client to abandon the venture only seven months after IIC’s disbursement. The second loan to a B-country, frozen-fish exporter was downgraded to substandard and transferred to the Special Operations Unit, as the client failed to disclose his true financial standing to the IIC.

Box 2.1 Corporate Operations – Examples of successful *Development Outcomes* ratings

- ✓ **One operation with a high *Development Outcomes* was a loan to a manufacturing company to improve its financing tenor**. Even though the company had a slight increase in the number of employees from 1,555 to 1,600, there was a significant impact on the company’s supply chain. At the time of appraisal, the supply chain comprised twelve cooperatives and about fifty micro entrepreneurs, half of which were female-owned micro-enterprises, accounting for approximately 2,500 direct and indirect jobs. By the end of the operation, it had significantly grown to approximately 5,000 direct and 3,000 indirect jobs (1,100 employed by the cooperatives and about 2,000 small manufacturers).
- ✓ **Another loan aimed to address the high working capital requirements of a retail company.** The client’s need arose from its opening of new branches and its rapid sales growth. At the time of appraisal the company had 519 employees. It was expected that approximately 140 jobs would be created between 2009 and 2010 and an additional 80 jobs for 2011 to 2012. As of September 2011, the company had created a total of 148 jobs.

2.11 **IIC’s satisfactory *Investment Outcome* ratings for corporate projects represented 88% of funds (or 11 out of the 13 corporate projects).** This batch also included two projects with low investment outcomes. This IIC investment performance in the high 80s% is similar to the one obtained in prior batches. (see Figure 2.7). In terms of *IIC Work Quality*, eight projects received satisfactory ratings. Finally, only 46% of projects (34% of disbursements) received favorable *Additionality* ratings (see Box 2.2).

Figure 2.7 Corporate Favorable Investment Outcome Ratings

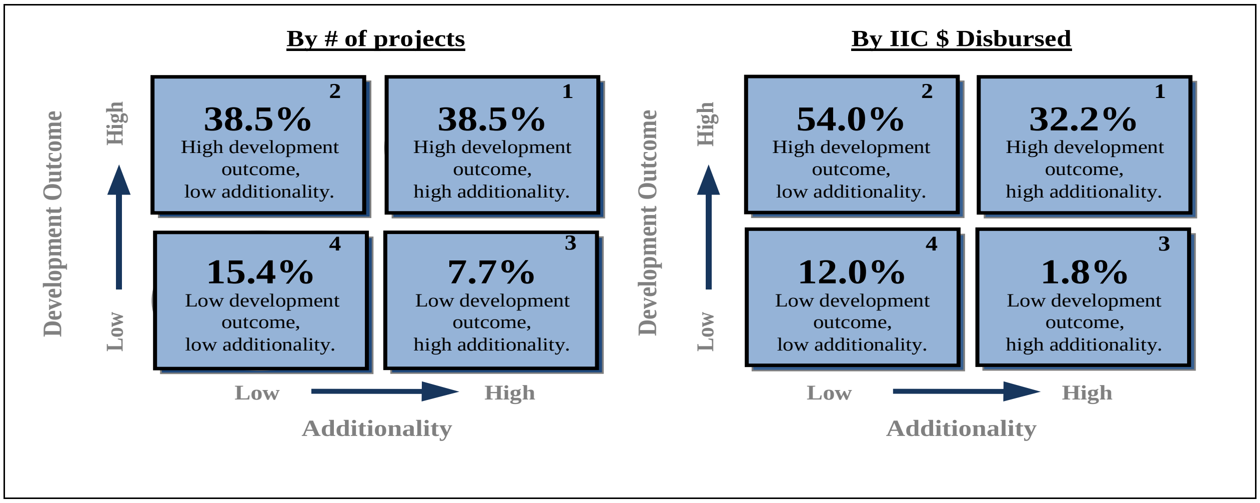


Box 2.2 Corporate Operations – Some drivers of IO, WQ and Additionality Ratings

- ✓ **A project for expanding a company's manufacturing capacity was rated unsatisfactory in *Investment Outcome* (IO)**. The company incurred in higher start-up costs, lower demand, price erosion, coupled with higher input prices. Of the US$2.5 million loan disbursed only US$1.2 million was recovered. The remaining US$1.3 million were written off.
- ✓ **Another operation for financing working capital in a food producer and exporter was rated unsatisfactory in *Work Quality* (WQ).** The company lacked sound financial controls and corporate governance which seems to have contributed to the underperformance of the loan. Those problems were not detected during the screening and risk assessment processes.
- ✓ **A combination of financing and technical assistance helped an SME strengthen its competitive position, getting IIC a satisfactory *Additionality* rating.** IIC provided a large loan for a small company with terms that were not available in the country. Moreover, the company requested and was awarded technical assistance to improve its competitive position, develop a business strategy and improve corporate governance of a family owned business.

2.12 **High ratings in *Development Outcome* are not correlated with favorable ratings in *IIC's Additionality* which gives rise to questions regarding the extent to which IIC can take credit for the positive developmental effects produced by those clients, particularly when the claim to IIC's Additionality is mostly financial**. A general argument that runs across most XASRs is the claim that IIC added value by providing terms that would otherwise be unavailable in the market. However, not only do the Board Approval documents and XASRs fail to show evidence that this was the case, but they also fall short from demonstrating that without those allegedly better terms the developmental results would have been significantly different.

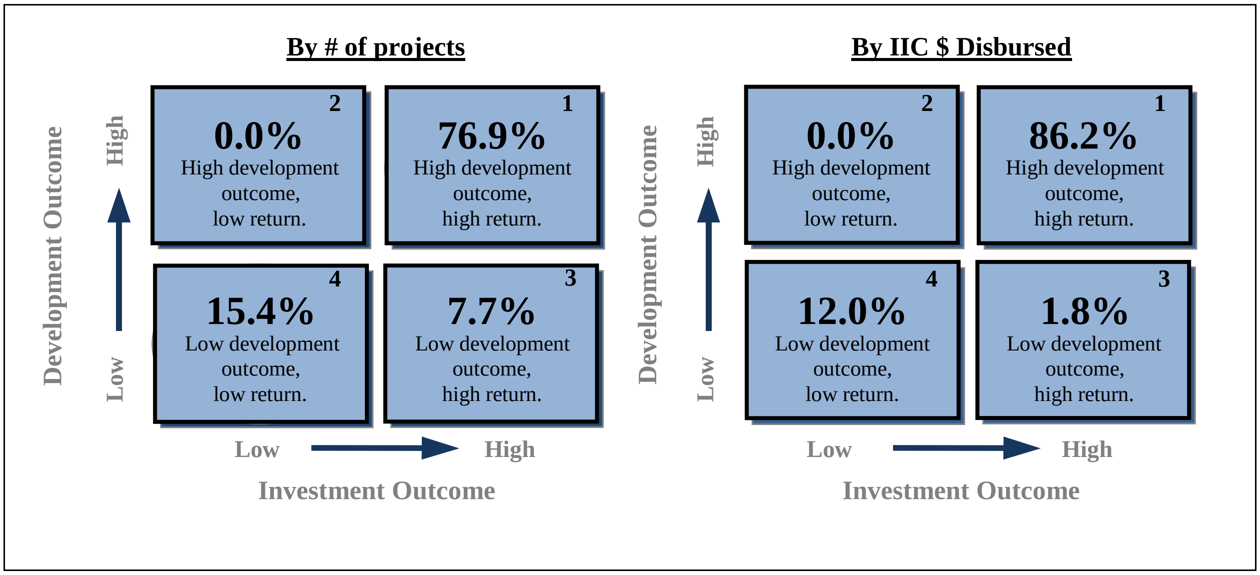
Figure 2.8: Development Outcome *vs.* Additionality Ratings – Corporate Projects



