

OFFICE MEMORANDUM

Date: January 8, 1997

TO: Mohamed El-Ashry, Chief Executive Officer and Chairman, GEF

FROM: Lars Vidaeus, Executive Coordinator, GEF Operations, ENVGC

EXTENSION: 3-4188

SUBJECT: **Small and Medium Scale Enterprise Program Replenishment
Circulation of Final Document to Council/CEO Endorsement**

1. Please find attached 75 copies of the Project Document for the above-mentioned project for circulation to Council Members prior to your final endorsement.
2. The project is entirely consistent in scope and objectives with the document reviewed and approved by the GEF Council at its October 1996 meeting. In response to a call from some members of the Council for an interim evaluation of the Pilot Phase Small and Medium Scale Enterprise project to accompany the replenishment request, I would like to clarify that:
 - a) Only three sub-projects have received funding to date and these sub-projects are long term initiatives (5-10 years). It is not possible to evaluate either the financial or environmental performance of these projects yet.
 - b) Replenishment of the SME Program is critical to maintain its momentum and to ensure that the activity which has begun can be monitored and supervised. Funds provided during the Pilot Phase for administration are expected to be fully expended by June 1997 and funds for lending to Intermediaries and projects will be committed by January 1997. (There is a lag of 12-18 months from the time funds are committed to an Intermediary until these funds are fully disbursed to sub-projects).
 - c) There will be an evaluation of sub-projects as part of a mid term or second interim evaluation of the SME Program. This second interim evaluation will be completed before the second tranche of the proposed replenishment is made available by the Trustee to IFC.
3. Under these circumstances, the information that can meaningfully be included in an interim evaluation has been prepared and attached as annexes to the Project Document as follows:
 - **Annex 1: Summary of Uses of Pilot Phase Funds**, summarizes how funds received from GEF to date have been spent or committed as of October 31, 1996. It also contains a forecast of the status of these funds as of January 31, 1997, the date when disbursement of the Replenishment is expected to be requested.
 - **Annex 2: Summary of Intermediaries and Projects Selected**, summarizes the SME Program lending activity as of October 31, 1996.

- **Annex 3: Pipeline of Opportunities**, is an indicative but not final or exhaustive list of potential participants. Additional participants will continue to be identified and evaluated by the Program during the proposed expansion.
- **Annex 4: Pilot Phase SME Program Interim Review**, which was attached to the proposal reviewed by the GEF Council at the October 1996 meeting.

4. We had proposed in a memorandum to Al Duda dated November 1, 1996 that, to accommodate IFC's need for a replenishment of \$15.5 million in present value terms (\$16.5 million in nominal terms), the full \$15.5 million be fully disbursed up front to IFC. The funds not needed by the SME program until 1999 would then have been invested, with IFC retaining the interest income. It appears that, for Trust Fund management purposes, the practice of disbursing the full amount of a grant up front is not supported by the Trustee (except under very special circumstances such as capitalizing a "fund"), and that the modalities under which the IFC and Bank collaborate on GEF activities preclude IFC from claiming in advance the interest on any GEF funds which they might invest (the Trustee retains the right to require IFC to return the income from any invested funds to the GEF Trust Fund). The solution agreed with IFC and the Trustee is to clearly state that the SME program will be replenished for \$16.5 million, which will be disbursed in two equal tranches. In order to provide an explanation to Council members for what appears to be a change in grant amount, we suggest that your cover letter include a paragraph similar to the following:

"In IFC's proposal to expand the SME Program, as described in the Work Program presented to the Council on October 8, 1996, the funding requirement for this activity was expressed in present value terms as US \$15.5 million, consisting of two equal disbursements of US \$8.25 million, over a three year period. Whereas this was an accurate statement of the funding which is required by IFC (applying a discount rate of 4% p.a., the two disbursements have a present value of US \$15.5 million), the funding requirement is more easily understood and disbursements from the GEF Trust Fund more easily managed when the grant amount is expressed in nominal terms. The nominal value of the disbursements that IFC requires for the expansion of the SME Program is US \$16.5 million, and the attached Project Document now states the GEF grant in nominal terms in the amount of \$16.5 million to fund the SME Program as described therein."

5. We would appreciate receiving a copy of your out-going letter to Council Members for our records.

Attachment

cc: Messes./Mmes. Ahuja, Bliss-Guest, Duda, King (GEF Secretariat), Younger, Salloum (CTESP); Broadfield, Suter (ENVGC); ENVGC ISC



Global Small and Medium Scale Enterprise Program Replenishment

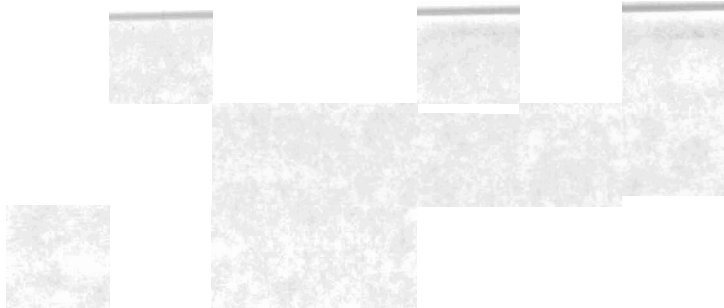
**Project Document
January 1997**

**Environment Division
Technical and Environment Department
International Finance Corporation**

**GLOBAL
SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM
REPLENISHMENT**

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**GLOBAL
SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM
REPLENISHMENT**

