Fund for small and medium-sized enterprises

Summary of the Operation Performance Evaluation Review

THE PROJECT

In November 2001 the EBRD approved an equity investment of €2 million in an unincorporated investment fund (the Fund) for investing in small and medium-sized enterprises (SMEs). The Italian Treasury also committed several million euros to cover expenses of the Fund. The project turned out to be one of the pillars of the EBRD's strategy for the country's financial sector until 2004.

PROJECT RATIONALE

The project was to enable the Fund to make equity and quasi-equity investments in commercially viable SMEs with the objective of achieving long-term capital growth. The Fund was to invest €4 million directly in several SMEs as equity or quasi-equity. It was to have a life of 10 years and make equity investments with a horizon in each investment of four to six years. It was to be one of the first non-bank suppliers of long-term finance to private firms and make an important contribution to the recovery of the country's economy. It was also meant to contribute to improving corporate governance and to laying the foundations for sustainable private sector development. The Bank hoped that the project could help overcome the obstacles presented by the country's uncertain political status to direct investment in the private sector. As it turned out, the Fund could not make equity investments as it was legally impossible in the country. Instead, it made long-term loans secured by real assets.

ACHIEVEMENT OF OBJECTIVES

Establishing an investment fund implies a certain amount of institution building to achieve objectives such as outreach to SMEs. The institution of the investment fund, with its skills and behaviours, is the instrument for achieving transition impact through the sub-projects that the fund produces. Therefore, institution building must be an objective, with its success measured by the creation of a sustainable investment fund managed to accepted standards of performance. The project did not set out institution building as an objective, which is a shortcoming of project design.

The project had the following objectives:

- to achieve long term capital appreciation by:
  - assisting with the modernisation, restructuring, expansion and development of SMEs in the country
  - taking equity and quasi-equity (or any other means) investments in commercially viable firms
  - taking a significant minority stake in portfolio companies
  - taking an active role to influence operations and management
- to demonstrate the little-known equity instrument as a new way of financing local entrepreneurs
- to transfer skills through training of local staff.

OVERALL ASSESSMENT

The project did not achieve its objectives despite hard work by the Banking Team and was rated

Unsuccessful. It had *Marginal* overall transition impact, both verified and potential, and the risk to potential transition was *Medium.* Half of its six sub-projects were incomplete and in a state of paralysis that will likely lead to loss on each of the three underlying loans. Only one sub-project was clearly successful. The likely substantial losses for the Fund have caused *Unsatisfactory* company performance to the project as a portfolio. Nevertheless, the Bank may recover its money in full and cover its costs thanks to the first loss provisions built into the Fund's structure, justifying a *Satisfactory* rating for bank investment performance. The project had *Marginal* achievement of objectives, mainly because of the poor performance of sub-projects and also because its investments were structured as debt rather than equity, therefore losing the intended equity demonstration effects. Bank handling was *Satisfactory*; the EBRD elected a delivery mechanism that faced poor prospects of success, as later described in PED's special study of the EBRD's investment in equity funds. The project's environmental performance was *Satisfactory*. The extent of environmental change through the sub-projects was *None*.

BANK HANDLING

Bank handling was rated *Satisfactory*. The Bank responded to urgent calls from the World Bank and the European Commission to aid in the reconstruction of the country. The country lacked the basic features of a market economy, such as property rights, and the physical and institutional infrastructure was in disarray. The Bank recognised that without donor support to shield it from losses an investment in the Fund would not meet sound banking standards. The Bank was also aware, based on past experience with small donor-supported SME funds, that the chances of a successful outcome and adequate realised transition impact were remote. Using donor funds to shield the Bank from sure loss in a project with high transition risk is a course of action that the Bank should avoid in future.

MAIN ISSUES AND LESSONS LEARNED

Risks associated with small donor-supported SME funds in early transition countries should be mitigated. Creating ad hoc funds backed by donor-support may not lead to sustainable institution building. Past experience shows that the funds are too small and too risky to attract management by quality, established fund managers that possess the skills and infrastructure to institute a sustainable fund in the early transition environment. Therefore, delivery will not benefit from a seasoned institutional approach, causing lower chances of success. Consequently, the fund is unlikely to produce quality investment results, or adequate returns, that could capitalise a sustainable institution. The Bank should be careful to find ways, if possible, to mitigate these risks.

The Bank's IFI status must be clear before project work begins in UN-governed post-conflict situations. The Bank's experience shows that, where the UN is the authority on the ground, the EBRD should not venture in until the UN has recognised the EBRD's status afforded by the Agreement Establishing the Bank.