2.13 **By contrast, IIC *Investment Outcome* ratings are highly correlated with the ratings assigned to *Development Outcome* under the current GPS, which raises questions as to the potentially excessive reliance of developmental ratings on purely financial considerations.** As explained before, the current GPS relies heavily on financial measures and benchmarks to develop metrics for

developmental effects. This is built into the current GPS, because economic rates of return are estimated by introducing correcting factors on the project's underlying financial rates of return, such adding taxes paid, as one of the proxies for wider societal benefits.

Figure 2.9: Development Outcome vs. Investment Outcome – Corporate Projects



3. Project Ratings – Financial Intermediary Operations

Table 2.3 Share of Favorable Ratings
(All 11 Financial Projects in this year's batch)

Dimensions and Sub-categories	% of Number of Projects	% of Funds Disbursed
1. Development Outcome	**82%**	**89%**
Project business performance	91%	98%
Economic impact	36%	14%
Environmental effects	91%	93%
Private sector development	91%	98%
2. IIC Investment Outcome	**91%**	**89%**
Loan	100%	100%
Equity	0%	0%
3. IIC Work Quality	**100%**	**100%**
Screening, appraisal, structuring	82%	60%
Supervision, administration	100%	100%
Role and contribution	100%	100%
4. IIC Additionality	**82%**	**89%**

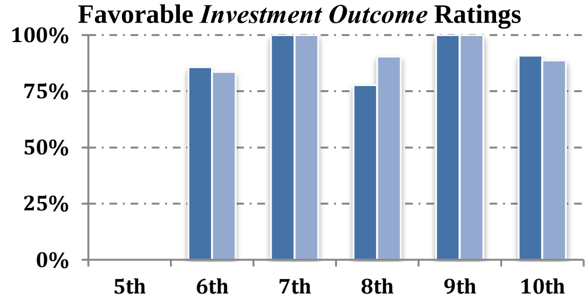
2.14 **While the current GPS measure of *Development Outcome* yielded favorable ratings for 82% of FI projects in this batch (representing 89% of disbursements), this is not necessarily an accurate reflection of development effectiveness due to the way this dimension is assessed under the current GPS.** FI operations with favorable *Development Outcome* ratings as per the current GPS included one loan to a small, B-country factoring company, one loan

to a large B-country government owned bank, and one to an A-country mutual guarantee company. However, it is important to point out that these ratings were largely driven by the project's financial performance; as estimates of economic return were derived as incremental corrections, e.g., taxes paid, to the project's underlying financial results. In general, it was difficult to find independent evidence of direct contributions to economic development.

2.15 **Two projects were rated "highly successful" in Development Outcomes and one received a "successful" rating.** These three projects had one characteristic in common: clients had received prior assistance from either IIC or from other international development institution. By contrast, two FI projects rated "mostly unsuccessful" on *Development Outcomes* because they could not produce evidence of positive developmental contributions beyond their own business performance. One of them, a small bank in a Caribbean Country, faced structural and strategic problems that compromised project results and had been not adequately considered during appraisal.

2.16 **Similar to prior batches, *Investment Outcomes* were satisfactory for 10 out of 11 FI operations in this batch, as only one project received a "partly unsatisfactory" rating**. In terms of *IIC Work Quality*, all of the FI projects were rated "satisfactory", whereas only eight out of 11 FI projects were satisfactory in terms of *Additionality*. In all of these cases the XASRs argue that IIC had added value by helping the FIs improve their financial position through terms not available in the market (including longer tenors and access to dollar financing to support export oriented SMEs).