GRANT AND PROJECT SUMMARY

Recipients:	Institutions that provide financing and environmental services to small and medium scale enterprises, small and medium scale enterprises and projects
Beneficiaries:	small and medium scale enterprises and projects - global - available in all GEF eligible countries
Amount:	US \$ 16.5 million *
Terms:	loan (administered by International Finance Corporation)
Financing:	financing to be provided to Intermediaries and to small and medium scale enterprises on terms as commercial in nature as possible in the individual circumstances
Economic Rate of Return:	minimum required for SME projects: 4% p.a. in US\$

*** Note:**

In IFC's proposal to expand the SME Program, as described in the Work Plan presented to the GEF Council on October 8, 1996, the funding requirement for this activity was expressed in present value terms as US\$ 15.5 million, consisting of two equal disbursements of US\$ 8.25 million over a three year period. Whereas this was a accurate statement of the funding which is required by IFC (applying a discount rate of 4% p.a. the two disbursements have a present value of US\$ 15.5 million), the funding requirement is more easily understood and the disbursements from the GEF Trust Fund more easily managed, when the grant amount is expressed in nominal terms. The nominal value of the disbursements that IFC requires for the expansion of the SME Program is US\$ 16.5 million. The Project Document now states the GEF grant in nominal terms, in the amount of \$16.5 million, to fund the SME Program as described herein.

**GLOBAL
SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM
REPLENISHMENT**

EXECUTIVE SUMMARY

1. This proposal seeks a funding replenishment from the GEF to extend and expand the SME Program. This replenishment request to the GEF is for a funding commitment of \$ 16.5 million.
2. The Small and Medium Scale Enterprise Program ("SME Program") was approved as a Pilot Phase activity of the GEF in July 1994 and began developing its current operating structure under the administration of the International Finance Corporation ("IFC") in March 1995. The mandate given to IFC was to design and test procedures that could finance the incremental costs of GEF eligible projects as carried out by small and medium scale enterprises ("SMEs"). SMEs, for the purposes of the Program, were defined as private sector enterprises with total assets valued at less than \$ 5 million. Eligible projects are those that fall under one of the seven long term GEF Operational Programs in biodiversity and climate change. The SME Program was designed as a global initiative, available to finance eligible projects in any recipient country that has signed the Biodiversity and/or Climate Change Conventions.
3. A basic feature of the design developed by IFC for the SME Program is that it operates primarily through Intermediaries. These Intermediaries are selected by IFC on the basis of their experience with SMEs, their financial viability, and their financial and environmental technical capabilities. The Intermediaries identify, analyze, finance and monitor GEF eligible SME projects and in the process assume the risks inherent in these projects through the provision of loans or equity investments, not grants. The Intermediaries receive a long term, low interest rate loan from the Program but combine their own and other sources of funding to complete the financing requirements of the eligible SME projects. Projects funded with debt or equity do not consume or expend GEF funds since these funds will return to the GEF. GEF funds will, however, be expended at the level of the Intermediaries to overcome the incremental costs incurred by Intermediaries in financing GEF eligible SME projects. The full treatment of incremental costs in the SME Program is provided in Sections 40 - 46 of this Document.
4. During the Pilot Phase of the Program the incremental cost of the additional risk incurred by Intermediaries was covered by a feature of the loan which allowed Intermediaries to retain 50% of the funds that they loaned to or invested in eligible projects, if those loans or investments were repaid. Whereas this feature was found to be effective at overcoming the additional risk incurred by the Intermediaries, the 50% amount may not in all cases have been optimal. In the expansion of the SME Program the amount that Intermediaries will be allowed to retain will be negotiated on a project by project basis, up to a maximum of 50% of the loan or investment provided. This modification will be implemented to assure, to the fullest practical extent possible, that only the incremental cost of the additional risk facing the Intermediary is funded by the GEF, and not more.
5. In its first year of operation the SME Program developed and implemented the procedures for selecting Intermediaries, for analyzing and approving SME projects and for monitoring these projects. Standard loan agreements and Program reports have been developed as well. Five Intermediaries have been selected to date and these Intermediaries in turn have committed to finance a total of at least 23 different SME projects (of which three have been approved by the process outlined on page 9, for total SME Program funding of \$ 143,000 - see Annex 2. There is a lag of 12 -

18 months from the time that the SME Program commits funds to an Intermediary until those funds are fully advanced to approved SME projects). The forecast average amount of financing that any one SME project will receive from the SME Program is approximately \$ 150,000. Estimated total financing that will be provided to these 23 SME projects from all sources is \$ 11.5 million which represents a leverage of approximately 4 times on the GEF funds provided.