It is important projects in post-conflict environments are completed. Donors rightly lose interest and enthusiasm when ambitious projects lose momentum and stall before completion. It is important to keep projects simple and focused to demonstrate to donors and investors that it is possible to successfully complete a capital investment in the post-conflict environment. Implementing troubled projects may require additional investment to ensure completion and an incentive may be required to compensate the fund manager. The financing plan for the activity should allow for completion risks and cost overruns and should find innovative ways to fund project completion as long as the marginal investments have a positive net present value.

It is important SMEs compile financial statements to gain access to project finance. SMEs in early transition countries rarely prepare formal financial statements on a reliable basis. Lending money short term to finance working capital may not require formal financial statements in the case of micro enterprises. However, lending money long term to finance capital projects of larger firms does require formal financial reporting for sound banking. Such statements signal that the owners of the enterprise acknowledge the claims of suppliers, lenders and owners according to their rank. They disclose the size of those claims in relationship to the size of the firm, and state whether or not the firm is solvent. A supplier of capital, faced with a refusal to supply financial statements, should not be confident that the enterprise has the intention of honouring its claims in the long run. The Bank can help an SME gain the advantages of financial control and transparency by financing projects that enable the SME to comply with IFRS. Such projects are long term and require investments in skills, systems and the purchase of professional services over a period of several years. They are as worthy of external finance as any investment in capital goods.

A recovery phase should be factored into troubled investment funds to maximise transition impact. Investing in capital projects through funds in early transition countries inevitably leads to a few troubled sub-projects. Plans for such funds should take into account the heavy monitoring and restructuring burden to reduce risk of failure and to capture the potential transition impact from recovery processes. The recovery processes are decisive for testing and demonstrating EBRD instruments, investors' rights and public and corporate governance processes.

Reliable electric power infrastructure is essential for SME development. Adequate access to reliable electric power is a must for small firms. Project design should take into account power provision, and avoid projects involving equipment that is not well adapted to the likely state of power supply. In other words, where the power supply is unreliable, we should avoid investing in equipment that requires large amounts of reliable power. Provisions, both physically and in the financial plan, should be made for back-up generators and their higher operation costs. Again, the need for adequate back-up capacity may make certain projects uneconomical, especially those requiring large amounts of reliable electric power at predictable prices. The sub-projects should also take into account the negative environmental impacts that back-up generators may produce.

Assumptions about the economic outlook should be realistic. Business and financial plans should base their case on a continuation of the main institutional frameworks such as customs duties and taxes, quality of infrastructure, the state of public services, etc. They should give due weight to both a downside scenario of deterioration (worst case) and an upside scenario (best case) driven by changes to the structural features of the operational environment.

A plan should be developed for financing the working capital needs of growing SMEs. First time entrepreneurs in the region and their bankers rarely model correctly the working capital requirements of the business. These are driven by the seasonal patterns of every business and the incremental revenue growth from the capital project. Corporate projects can fail for lack of working capital finance. It is important to study the working capital needs, both their seasonality and the degree of growth that revenue expansion will engender. These needs should then be met by providing, through the EBRD or another bank, a committed revolving working capital facility. A working capital facility should be part of every financing plan.

Documentary credit will reduce settlement risk in international trade. A key risk in trade is settlement risk: the risk that the seller will not receive payment for delivered goods, and the risk that the buyer will not take ownership of the goods per the sales contract. The documentary letter of credit (LC) guarantees payment against transfer of ownership of the goods or services, protecting buyer and seller against settlement risk. LCs ensure that the buyer will not pay until he takes ownership of the goods, and that the seller will be paid if he delivers the goods.

There should be continuity in the supervision of the project to ensure the detection of deteriorating performance or integrity. It is important to maintain continuity in project monitoring to ease detection of changes in project and sponsor outlook. Where such continuity is impossible, it is important to maintain, especially for difficult projects, a consistent level of banking experience opposite the project.

Investment agreements should communicate and promote the EBRD's mandate objectives. Incorporation of positive incentives in investment agreements to promote the EBRD's environmental objectives may lead to better outcomes. The environmental section could refer to the Bank's environmental policy. It could encourage efforts by the fund manager or sponsor to make environmental improvements, as well as complying with regulations. It could require a report in a form specified by the EBRD about the project's environmental accomplishments as well as its compliance track record.

Local environmental regulatory capacity should be assessed. The EBRD should appraise not only the capacity of the fund manager to adhere to the EBRD's environmental standards, but also the capacity of local environmental authorities to enforce environmental laws and regulations. Where capacity is recognised to be weak, the EBRD should consider teaming with other multilateral or bilateral agencies to implement a programme to improve local capacity.