Figure 2.9: FI Share of Favorable *Investment Outcome* Ratings

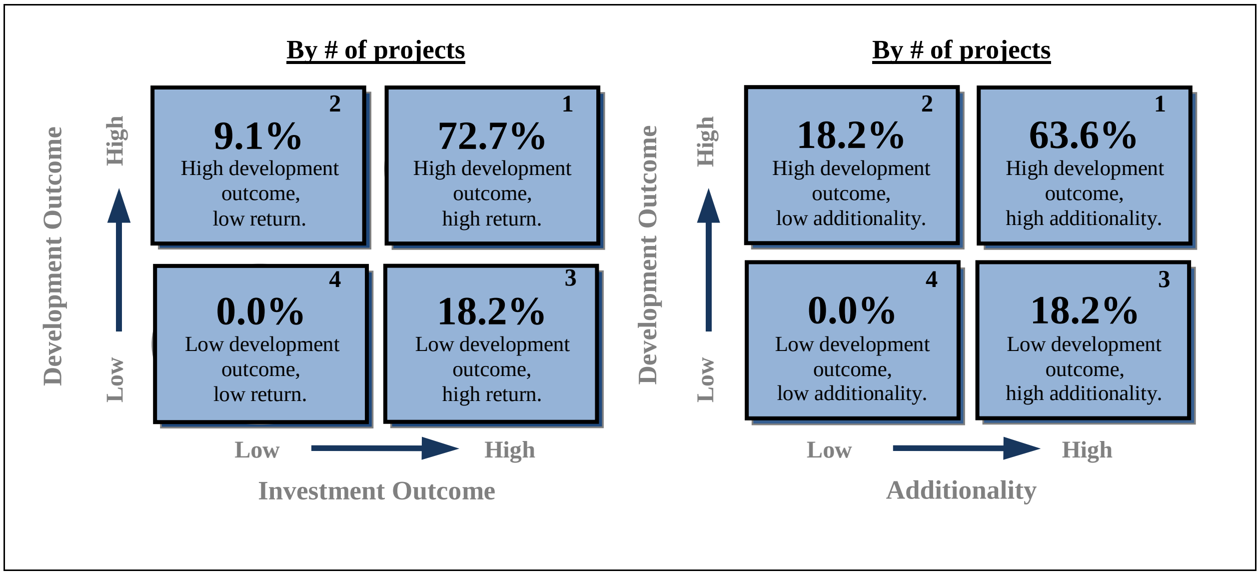


Box 2.3 FI Operations – Examples of highly successful Development Outcome

- ✓ **One operation was designed to provide medium term sub loans to micro, small and medium size enterprises for the purchase of machinery and equipment.** The FI in turn supported about 260 productive MSME, employment generation and deepened the financial sector of the country. Most of the loans beneficiaries were in the agricultural, trade and service sectors. Many of them were low income farmers living in rural areas without access to any source of formal financial services. Sub loans averaged US$ 10.500. FI SME portfolio increased from approximately US$ 4m in 2006 to US$ 10.1m in June 2010. The microenterprise portfolio increased from US$ 10m in 2006 to US$52.6m in June 2010.
- ✓ **Another similar operation enabled a small FI to grow and consolidate its position in the micro-lending segment and become a bank in 2008.** The FI SME portfolio increased from 10% of its total portfolio as of December 2008 to 19.5% as of December 2010. Loan volume increased from US$18 million to US$66 million as of December 2011. The microenterprise portfolio increased from US$86 million in 2008 to US$185 million in 2011. The number of branches increased from 31 in 2008 to 69 as of June 2011, mostly in rural areas.

2.17 **Unlike in Corporate projects, Development Outcome ratings for FIs are not as clearly correlated with the other ratings.** As explained before, the methodology relies heavily on financial measures to creating metrics for developmental effects and thus there is probably excessive reliance of developmental ratings on purely financial considerations. This could explain in part the association between high investment outcomes or additionality with high development outcome ratings (Figure 2.10). However, when projects have unfavorable financial returns there are no strong correlations with the performance with other dimensions.

Figure 2.10: FI Development Outcome *vs.* Investment Outcome and Additionality Ratings



B. Analysis of Validated XASRs - Long-Term Trends

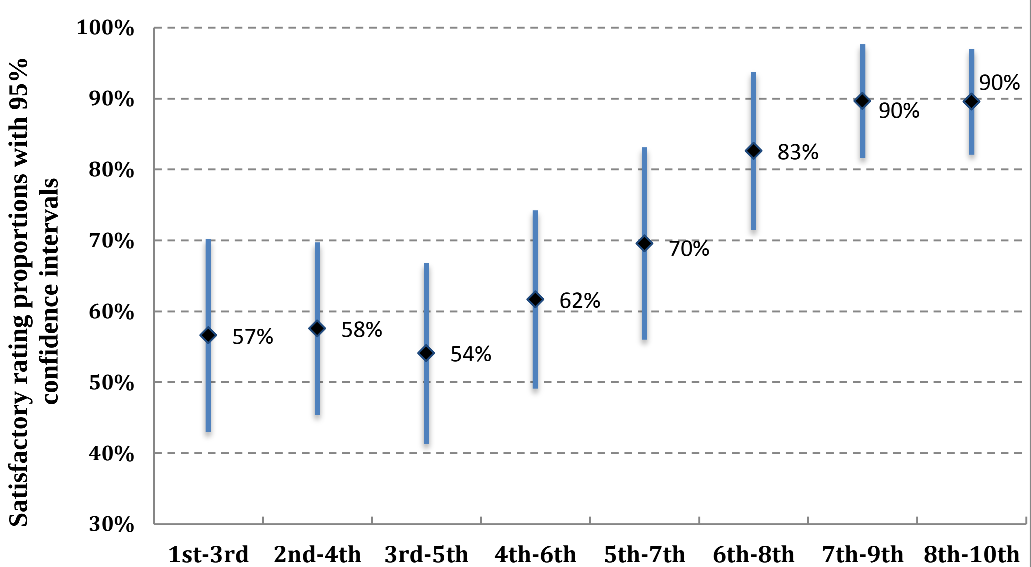
2.18 **Since the first report, OVE has validated a total of 195 XASRs.** As required by GPS, OVE reports on these longer-term trends. Ratings averages were calculated for the eight successive, three-year rolling groups available to date.[19] Under the current GPS, most of the three-year rolling distributions show a mean of favorable *Development Outcomes*, and gradually improving ratings in *IIC Work Quality* - both in the 80% range.

2.19 **Reporting on these long term trends is a GPS requirement, but these yearly variations have no statistical significance due to low number of observations, with the exception of *IIC's Investment Outcomes*, where results have shifted towards positive ratings.** The share of "Satisfactory" investment outcomes has increased consistently over the five most recent rolling groups (from 62% to 90%). The most recent group also confirms a trend towards a decrease in "Unsatisfactory" projects (from 26% in the first three-year rolling batch, to 3% in

19 1st to 3rd reports (53 projects), 2nd to 4th reports (66 projects), 3rd to 5th reports (61 projects), 4th to 6th reports (60 projects), 5th to 7th reports (46 projects), 6th to 8th reports (46 projects), 7th to 9th reports (58 projects), and 8th to 10th reports (67 projects).

the two most recent ones). In addition, the share of projects with "Partly Unsatisfactory" outcomes has also decreased during the last six rolling batches. This positive reversal is highly relevant because in the first three rolling batches this proportion was rising.

Figure 2.11 *Investment Outcomes* - Multiyear Trend



C. Analysis of Validated XASRs - Correlations

2.20 **As in past reports, this section tests the robustness of long-term correlations between *ex-post project results* and *ex-ante project characteristics*.** OVE applied a probability model to test statistically-significant association between inputs and results. Although this method controls for observable elements, e.g., economic crises; it can only reveal descriptive relations rather than causal impacts. This follows from the fact that only the sample of evaluated projects is being analyzed; there is no control group against which to contrast it and an insufficiently large set of observations. Finally, some projects outcomes might also have been endogenous to unobservable project characteristics, and as such their effects cannot be disentangled by this model.

2.21 **The analysis corroborates a clear direct association between *IIC's Work Quality* and high *Investment Outcomes*, as well as between IIC's Work Quality and Developmental Ratings.** In previous reports, only an indirect association between *work quality* and *developmental* success was observed and it was assumed that this indirect channel flows through the projects' investment success. However, including this year's batch into the probability model indicates that IIC's work quality is positively correlated with development success. Thus, IIC work quality significantly reduces the likelihood of project failure, in financial and developmental terms.

2.22 **Finally, there is no evidence that financial structure had any discernible correlation with project performance.** OVE tested whether project outcomes were related with the project's financial structure, represented by three key project design variables: investment amount, interest rate and project maturity. Evidence suggests that the project's financial structure is unrelated with outcomes. This provides direct evidence that the plausible hypothesis that larger projects receive greater IIC effort appears to be unsubstantiated by the projects evaluated so far.[20]

[20] See Annex VIII for a detailed description and numerical results of this econometric analysis.

III. XASRs AND THE DIAS

3.1 **This 10th Validation Report is the first one to include projects for which an IIC-generated Development Impact and Additionality Score (DIAS) was assigned at the time of project approval.** Out of the 24 projects in this batch, 12 (totaling $78.7 million in disbursements) had DIAS scores at approval. DIAS scores were also meant to be updated during execution and at completion, making it viable to compare them with the GPS ratings analyzed in this report for the same 12 projects.