6. The SME Program's period of development, as funded by the Pilot Phase of the GEF, is nearing an end. Funds provided for administering the Program are forecast to be fully expended by June 30, 1997. Funds available for lending to the Intermediaries are forecast to be fully committed by January 31, 1997. This replenishment request is being submitted at this time in order to ensure that the administrative structure required to monitor and evaluate the loans to the Intermediaries and the projects that are now in place, is maintained until these loans are fully repaid. There is also evidence of strong demand for this innovative source of financing and the SME Program is requesting additional funding to respond to this demand.

7. An Interim Evaluation of the SME Program has been carried out and is presented as Annexes 1 to 4 of this Project Document. This Interim Evaluation supports the need for additional funding at this time and concludes that the SME Program has been well designed and structured and that the procedures are in place to achieve the GEF objectives with respect to identifying and financing eligible SME Projects. The Interim Evaluation consists of the following components:

- **Annex 1: Summary of Uses of Pilot Phase Funds** - summarizes how funds received from GEF to date have been expended or committed as of October 31, 1996. In addition, a forecast of the status of these funds at the end of January 1997, the date when this replenishment is requested to be disbursed, is provided,
- **Annex 2: Summary of Intermediaries and projects Selected** - summarizes the SME Program lending activity as of October 31, 1996,
- **Annex 3: Pipeline of Opportunities** - this indicative list of potential participants is not final or exhaustive. Additional participants will continue to be identified and evaluated by the Program during the proposed expansion,
- **Annex 4: Interim Review** - independent consultants were asked to provide an evaluation with respect to the ability of the SME Program to achieve the objectives set for it by IFC and GEF. The consultants' review was focused on the structures and procedures developed for the Program. The consultants did not review individual SME projects. SME Projects selected to date have only recently received funding. These projects are long term initiatives - 6 to 10 years. It was not possible at the time of the Interim Review, and will not be possible for several years, to assess the financial and global environmental benefit of the SME Program at the level of the SME Projects. (The second Interim Evaluation, which will occur in three or four years, will include reviews of SME Projects, since by that time many of them will have been operating for several years). However, the SME projects selected to date have all gone through the Program's review procedure as described on page 9 and were considered to meet GEF eligibility and incremental cost criteria/objectives.

8. To accomplish the goals of the expanded SME Program, as outlined in Sections 22 - 24 of this Document, requires a budget of \$ 17.5 million; \$ 12.0 million for SME projects and Intermediaries,

\$ 3.1 million for Program specific administration, \$ 1.5 million for Technical Assistance and \$ 0.9 million for contingencies and inflation. The budget exceeds this request for funding from the GEF by \$ 1 million. This is because the administrative costs of the SME Program will be partially offset by interest earned on funds loaned to Intermediaries - estimated to equal \$ 1 million. (see Budget Summary prior to Section 32 to this Document and Schedule A). IFC estimates that of the \$ 16.5 million requested, \$ 6.9 - 7.4 million will be recovered by the SME Program in loan principal repayments. These recovered funds may in the future be used to finance objectives similar to those of the SME Program or may be returned to GEF for reallocation to other activities. Until the final disposition of the reflows is determined they will remain with the SME Program under the administration of IFC.

9. To express the requested funding in incremental cost terms, GEF will be funding (in addition to the administrative costs, inflation and contingencies) incremental costs totaling \$ 6.1 - 6.6 million. Of this total \$ 1.5 million will be expended for technical assistance and \$ 4.6 - 5.1 million (of the \$ 12 million required for Intermediaries and projects) will be expended to fund the incremental costs incurred by Intermediaries.

10. At \$ 3.1 million, or 18% of the proposed budget, the amount of funding allocated for administrative expenses appears high, but this is the amount required over a ten year period. On an annual basis, as a percent of loan funds under management, the forecast administrative expenses are a respectable 3% - 4% p.a. by the year 2001. These administrative expenses are for the specified project-related costs of the SME Program team contracted by IFC to implement the Program - not IFC's own management costs. IFC is contributing, and not recovering the cost of, significant senior management time to the Program.

11. This proposal requests that the GEF Trustee disburse the replenishment funding in two equal tranches. The first tranche of \$ 8.25 million shall be disbursed to IFC during January, 1997. The second disbursement shall be available to IFC at the option of the CEO of GEF once the first half of the funds have been expended or committed, which situation is expected to occur by or before January, 2000. This request to the CEO for the second half of the replenishment will be supported by a second Interim Evaluation of the Program. This second Interim Evaluation will include appraisals of the financial performance of specific SME Projects as well as a review of the global environmental benefits achieved by these projects. The incremental costs as defined and funded by the Program will be reviewed also.

12. The requested replenishment will provide sufficient funding to finance an estimated 75 additional SME projects as well as to provide technical assistance funds to increase the financial and technical capacity of selected Intermediaries. The SME Program will continue to work with Intermediaries but in addition will lend directly to selected eligible SME projects that have been identified and structured by IFC's Project Development Facilities. The replenishment will provide sufficient funding to administer the SME Program and to monitor and evaluate the approximately 100 SME projects which will have been financed by the Program - for the full term of these proposed financings. This period of monitoring and evaluation will in some cases extend to 10 years. It is necessary to commit to the full term of the SME project financings to ensure that the lessons of the SME Program are thoroughly monitored, analyzed and disseminated.