> **Box 3.1 IIC's Development Impact and Additionality Scoring system (DIAS)**
>
> - ✓ The Development Impact and Additionality Scoring system (DIAS) was applied to all operations in 2008. It uses a portfolio approach, where each project is evaluated in terms of its contribution to this portfolio, based on the understanding that the goal is not to have all projects achieve the same level of development impact and/or financial contribution.
> - ✓ With this principle in mind, the DIAS system offers a simple way to measure the extent to which the IIC is achieving its developmental mandate. The two main goals of the system are, first, to assess the project itself, regardless of the source of financing (developmental impact), and second, to determine what it is that the IIC is bringing to the table by financing the project (Additionality).

3.2 **While the universe of projects with both DIAS scores and GPS validation is still too small to make generalizations, these early DIAS scores do not appear to be able to properly quantify the projects' developmental potential.** Despite the heterogeneity of projects in terms of investment size, use of funds and type of IIC Additionality, the variance of overall DIAS score was only 0.31, with an average DIAS score of 7.38 and a median of 7.5. This suggests that the DIAS for these early projects may have played a role in the decision to invest or not in a specific project - depending on whether a minimum threshold was achieved - but not in providing a quantitative measurement of the relative extent of the expected developmental return of each investment.

3.3 **Yet, for the 12 projects in this batch the ex-ante *Development Outcome* and *Additionality* DIAS scores were relatively good predictors of ex-post XASR ratings.** Comparisons between ex-ante DIAS scores and ex-post ratings are not direct because different scales are used (for the DIAS, a continuous numerical scale; and for the XASR, 4 or 6-point scales, as well as "favorable" and "unfavorable" assessments). Additionally, by definition the DIAS score of approved projects reflects generally successful projects in terms of *Development Outcomes*, as presumably the projects whose DIAS scores would predict an "unsuccessful" project were submitted to the Board. Nonetheless, the tables below show that the majority of "unfavorable" ratings were observed among the lower half of projects, both in *Development Outcomes* and *Additionality*. Coincidences are marked in green, while disagreements are marked in red.

Development Outcome		
DIAS Score (Ascending Order)	XASR Rating	Type of Project
3.57	Unfavorable	FI
4.21	Unfavorable	FI
4.22	Unfavorable	FI
4.23	Unfavorable	FI
4.64	Favorable	FI
4.67	Favorable	FI
4.68	Unfavorable	Corp
4.685	Favorable	Corp
4.86	Unfavorable	Corp
5.105	Favorable	Corp
5.44	Favorable	Corp
5.75	Favorable	Corp

Additionality		
DIAS Score (Ascending Order)	XASR Rating	Type of Project
1.75	Unfavorable	FI
1.75	Favorable	FI
1.75	Unfavorable	FI
1.75	Unfavorable	Corp
1.75	Unfavorable	Corp
1.95	Unfavorable	FI
2.15	Favorable	FI
2.35	Favorable	FI
2.35	Favorable	Corp
2.45	Unfavorable	Corp
2.85	Favorable	Corp
3.05	Favorable	Corp

IV. LESSONS LEARNED FROM IIC PROJECTS

A. Lessons from the Current Batch

4.1 **This section presents key lessons drawn by IIC from the 24 operations in this 10th batch.** These lessons were extracted from the XASRs prepared by IIC Investment Officers themselves. To facilitate their use, OVE organized them around themes corresponding to the stages of a typical project: *Screening and Appraisal*, *Structuring*, *Supervision, and Project Results*. The 9 most significant lessons from this year's batch were distributed as follows: 33% (3 out of 9) related to screening and appraisal issues, 33% (3 out of 9) related to structuring, 11% (1 out of 9) to supervision issues, and 22% (2 out of 9) to project results.

4.2 **While these lessons are specific to this batch of projects, future operations with similar characteristics may benefit at one or more stages of their project lifecycles.** Because these lessons are potentially valuable inputs for future operations in similar settings, IIC compiles them and makes them available electronically to Investment Officers. To provide a deeper understanding of their applicability, the circumstances from which these lessons were extracted are also briefly described in the boxes situated below the explanation of each sub-theme.

1. Screening and Appraisal of Projects

4.3 **This 10th batch <u>reaffirms the significance of selecting clients with strong management expertise</u>.** Well established companies and institutions, well positioned in their markets, are vital to project's developmental success. IIC officers observed in particular that *selecting FIs with long established business relationships with SMEs, or enterprises in sectors with strong comparative advantages, highly increases the likelihood of successful project implementation*. Moreover, selecting financially sound partners with conservative dividend policies enabling them to grow organically also increases sustainability of project outcomes. Box 4.1 illustrates these lessons from projects in this batch.

Box 4.1 Selecting Strong Clients to Maximize Ability to Meet Targets

- ✓ ***Well managed retailer consolidated its market position and exceeded performance targets.*** The client is a well-managed company, has financially sound sponsors with conservative dividend policies that enable the company to grow. The company exceeded financial and business performance targets. As noted by the IIC Officer "<u>this project reiterates the value of lending to companies well positioned in their markets with good management and strong financial sponsors</u>."

- ✓ ***Financially sound retailer exceeded growth targets.*** The client is a well-managed company with strong financial support from its sponsor. The company does not distribute dividends, enabling the company to grow organically. The XASR states that "<u>IIC should lend to companies well positioned in their markets with good management and financial strong sponsors</u>."

- ✓ ***Supporting a financial institution with strong SME focus.*** The client financed 39 SMEs instead of 20 SMEs originally planned, by making use of its nationwide network and its expertise in SME lending. According to the Investment Officer, "<u>IIC should provide loans to established financial institutions with a strong outreach to SMEs</u>."

- ✓ ***One of the market leaders in residential mortgages exceeded targets.*** The FI has more than 40 years of experience in originating mortgage loans and an excellent credit risk system to evaluate this type of loans. With IIC resources, the client provided mortgages to 708 individuals, at an average amount of US$53,353 and average term of 26 years, exceeding expectations. The XASR noted the importance of "<u>choosing financially sound partners to achieve development objectives</u>."

- ✓ ***Financial company with a proven track record in IIC's target market exceeded project targets.*** The client had received prior equity investments from ACCION International and IFC as well as technical assistance from MIF. The client increased its SME portfolio from approximately US$4 million in 2006 to US$10.1 million as of June 2010. According to the XASR, "<u>the borrower's long established business relationships with micro and small enterprises gave it a comparative advantage; excellent management and a clear business model made successful implementation of the project highly probable</u>."

- ✓ ***Successful microfinance institution aiming at establishing itself in the SME segment exceeded expectations.*** IIC channeled resources more than 455 micro and small enterprises, with an average sub-loan size of about US$4,000 – less than the expected average amount of US$10,000, which means that more SMEs than expected benefited. The client increased its MSME portfolio from approximately US$136 million in 2008 to US$414 million as of June 2011. As per the XASR "<u>the FI had excellent management, proven track record in microfinance and a successful growth strategy, [which] made project success highly probable</u>."

- ✓ ***IIC supported a well-managed wine producer in its expansion plan, helping it take advantage of its comparative advantages.*** The client is located in a leading wine producing region, uses modern technology, and has reasonable production costs, which makes it a competitive producer of high-quality wine. The XASR states that "<u>IIC should strive to work with clients in sectors with strong comparative advantages and sponsors which strongly back their enterprise.</u>"

4.4 **IIC would benefit from further <u>enhancements in its assessment of client and project risk</u>.** XASRs from this batch suggest that market and project risk assessments were incomplete and that key forecast assumptions did not account for adverse economic scenarios. In order to also guarantee project success in times of economic turbulences IIC should forecast key variables for varying economic scenarios. This batch also included one project where the due diligence was not able to detect fraudulent client activities, as recommendations by

unknown auditing firms were accepted. To prevent fraud, IIC should only accept clients with recommendations by reputable auditing firms.

Box 4.2. Refining the assessment of client and project risks

- ✓ ***Incomplete market risk assessment threatened the financial feasibility of a capacity expansion project.*** IIC provided a freight and shipping company with funds to repair and remodel its entire fleet. A significant increase of the price of steel raised project costs by almost three times. According to the XASR: "key [forecast] assumptions did not include the possibility of price increases in the price of steel, which was crucial for remodeling the barges. In general, including price increases in projections is valid."

- ✓ ***A big picture assessment of project risks is crucial in times of economic instability.*** IIC supported an international container facility in its capacity expansion plan. The significant drop in foreign trade due to the economic crisis caused a 24% reduction in the client's revenues. However, the company continued to meet its financial obligations thanks to the client's well-structured financial liabilities. According to the XASR: "IIC should ensure that not only the financial plan for the specific project that is being financed is appropriately structured but that the financial plan also reflects the entire company's financial situation so that it would be better positioned [to weather crises]."

- ✓ ***Inability to detect operational and financial issues of a fish exporter resulted in financial losses for IIC.*** The client deliberately committed fraud to obtain financing by hiding the true financial situation from the IIC. The company worked with an unknown accountant, and the recommendation by the IIC team to change the auditing firm was not followed. The XASR states that, given the inherently high risk of operating with trading companies "IIC should make the adoption of well-known auditing firms a precondition for disbursement."

- ✓ ***FI faced difficulties, but eventually achieved project targets.*** Due to low economic activity, the FI's portfolio growth almost stopped in 2009 while asset quality deteriorated rapidly. The client was, however, able to turn the situation around in 2011 and achieved its project objectives, despite the limited experience in the target segment. Overall it was a solid, well-managed institution. The Investment Officer states that "when IIC provides financing to a small financial institution with less experience in lending to smaller companies, the track record of the bank in other segments of corporate lending [should be carefully evaluated]."

4.5 **IIC could multiply its developmental impact by supporting clients with deeply integrated supply chains.** The IIC Officer observed that despite the fact that the client was large, the project indirectly benefitted many SMEs involved in the supply chain. As a result the loan did not only improve the clients economic situation but also created jobs and improved environmental and health standards in the client's entire supply chain. Box 4.3 illustrates the case of how the IIC loan to an apparel manufacturer led to an augmented developmental impact.

Box 4.3 Seeking clients with high potential for developmental impact

- ✓ ***Supporting large companies in labor intensive industries was an effective way of reaching micro and small businesses.*** An apparel manufacturing company used IIC's medium-term resources to refinance short-term debt. Although this is a large borrower, the loan indirectly benefitted small businesses, since this client outsources 50% of its garment manufacturing to micro and small garment producers. Therefore the loan also indirectly contributed to the creation of jobs in the supply chain. According to the XASR: "IIC should support companies in labor intensive industries with high participation of women and deep supply chains. These types of projects have high development impacts and should be replicated."

2. Structuring of Projects

4.6 **IIC would benefit by using innovative structures to support small companies in difficult markets and business environments.** Mutual guarantee companies can increase access to credit for SMEs as guarantees are backed by equity contributions from sponsoring shareholders of the guarantee association. IIC can enhance is outreach to SMEs and multiply its developmental impact by building a reciprocal guarantee mechanism with guarantee entities performing client identification and due diligence on top of providing loan guarantees to IIC. Box 4.4 shows a pilot project where IIC was able to lend directly to several small companies with a guarantee from its client. Especially in adverse macroeconomic environments and heightened risk settings such reciprocal business relationships can support IIC to finance SME directly. However, the IIC officer notes that it is important to divide the programs in several tranches so that clients can enhance their learning curves.

Box 4.4 Using innovative structures to reach beneficiaries in difficult markets

- ✓ ***IIC developed an innovative guarantee program to channel resources to SMEs directly in the midst of an economic crisis.*** In this pilot, a mutual guarantee entity performed identification, conducted a due diligence, and provided guarantees to IIC for direct loans to small companies. With this innovative arrangement, IIC was able to provide 28 direct loans to small companies despite the adverse macroeconomic environment. The Investment Officer states that "for future operations, this pilot program should be broken into several tranches with different end dates. [This will] provide the FI with a learning curve, particularly with regards to adjusting to IIC financing and properly submitting the necessary paper work."

4.7 **IIC could consider further tailoring security packages to client and market characteristics.** This 10th batch demonstrated once more the importance of ensuring appropriate security packages, which should be tailored to specific project characteristics. IIC officers observed that warrants of raw materials or perishable assets are difficult to liquidate and greatly at risk of losing value. In the case of warrants of raw materials with volatile prices, the IIC officer should take into account price forecast also for adverse economic scenarios and consult experts to understand price dynamics in the relevant market. Solid security packages should include a variety of security instruments preferably from clients as well as sponsors, such as real and personal guarantees and access to revenues by setting up escrow accounts. IIC officers could improve risk instruments by taking advantage of expert technical assistance for clients that are vulnerable to

certain types of risks such as governance in family-owned businesses, export demand, and commodity price volatility, among others.

Box 4.5 Protecting IIC investment through appropriate security packages

- ✓ ***Weak guarantee structure resulted in financial losses to IIC.*** The security package consisted of warrants (pledge of warehouse receipts) established on the sponsor's and the client's paper inventories. However the liquidation value of the paper was lower than its commercial value. The guarantees were not sufficient to cover the loan, resulting in loss of principal for IIC. The XASR concludes that: "<u>when structuring loans, [IIC should] avoid warrants on raw material because they may not produce the amounts which their original prices imply</u>." When including this type of guarantee in the loan structure, IIC should seek support from a consultant who understands the price dynamics in the relevant market.