13. This long-term commitment to evaluate the results of the proposed SME projects relates directly to the fundamental issue being addressed by the SME Program - the critical need for increased participation by the private sector in the finance of small scale projects with global

environmental benefits. Financing GEF eligible SME projects is a relatively new opportunity and without evidence to the contrary the private sector will always assume that new initiatives are either highly risky or unprofitable, or both. The SME Program will use GEF funds to first develop a significant number of SME projects and then to document the true risk/return nature of these initiatives. If a significant number of projects funded by the SME Program are shown to be commercially viable, and if private sector funding follows as a result of this experience, GEF funds will have been used in a very strategic and practical manner to leverage much larger flows of capital to GEF focused SME activities.

14. The operational modalities proposed for the SME Program are consistent with GEF Council decisions and guidance, the GEF Instrument and the GEF incremental cost approach. At its May 1995 meeting, the Council agreed that Implementing Agencies could prepare project concepts with non-grant financing approaches.

15. Following approval of this proposal, all GEF country focal points in recipient countries will be advised of the SME Program. Countries will be asked to endorse the SME Program, on a no objection basis, with a two month response period. All recipient countries, except those objecting, will then be potential hosts for sub-projects. Thereafter, the GEF focal points for specific countries will be advised each time an SME Program standard Loan Agreement has been signed with a selected Intermediary from that country. The GEF focal points for a specific country will also be advised each time an SME project has been approved. This is the same approach with respect to GEF country focal point notification to be implemented by another global initiative recently approved by Council, the Renewable Energy Efficiency Fund ("REEF").

BACKGROUND AND PROJECT CONTEXT

16. Institutions selected by IFC to be Intermediaries may be traditional financial institutions, NGOs or specialized entities such as venture capital funds. Institutions which are financially viable and technically capable are first screened on the basis of the kind of projects they intend to finance. Preference is given to prospective Intermediaries with a pipeline of projects that are innovative and relatively risky. Once selected, Intermediaries receive long term low interest rate loans (up to 10 years at an interest rate of 2.5% per year) from the Program. The Intermediaries commit to use the loan proceeds to finance a specific minimum number of eligible SME projects, providing to these SMEs either debt or equity, but not grants. The long term source of funds from the Program allows the Intermediary to fund long term loans or equity investments in relatively high risk experimental SME projects. A portion of the proceeds of the loan from the Program will be paid to the Intermediary in compensation for identifying, analyzing, structuring and monitoring projects. A final feature of the loan is a provision to compensate the Intermediary for the incremental cost of the additional risk associated with financing SME projects with GEF benefits. During the Pilot Phase, the Intermediaries were allowed to retain 50% of the funds that they recovered from loans or equity investments made to approved SMEs. In the expansion phase this 50% figure will be reduced through competitive bidding and negotiation.

17. As of October 31, 1996 the SME Program has committed to lend \$ 2.9 million to five different Intermediaries as shown in Annex 2. To date these Intermediaries have identified a total of 18 different projects which are in various stages of evaluation (estimated amount of SME Program funding currently being evaluated is \$ 600,000). Three SME projects totaling \$ 143,000 in Program funding have been approved. One or two additional Intermediaries will be selected and will receive

loans from the funding provided during the Pilot Phase of the SME Program by the end of January 1997. The intention is that at least one of the next Intermediaries will be in sub-Saharan Africa.

18. The procedures of the SME Program require that all Intermediaries present their projects to a Review Committee and an Advisory Panel. Intermediaries are all initially classified as Approved Intermediaries, and then once the Review Committee and the Advisory Panel are convinced that an Intermediary can identify, analyze and structure SME projects that are commercially viable and that address the GEF objectives then that Intermediary is authorized to finance projects without Committee approval (i.e. they are considered Authorized Intermediaries). Authorized Intermediaries must advise the Program Task Manager of the details of all projects financed according to a standard SME Program reporting format. One of the requirements of the SME Program is that Intermediaries describe the global environmental benefits (climate change and/or biodiversity) of each project. The role of the Advisory Panel is to review and confirm these benefit descriptions. (Criteria and procedures for the selection of Intermediaries and SME projects are summarized in the panels following item 19 of this Document).

19. The first of the Intermediaries to submit SME projects for approval was FUNDECOR, an NGO in Costa Rica. The Review Committee and Advisory Panel approved FUNDECOR's plans to finance forestry projects with small landowners in a buffer zone around the national parks in the Cordillera Central. The projects that were submitted were for a sustainable forestry initiative on 41 hectares of natural forest and a reforestation project on 25 hectares of land that had been converted from forest to cattle pasture. The amount of financing required for these projects was \$ 1,757 and \$ 6,213 respectively. CARESBAC Polska has also had a project approved - planting trees and hedges and installing a flax compacter on a cattle operation. The total SME program funding approved was \$ 135,000 and the benefit will be primarily in the area of climate change from the use of flax cubes as an alternative fuel.