- ✓ ***Solid guarantee structure helped protect IIC investment when client filed for bankruptcy.*** The security package included a first-ranking mortgage on the plant and pledges over other assets, as well as warrants on product inventory owned by the borrower. The Investment Officer tells in the XASR that "<u>the warrants on product inventory - which consisted of perishable assets - were not as liquid as originally thought</u>." In contrast, the mortgage on the plant and pledge over other assets constituted a solid guarantee, and allowed IIC to protect 100% of the principal.

- ✓ ***Risks of supporting a Greenfield cellulose transport project were mitigated by a strong security package.*** The start-up had signed a 10-year contract with its sole client with a "take or pay" clause, assuring a minimum volume per year. The company had established an escrow account to which the borrower's client deposited payments for freight services. All revenues passed through that escrow account, from which the debt was served. The investment officer states that "<u>in risky Greenfield projects […] the loan should be structured in such a way that besides real and personal guarantees, the IIC should also have access to the revenues through an escrow account</u>."

- ✓ ***Long-term sustainability of a vulnerable FI business model operating in a small, highly competitive market was questioned by IIC.*** The FI faced strong client concentration, and a large share of its assets is allocated to its C Country's government securities. This business model makes the bank extremely vulnerable to outside events such as financial crises, sovereign debt downgrades and even credit downgrades for the large borrowers. The XASR states that "<u>with this type of client, guarantees should be required or loan terms should be shortened</u>."

4.8 **IIC could further <u>align incentives with clients by building them into the loan structure</u>.** This batch illustrated that failure to create incentives led to violations and ignorance of loan covenants. Loan officers observed that it is of utmost importance to construct strong incentives to accelerate developmental impact and increase the additionality of their projects. Incentives can be made more powerful by tying them to the loan structure, as demonstrated by one project in this 10th batch. IIC introduced an innovative feature to its loan structure, by which the loan is renewable at IIC's discretion after a certain period of time if the company performs well and complies with loan covenants.

Box 4.6 Aligning incentives through loan structures

- ✓ ***IIC used a non-traditional loan structure to align incentives and add value to a mid-sized cardboard boxes manufacturer.*** The IIC offered a loan that could be renewed at IIC's discretion for an amount equal to the repaid principal, thirty months from the first disbursement up to the original maturity date. This created a powerful incentive for the client to remain compliant with the loan covenants. According to the XASR: "<u>where appropriate, this product should be replicated […] throughout the region. This is a profitable product for IIC with high margins and low processing costs due to the revolving nature of product</u>."

- ✓ ***Misaligned incentives limited the potential of an Agency Line Agreement.*** Under an agency line agreement IIC reviews projects for credit assessment, eligibility, and compliance with environmental, labor and legal requirements. However, only one project was financed under this agreement, as the agent did not have any incentive to refer clients to the IIC. The IIC officer stated that "<u>in order to make agency lines work, the IIC should provide incentives to the agent to encourage the sharing of clients</u>."

- ✓ ***Loan conditions were inconsistent and compromised the achievement of objectives of a financial intermediary line.*** IIC supported the expansion of an SME portfolio but financed fewer projects than expected as the maximum loan size established in the Loan Agreement was much higher than the average amount established in the Economic Impact section of the Board Report. The Investment Officer concluded in the XASR that "<u>if the objective is to reach a large number of SMEs then the loan conditions which set upper limits for sub-loans should be close to the average projected loan size</u>."

- ✓ ***Despite IIC's recommendations and willingness to provide support, the client was not compelled to strengthen its corporate governance.*** The IIC Officer observed that the client, a family-owned business, needed to improve its corporate governance. However, this was not included as a prerequisite in the loan agreement. The XASR concluded that "<u>when providing loans to family-owned businesses with weak corporate governance, improvement of corporate governance through technical assistance should be a loan condition</u>."

3. Supervision of Projects

4.9 **IIC would benefit from a <u>more formalized system to adjust loan structures and covenants</u> to respond to changing economic or business conditions.** IIC has effective mechanisms in place to monitor clients' ability to meet their financial obligations. Without jeopardizing the crucial goal of preserving IIC's financial soundness, IIC should be able to proactively support clients that are facing potential repayment difficulties in the event of unexpected changes in market conditions. A preemptive identification of those operations that require financial restructuring, as well as an approval of new terms would substantially support an improved alignment with the client's situation and can increase the likelihood of a satisfactory project outcome in times of economic difficulties. The value of this lesson is especially visible in the 9th and 10th batch of projects in the context of protracted negative repercussions of the global financial crisis.

Box 4.7 Responding to a changing business environment

- ✓ ***Plastic container group faced dramatic changes in market conditions and was forced to adjust its ambitious expansion plan.*** IIC supported the group's rapid growth by adjusting its debt maturity profile. When market conditions worsened, the company had to increase its external debt financing and planned asset sales to reduce its debt. Based on the strong financial capacity of the client's sponsors and their commitment to support the company the investment officer believes that "<u>the IIC should consider helping the sponsors by extending the tenor of the loan to adjust it to the company's cash flow and debt servicing capacity</u>."

4. Results of Projects

4.10 **IIC would benefit from <u>building long-term business partnerships with clients</u> in order to accelerate developmental impact and long-term sustainability.** IIC should bring its technical expertise into these partnerships with companies already in early stages for them to be able to build strong foundations with competent management teams and stable structures. This strategy does not only increase the likelihood of positive project results but can also lead to follow up operations. Box 4.8 illustrates an example where IIC was able to replicate project success 15 years after it supported the client at its start-up stage. Another example shows how a successful loan experience can open up additional opportunities to magnify the developmental impact.

Box 4.8 Developing partnerships with clients

- ✓ ***Microfinance institution supported by the IIC in its early stages became a leader in its segment.*** IIC already supported the client at the start-up stage through an equity investment in 1992. The client is now considered a major player in the microfinance market because of its stable management team, deep focus on the microfinance segment, good business performance, and solid financial position. The XASR pointed out the importance of the "<u>special relationship with the client, the experience it acquired and the time invested when [the client] was created.</u>"

- ✓ ***Positive experiences of an FI loan resulted in follow-up operations.*** The successful project with the FI led to an additional loan to another FI. Moreover, IIC selected this group to be a partner for launching a family business seminar for SMEs as well as other FINPYME initiatives. The XASR points out that "<u>positive experience [with an FI] can open the door for undertaking follow-up operations with great confidence. [This approach allows IIC to leverage] the local knowledge and experience of financial institutions operating in C and D countries, in order to successfully reach SMEs while assuming the least risk possible</u>."

- ✓ ***IIC intended to support a company's ambitious expansion plan, but failure to tailor the loan structure to the client's profile aggravated risks.*** The client is an office supplies producer which had participated in the FINPYME program. Project results were weaker than expected, as high logistics costs and strong competition from Chinese products threatened the financial sustainability of the client. XASR states that "<u>IIC should accompany existing clients throughout the project cycle and through the different stages of their institutional life. The IIC through TAS under the FINPYME Technical Assistance program should provide technical assistance for existing clients that experience problems during execution</u>."

4.11 **IIC would benefit from <u>increasing its focus on adding value to projects to achieve the highest possible developmental impact</u> and better utilize scarce financial resources to its full potential.** This 10th batch displayed that some IIC projects failed to add substantial value to its clients, suggesting that IIC's scarce

resources would have been more effectively used for projects with higher additionality potential. While selecting well established and financially sound companies may support a successful investment outcome (see lesson 1), the potential of adding financial or non-financial value decreases. Box 4.9 show two examples where IIC succeeded to add value to clients in order to achieve full developmental potential of its scarce IIC resources.

Box 4.9 Adding value to achieve projects' full developmental potential

- ✓ ***IIC added value to wheat milling company by convincing commercial banks to provide longer term financing.*** IIC was able to mobilize $27 million from two local commercial banks. According to the XASR, "<u>these commercial banks had been operating with [the client] for many years through revolving short- and medium-term lines of credit, but [decided to] provide the company with longer term financing under the syndicated loan proposed by IIC. Without IIC, they would have continued to extend only short and medium term loans to [this client]</u>."

- ✓ ***IIC supported a large financial company to increase the volume of factoring lending to small and medium exporters.*** IIC loan added value because it was denominated in dollars. The FI had limited access to dollar financing, and usually transferred exchange rate risk to its clients by charging higher discount rates on dollar-denominated export receivables. This project allowed the client to reduce the costs to the small and medium exporters that ultimately benefited from it.

B. Accumulated Lessons from Prior Batches

4.12 **The GPS require that IIC systematically identify and apply past lessons to new operations.** In this regard, IIC has taken important steps to facilitate the learning process within the organization. In 2005 IIC started the documentation of lessons in the XASRs, instituting a discipline for critically assessing and documenting them in a structured manner. In 2010, IIC took the additional initiative of reviewing, editing, and compiling its repository of lessons, working in partnership with the Knowledge and Learning Department (KNL) of the IDB, leading to the development of the "Lessons in Action" system. [21]

4.13 **Additionally, GPS require that OVE report periodically on the incorporation of these lessons into new IIC operations.** IIC has engaged OVE to implement GPS, which deals mostly with the validation of mature operations, examined approximately 4 to 7 years after their approval. Therefore the linkage between the lessons extracted from these mature operations and IIC's newly-approved transactions needs to be built separately, e.g., via systems such as IIC's "Lessons in Action". As this system gets more consolidated, OVE will expand its validation activities to report also on its usage and effectiveness.

4.14 **Until the time effective usage can be tracked, OVE will report on the common themes emerging from the body of lessons found in the most recent**

[21] "Lessons in Action" constitutes a user-friendly database of relevant lessons created to serve as a learning tool for the entire IDB Group. Although the system is functional, it has not been officially launched to IIC officers, since IIC and KNL are still working on tailoring the system to fit their needs.

Annual Reports.[22] OVE reviewed the lessons drawn by IIC Officers during the last 7 Annual Validation exercises, and classified them into the lifecycle stages of a typical project: *Screening*, *Structuring*, *Supervision and Results*.[23] Lessons were further categorized within each stage, as shown in table 4.1. Lessons from the *Screening stage* corresponded mostly to issues of *Client Selection* and *Innovation*; lessons for the *Structuring stage* were associated with *Project Terms* and *Risk Management*; lessons from the *Supervision stage* addressed *Compliance* and *Support* issues; and lessons from the *Results stage* corresponded to *Inter-IDB Group Cooperation* and *Value Added*.

Table 4.1 Lessons - Categories and Sub-categories

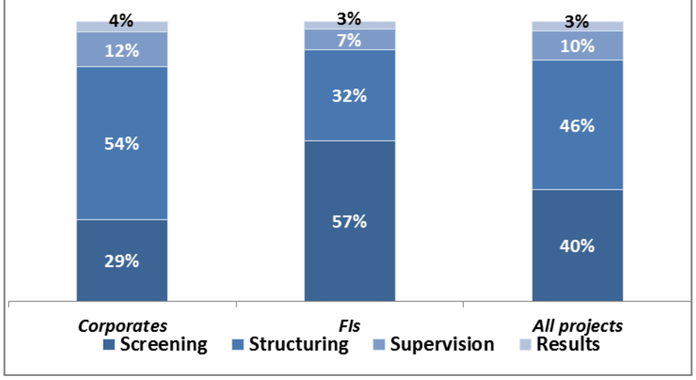
Screening	
Alignment with IIC Strategy/Objectives	*New Markets*
Client Strategic Positioning	*New Products*
Client Managerial/Financial Capabilities	*Forecasting Practices*
Sponsor Credit Assessment	*Enhancement of Developmental Impact*
Structuring	
Financial Structure/Additionality	*Market/Commodity Risk*
Matching of Contractual Terms with IIC Objectives	*Exchange/Interest Rate Risk*
Adequacy of Financial Covenants	*Political Risk*
Incentive Structures	
Supervision	
Supervision Tools	*IIC Support/ Influence over Management*
Flexibility/Risk Tolerance	*Relationship with other co-lenders*
Restructuring Issues	*Technical Assistance*
Results	
Responding to Crises	*Cooperation between IIC and IDB*
Financial Security/Additionality	*Long-term Partnerships*

22 The first three sets of XASRs were not considered in this analysis due to the long period elapsed since the documentation of those lessons, which means they are less likely to be representative of IIC's current activities.

23 Out of these, 48 were for Corporate investments and 34 for Financial Intermediary operations.

4.15 **To date, IIC Officers have identified over 100 project lessons in the XASRs.** At the *screening stage*, IIC Investment Officers stressed the importance of *Client Selection* and *Innovation*. At the *structuring stage*, IIC Officers emphasized the importance of tailoring *Project Terms* and *Risk Management* to market conditions. At the *supervision* stage lessons related mostly to

Figure 4.1 Distribution according with Stage in Project Cycle



Restructuring Issues and to the use of *Technical Assistance*. At the *results stage*, IIC Officers called for *Improved Cooperation within the IDB Group* and *Greater Value Added* of operations. However, comparing with other stages of the project cycle, lessons learned for the *results stage* are very scarce, potentially as a reflection of weaknesses in the project evaluation system.

4.16 **When comparing Corporate and Financial operations, OVE still finds a contrast in the relative distribution of lessons.** A majority of lessons for Corporate investments (54%) were related to the *structuring stage* of the project cycle. By contrast, a majority of the lessons from Financial Intermediaries (57%) were related to the *screening stage*. Corporate operations usually involved more client diversity, impacting on the level of specialization required to tailor project structuring. By contrast, the structure of financial projects has so far presented fewer degrees of freedom for IIC. Thus, Officers have tended to emphasize FI selection issues, and then apply a fairly standardized structuring to those FIs selected.