20. Other proposals currently under development for individual SME projects include the following:

- Environmental Enterprises Assistance Fund (in South East Asia and Central America):
alternative energy projects - biomass and small hydro electrical generation
eco-tourism facilities
- CARESBAC - Polska (in Poland):
energy system conversions (coal to gas furnaces)
suppliers of energy saving equipment (thermostatic valves for centrally supplied
heating, insulated window manufactures, etc.)
- El Sewedy Electrical Supplies (in Cairo, Egypt):
energy efficient lighting
- World Wildlife Fund (in Papua New Guinea):
sustainable community based forestry
community based eco-tourism

21. In addition to the Review Committee (staffed by IFC senior management) and the Advisory Panel, which consists of two independent consultants from the STAP roster (one with biodiversity experience and the other with climate change experience) plus a representative from the World Bank

Global Environment Division (or the World Bank Environment Department), the IFC has contracted a Task Manager to administer the Program. Item 35 of this Document provides further information with respect to future staffing plans for the SME Program.

Criteria and Procedures for the selection of SME Program Intermediaries:

A. Intermediaries are selected on the basis of four criteria:

1. **experience with small and medium scale enterprises:** All potential Intermediaries must have several years of field experience in working with SMEs - either in the environmental or the financial sector, and must have a pipeline of GEF eligible projects. Preference is given to Intermediaries willing to finance innovative or relatively high risk projects,
2. **financial viability:** The SME Program is providing a long term loan to Intermediaries and as a result potential participants are analyzed carefully to determine their long term credit worthiness,
3. **financial technical expertise:** Each Intermediary must have the technical ability to analyze and structure commercially viable SME projects,
4. **environmental technical expertise:** The Intermediary must analyze the GEF benefits of the proposed SME project and must also carry out an Environmental Review consistent with IFC's requirements for all financial institutions receiving financing.

Intermediaries must be acceptable on the basis of the first two criteria and may contract out for either of the second two if these specific forms of expertise are not available in the institution.

B. Approval of Intermediaries:

All Intermediaries are first identified by the SME Program Task Manager and then reviewed by the Program Review Committee, consisting of representatives of IFC's Technical and Environment Department (CTE) and Central Capital Markets Department CCM). If accepted by the Review Committee the recommendation for the selection of an Intermediary is submitted to IFC management for approval.

Criteria and Procedures for the Selection of GEF eligible SME projects:

A. Intermediaries are instructed to finance SME projects which have the following characteristics:

1. **financial viability:** All projects must demonstrate a minimum IRR of 4% p.a. in real terms. The proposed financing provided by the Intermediary must match the base case financial forecast for the project, i.e. an Intermediary may provide financing at 4% p.a. or more, but not less,
2. **GEF benefit:** All projects must fall under one of the seven GEF long term Operational Programs in biodiversity and climate change,
3. **leverage:** The Intermediary must combine funds from the project sponsors and from other sources to the full extent possible, in order to complete the financing requirements of the project. The amount of funding provided by the SME Program generally will not equal the full cost of the project,
4. **no negative environmental impact:** The Intermediary must carry out an Environmental Review of the proposed project.

B. Approval of projects:

Initially all projects developed by an Intermediary are submitted to the Review Committee for approval. In addition, all projects are reviewed by an independent Advisory Panel consisting of two consultants from the STAP consultant roster and chaired by a representative of the World Bank's Global Environment Division. The primary role of the Advisory Panel is the confirmation of the project GEF benefit.

OBJECTIVES OF SME PROGRAM EXPANSION

Global Environmental Objectives and Benefits

22. As in its initial phase of operation the extended SME Program will continue to finance small scale projects with either or both biodiversity and climate change benefit. The number and kinds of projects will increase in the proposed extension, as will the geographic range of the activities financed. The direct global benefits of the projects financed will be relatively small because the funding provided in any one case will be small - less than \$ 250,000 (and often much less). More important may be the long term demonstration effect of the Program.

Specific SME Program Objectives

23. To attract greater participation by the private sector in the financing of GEF eligible SME projects, more successful examples of these kinds of projects need to be developed and documented. The SME Program seeks the replenishment to fund and evaluate at least 100 different GEF SME projects. IFC believes that this target number of projects is necessary to provide valid conclusions.

PROJECT DESCRIPTION

24. In the proposed extension of the SME Program, GEF funds will be used to finance three specific strategies related to the role of the private sector and financing for GEF eligible SMEs.

- **A sufficient number of projects need to be developed to provide a basis for future conclusions and lessons:** Financing for a total of 100 SME projects has been set as the goal of the SME Program. This requires that an additional 75 SME projects be financed with funds from this replenishment request to the GEF. Funding for new SME projects represents approximately 80% of the requested replenishment.
- **Building capacity in non-financial Intermediaries:** Half of the Intermediaries selected to date by the Program are not financial institutions. Two are NGOs without formal financial sector experience in project analysis, financial design or investment monitoring. In the extension of the SME Program more non-financial Intermediaries will likely be selected. IFC has excellent experience in building financial capacity in partner institutions and has an opportunity and responsibility to bring this experience to the Intermediaries. By using GEF funds to strengthen the capacity of Intermediaries, the Program will be increasing the ability of these institutions to invest in projects with global environmental benefits.
- **Monitoring, evaluation and dissemination of the Program results:** It is not sufficient that the SME Program develop 100 SME projects that are commercially viable and that produce global environmental benefits. It is also important to study the experiences of the Program, to analyze them and to disseminate those experiences. The dissemination of the lessons learned from the Program is fundamental to potential for commercial financing of GEF SME projects in the future.

RATIONALE FOR GEF FINANCING

25. The SME Program responds to the objectives of the Climate Change and Biodiversity Conventions and the GEF Operational Strategy for controlling greenhouse gas emissions and loss of biodiversity. The GEF Operational Strategy suggests that GEF funds should be used to leverage additional finance through collaboration with the private sector. The SME Program addresses and/or seeks to accomplish these objectives and strategies. Based on the experience gained to date, it is estimated that the \$ 12 million requested for funding to Intermediaries will leverage sufficient private sector funds to finance approximately \$ 48 million in GEF eligible SME project costs.

26. In general the private sector has not acknowledged the need or the opportunity to finance commercial projects with global environmental benefit. The SME Program is attempting to stimulate the development of this kind of project by using public sector funds from the GEF to finance small projects at the margin of private sector activity. This strategy is new and somewhat radical. It is not at all certain how profitable projects with global environmental benefit can actually be, particularly when carried out at the level of SMEs.

27. If the SME Program is successful in developing a significant number of commercially viable projects with global environmental benefits, this example may cause the private sector to consider investing in these projects as well. If the SME Program is successful, a relatively small amount of GEF funding will have been used to attract much larger flows of capital from the private sector.

SUSTAINABILITY AND PARTICIPATION

28. Sustainability of financing for GEF SME projects is a basic objective of the SME Program in all of its activities. If the SME Program is successful in the pursuit of this objective the following evidence of success will be observed:

- **at the SME level:** With a clear record of profitable operation, some of the SMEs financed with Program funds may in the future be able to access commercial financing,
- **at the level of the Intermediaries:** As the Intermediaries determine that the risk of the SME projects and their related financial returns are acceptable they will also be able to attract financing from commercial sources to continue this activity, and
- **at the level of the SME Program:** The final proof of the sustainable nature of GEF SME projects would be the establishment of a private sector financed loan or equity fund targeting these activities. The SME program may in the future attempt to structure this kind of specialized financial vehicle, perhaps using the reflows of capital from the Intermediaries. Subsequent requests for funding of GEF SME projects may then be shared between the GEF and private sector investors and lenders.

29. Many of the non-financial Intermediaries selected by the SME Program have excellent experience with environmental issues or with SMEs but lack the experience necessary to finance commercial projects. As donor funding to NGOs and non-profit institutions becomes constrained and competitive, the sustainability of these organizations will depend on their own ability to attract

and manage commercial funds. The SME Program seeks to increase the long term sustainability of non-profit institutions through the provision of technical assistance funds for two purposes:

- **increasing management capacity:** The Program will contract independent consultants to work with non-financial Intermediaries to improve management's ability to identify, analyze and structure commercially viable financial opportunities with global environmental benefit, and
- **commissioning business plans:** Often NGOs have good community based or environmental technical experience but lack the ability to convert this experience to a commercial opportunity. In these cases the SME Program will fund the cost of preparing business plans for the commercialization of their experience.

LESSONS LEARNED AND TECHNICAL REVIEW

30. The Pilot Phase of the SME Program has in a relatively short period of time laid the groundwork for the proposed extension by concentrating on the following activities:

- **establishment of the procedures and processes for approval, disbursement and monitoring:** The procedures developed for the SME Program have been fully designed and implemented. All activities except for monitoring of the individual projects have been tested.
- **selection of a diverse group of institutions as Intermediaries:** The Program has selected Intermediaries with good geographic diversity and a variety of structures. Two are small business venture capital funds financed by a combination of grants and private sector capital (EEAF and CARESBAC). One is a private company (El Sewedy). Two are non-profit NGOs (FUNDECOR and WWF). The Intermediaries are committed to financing projects that are small by traditional IFC or World Bank standards. Both biodiversity and climate change projects will be prepared by the selected Intermediaries.
- **training the Intermediaries in how to identify, analyze and monitor SME projects that meet the SME Program criteria:** Each Intermediary has been trained in the preparation of a standard evaluation technique for proposed SME projects. This evaluation requires that the Intermediary forecast the financial viability of the project as well as the incremental costs and the anticipated GEF benefits. In addition, the Intermediary is required to carry out an Environmental Review of the project and to avoid negative environmental impacts. Instructions to Intermediaries for monitoring SME projects have also been standardized and are provided to Intermediaries as part of their training.
- **development of contacts with potential Intermediaries:** In anticipation of an extension of the SME Program a pipeline of potential Intermediaries has been developed. Contacts have been made with a range of institutions, from NGOs to IFC's traditional financial intermediaries.