V. CONCLUSIONS AND RECOMMENDATIONS

A. Conclusions

5.1 **With the important caveat of the current GPS' aforementioned limitations, most projects in this batch received favorable ratings.** A majority of the projects (79%) received at least "mostly successful" ratings in the *Development Outcome* dimension. Regarding *IIC Investment Outcome* and *IIC Work Quality*, 88% and 79% of the projects respectively received favorable ratings. These ratings are similar to those of prior batches. By contrast, only 63% of projects rated favorably in *Additionality* - a decrease from prior years, largely owing to this year's introduction of stricter verification requirements by OVE.

5.2 **This 10th annual batch is the first one allowing OVE to compare the GPS system, with IIC's own "Development Impact and Additionality Scoring System" (DIAS).** The DIAS is a pioneering initiative by IIC - not yet evaluated by OVE - that seeks to systematize and document the drivers of IIC's additionality and development effectiveness. Out of the 24 projects in this batch, 12 (totaling $78.7 million in disbursements) also had DIAS scores. Overall DIAS scores where directionally consistent with GPS assessments, but less precise in capturing the magnitude of developmental effects. In fact, the DIAS scores observed in this batch had little variance, as if a minimum DIAS score had served as a threshold for project selection and approval.

5.3 **Despite its shortcomings, the continuous application of GPS has helped IIC institute a discipline to systematically extract project-based lessons learned.** GPS has a dual role: accountability and lessons learned. On the accountability side, the current GPS metrics still have a number of issues, as described before in this report. However, on the lessons learned side IIC has been able to identify over100 lessons that are potentially useful for improving future projects. Lessons clustered around the stages of a typical project's lifecycle, and have been the subject of improvement recommendations in past Annual Validation Reports.

5.4 **Past recommendations based on these lessons learned appear to still be valid.** These recommendations included: (i) Formalize a transitional period at the pre-investment screening stage, during which IIC and clients could engage in technical assistance activities aimed at improving client readiness, paying particular attention to smaller clients, in small and vulnerable countries; (ii) Enhance IIC's ability to partner with its clients via multi-product, longer term engagements tied to the pursuit of common goals, making technical assistance, equity and quasi-equity components more relevant components of IIC's project structures; and (iii) Enrich the project supervision function via a larger role for technical assistance, to help it combine its current financial risk mitigation function, with an ongoing developmental support function.

5.5 **OVE reviewed the implementation status of prior recommendations, and found generally positive (although early) progress.** Table 5.1 summarizes the implementation status of OVE's prior recommendations formulated in the last Annual Validation Report (9^{th} Annual Validation Report). This assessment required under GPS; however it is based on documentary evidence provided to OVE, rather than on a comprehensive review of IIC's current management practices. Such in-depth review would go beyond the scope of the evaluation services contracted by IIC, focused on validating a batch of mature projects.

Table 5.1 Implementation Status of Prior OVE Recommendations
1 - ***Formalize the possibility of a transitional period at the pre-investment screening stage.***
EARLY PROGRESS: IIC is currently overhauling its Technical Assistance process to mainstream its ability to support both potential and current clients. IIC plans to assign a Technical Assistance (TA) officer to project teams to proactively identify technical assistance opportunities. The Technical Assistance and Advisory Services Division (TAS) is working to standardize client support, yet still less that 5% of IIC clients funded during 2012 had received any direct TAS support.
2 - ***Enhance IIC's ability to partner with its clients via multi-product, longer term engagements tied to the pursuit of common goals.***
EARLY PROGRESS: Business teams are working to enhance and further adapt IIC's product offering on the basis of past experience. Yet, progress is still needed for fully developing an IIC product menu, including TA, equity, quasi-equity and performance driven instruments. IIC has recently formalized and Equity Investment Division. Finally, in the context of the IDB Group's private sector reform, it is expected that IIC will ramp up its equity investment role for the Group.
3 - ***Broaden the scope of IIC supervision to further strengthen client support activities.***
EARLY PROGRESS: Joint membership by the Portfolio Supervision, Development Effectiveness and Technical Assistance Divisions (PSU, DEC and TAS) in internal committees has increased inter-unit collaboration, and the profile of TAS within the business. Yet, there is still a dominant focus on financial risk considerations, i.e., preservation of IIC's capital, rather than ongoing technical assistance to enhance developmental results through IIC clients. Change is needed to more closely connect the two aspects. A potential avenue is demonstrating that "good developmental work" can also decrease / mitigate financial risk. This "expanded supervision" and ability to dynamically accompany clients continues being highlighted as a lesson in this batch.

B. Recommendations

5.6 **In past reports, OVE also identified lessons related to IIC's evaluation system.** The first one dealt with the need to generate candid and insightful lessons from projects that could be later used for the benefit of future IIC projects. The second one dealt with issues that go to the core of IIC's additionality and developmental contribution, but cannot be efficiently addressed in the context of individual projects. This pointed to the need to conduct in-depth sector/thematic analyses geared towards further promoting developmental results on final beneficiaries and the business environment in which they operate.

5.7 **In hindsight, and despite some progress on the formalization of lessons, IIC's evaluation capabilities still need enhancement.** The piecemeal approach implemented so far leaves some issues unresolved, including the lack of an independent party with an adequate mandate and resources to provide checks and balances to IIC's evaluation system. The relatively small size of IIC makes it impractical to create a separate independent evaluation counterpart. Given that there are synergies with similar questions posed by the governing bodies of the other private sector windows at the IDB-Group; the IDB Group Ad-Hoc Committee on Private Sector has suggested that IIC consider addressing the evaluation issue more systemically, as part of the Bank's overall restructuring of IDB's private sector windows.

5.8 **This report focuses on one overarching recommendation related to the unification of the project evaluation architecture and methodology among IDB's public and private sector windows.** In the context of ongoing work on the consolidation of IDB's Private Sector windows, it is clear that before addressing issues such as the independence of the evaluation function and the usefulness of the lessons extracted, there needs to be a solid architecture in place to measure project results. This includes not only ex-ante metrics but also project monitoring and ex-post project result assessment methodologies. To this end OVE offers one recommendation in this report:

5.9 <u>**Recommendation**</u>: **Work with OVE to revise IIC's project evaluation system to address current shortcomings and seek greater harmonization with the rest of the IDB Group.** The suggested work with OVE to review and revise the IIC project evaluation system would take place in the context of broader discussions, also underway, in the IDB Group, as well as within ECG. At a minimum this work should lead IIC to ensure: (i) evaluable IIC projects with clearly quantifiable objectives – including both outputs and desired outcomes – embedded in a coherent logical framework. (ii) enhanced project evaluation guidelines targeted at assessing the development effectiveness of IIC's projects, and (iii) minimum standards on the type and soundness of evidence supporting assessments of IIC's contribution to development effectiveness.