31. All of these elements of the current Program have been reviewed and are strongly supported by independent consultants. The Interim Review of the IFC/GEF Small and Medium Scale Enterprise Program is attached as Annex 4 to this document. There is no reason at this time to change significantly how the SME Program operates, with two exceptions; the amount that Intermediaries will be allowed to retain of the funds advanced to SME Projects will in the expansion

be negotiated, and the Intermediaries will not be required to analyze the incremental costs of the SME Programs. These two changes are discussed further in Sections 40 - 46.

PROJECT BUDGET AND FINANCING

Budget Summary

A.	Financing to Intermediaries and projects	\$ 12,000,000	68%
B.	Administration (including long term requirements for monitoring SME projects)	3,100,000	18%
C.	Technical Assistance		
	1. technical assistance to Intermediaries	750,000	
	2. monitoring and evaluation	250,000	
	3. dissemination	<u>500,000</u>	
	Total technical assistance	1,500,000	9%
D.	Inflation and contingencies	900,000	5%
Total SME Program cost		<u>17,500,000</u>	<u>100%</u>
Estimated reflows (interest earned on loans to Intermediaries)		1,000,000	6%
Total Project (replenishment request)		<u>\$ 16,500,000</u>	

Financing to Intermediaries and Projects

32. During the extension of the SME Program, the size and range of SME projects that the Program has developed to date will be maintained. Additional geographic diversity will be sought as will more projects. A particular effort will be made to develop SME projects in Africa. As a rough guideline the Program will attempt to finance projects by region as follows.

Region	Target number of projects	Number of projects as of October 31, 1996
Central America, South America and Caribbean	15	5
West Africa	5	
South and East Africa	10	
Northern Africa and Middle East	10	6
Eastern Europe	10	4
India and Pakistan	15	
South East Asia	10	
China	15	
Oceania	10	8
Total	100	23

33. A list of potential Intermediaries that has been collected over the last year will serve as the initial pipeline of opportunities for the extension to the SME Program. In addition, IFC's Project Development Facilities based in Africa, the South Pacific region and South East Asia have committed to actively seek out projects which meet the Program criteria. (The Project Development Facilities are independent offices staffed by experienced investment officers, hired by IFC but paid by a consortium of donors. The role of these advisors is to assist local small businesses to prepare viable business plans and to identify potential sources of financing. The Project Development Facilities do not have their own funds for lending to or investing in the small businesses that they assist). A conservative estimate is that the Project Development Facilities will identify and structure at least 10 of the targeted 75 new GEF eligible SME projects. Some of the current group of Intermediaries will advance all of the funding currently available to them from the SME Program and will be eligible for new loans within the proposed extension. These existing Intermediaries are expected to provide an additional 15 new SME projects. The remaining target of 50 new SME projects can realistically be obtained through the selection of an additional 10 to 12 new Intermediaries. The process of identifying and selecting the next group of Intermediaries is expected to take three to four years.

34. For the purposes of forecasting the required funds for the proposed increase in the number of SME projects, the Program has assumed that US \$ 4 million per 25 projects on average will be sufficient and that as a result \$ 12 million is required to reach the target number of projects.

Administrative structure

35. The administrative structure and functions of the team contracted by IFC to implement the first phase of the SME Program operation will continue but will be expanded. The requirement to monitor loan documentation, disbursements and repayments as well as the work associated with selection and approval of SME projects and Intermediaries will necessitate the extension of the contract with the Task Manager and the hiring of an Assistant Task Manager and an Administrative Assistant. The Assistant Task Manager and the Administrative Assistant will start in July 1997. The basic assumption is that the SME Program will require an administrative structure for at least ten years from the date of the first proposed disbursement from the GEF. These administrative expenses are offset in part by interest earned by the Program on funds loaned to the Intermediaries at 2.5% p.a. This forecast of interest income is the Estimated Reflows item in the Budget Summary prior to Section 32.

Technical Assistance to Intermediaries

36. Funding for six years of technical assistance to Intermediaries are forecast in the SME Program budget (see Section 29).

Monitoring and Evaluation of SME Project Risk and Return

37. IFC will assist in the design and management of these activities. Expenses include the cost of hiring consultants to design the information database for the collection and storing of the information on risk and return characteristics of each project financed by the Program.

38. Some preliminary analysis of this information can be carried out in the short term but since many of the SME projects may have long financing terms (as long as 10 or 12 years in extreme

cases) it is unlikely that conclusive results will be obtained before January 2000. Expenses for the monitoring and evaluation activities are forecast to be required for as long as the administrative structure is required, i.e. ten years.

Dissemination of Experiences

39. A conference will be scheduled each year to bring the Intermediaries together and to discuss lessons and practices. Intermediaries will develop and present case studies of projects with innovative technology or financing. The major costs of the proposed conferences will be space rental, materials and event coordination. In addition, funds will be set aside to assist participants from smaller Intermediaries to travel to the conferences. These dissemination expenses are assumed to be required until the termination of the Program, i.e. for at least ten years.

INCREMENTAL COSTS

40. All of the GEF eligible SME Projects which ultimately receive financing from the SME program will receive this financing in the form of loans or equity investments. If these projects were financed in a purely commercial manner there would be no need to justify the use of GEF funds in terms of incremental costs since (barring defaults) all loans or equity investments would eventually return to the GEF - i.e. no GEF funds would have been expended. In the case of the SME Program a portion of the \$12 million in GEF funding requested for lending to Intermediaries and projects will not return to the GEF and this expenditure of GEF funds must be justifiable on the basis of an incremental cost argument.

41. For the eligible SME Projects financed through Intermediaries (which will represent approximately 90% of all projects financed) GEF funds will be used to fund incremental costs at the Intermediary level and not at the SME Project level. Funds which are loaned or invested in the SME Projects are not GEF funds - they are funds of the Intermediaries. GEF incremental cost funding in the case of financial intermediaries is not required to fund the loans to the projects. Incremental cost funding is required, however, to overcome the costs incurred by these institutions when financing GEF eligible SME projects. The incremental costs may occur at the level of the Intermediaries as follows:

- **technical assistance costs:** As outlined in Section 29 a total of \$ 1.5 million has been allocated to technical assistance, including strengthening the capacity of selected Intermediaries. The capacity building expenses will focus primarily on improving the ability of Intermediaries to analyze and manage the commercial aspects of GEF eligible SME projects.
- **direct incremental cost:** The SME Program requires that Intermediaries carry out several tasks. Intermediaries must identify, analyze, finance and then monitor GEF eligible SME projects. The costs incurred in the performance of these tasks are incremental to the Intermediaries' business-as-usual activities. In compensation for this activity Intermediaries are paid Completion Fees and Monitoring Fees, both of which are provided on the basis of a percentage of SME Project costs. Without this funding the Intermediaries would not provide the reports that the SME Program requires for future analysis and would not identify and finance GEF eligible SME Projects. These fees are negotiated with the Intermediaries prior to signing the standard SME Program Loan Agreement. During the Pilot Phase funding

period the fees averaged 4% and 1% p.a., for Completion Fees and Monitoring Fees respectively.

- **incremental cost of additional risk:** The Intermediaries selected by the SME Program are not agents - they are true financial intermediaries. Unlike agents they are required to assume the risks inherent in financing the GEF eligible projects. The loans or equity investments made by Intermediaries are their own assets, not SME Program assets, and there is always a corresponding liability - the loan to the Program. If the SME projects fail, the loan to the SME Program will still have to be repaid. The perceived risk from the perspective of financial intermediaries is one of the greatest barriers faced in the financing of GEF eligible SME activities. This perceived risk can be overcome, however.

42. During the Pilot Phase of the Program it was demonstrated that the opportunity to retain 50% of the funds provided to GEF eligible SME projects was sufficient to induce Intermediaries to take the risk inherent in this activity. This figure of 50% was a preliminary estimate of the incremental cost of the added risk that the Intermediaries were being asked to assume and it was only available to the Intermediaries if their projects repaid the loans or equity investments. Clearly this feature was designed to encourage and reward Intermediaries that were able to structure and finance commercially viable GEF eligible SME projects. (The GEF objectives of the SME Program, whether the projects are ultimately commercially successful or not, are ensured through the process of project selection, approval and monitoring as summarized on page 9 of this Project Document).

43. The proposed expansion of the SME Program will seek to reduce to less than 50% the amount that can be retained, in order to not exceed the true incremental cost of the additional risk to be assumed by the Intermediaries. In the expansion of the SME Program this minimum level of incremental cost funding will be attained through a competitive bidding and negotiation process. All prospective Intermediaries will submit competitive bids to the SME Program. In their bids prospective Intermediaries will describe in general terms the kind of projects that they intend to finance and will state what percentage of the SME project funding they would need to retain to overcome the perceived incremental cost associated with the risk. If an Intermediary is proposing to finance several projects of similar risk characteristics and if the projects are considered to represent a significant risk to the Intermediary, the incremental cost of these risks will be negotiated once, at the beginning of the relationship. Otherwise the portion that an Intermediary can retain will be negotiated with the Task Manager and approved, on a project by project basis, by the Advisory Panel. The monitoring procedures of the SME Program will ensure that Intermediaries do not apply funds approved for one project to another, perhaps less risky, activity. Failure by an Intermediary to use funds for projects as approved is an event of default under the loan agreement and would result in an immediate acceleration of the loan principal repayment.

44. Where available, market standards and the experience gained to date will guide the Task Manager and the Advisory Panel in negotiating the percentage that can be retained by the Intermediary. In any case the incremental cost of the additional risk will not exceed 50% of the funds advanced to the eligible projects, the figure which was found in the Pilot Phase to be attractive to Intermediaries.

45. Approximately 10% of the 100 forecast SME projects are expected to be financed by the SME Program directly. The Program will lend to projects directly in certain cases but only if the opportunity has been identified, analyzed and structured by one of IFC's Project Development Facilities, as discussed in Section 33 of this Document. In these cases there may be a Completion

Fee and/or a Monitoring Fee paid either to the project or to a third party. These fees will only be funded by the SME Program if the case can be made that the identification, analysis, etc. is incremental to business-as-usual of the recipient. The Task manager will recommend, where appropriate, the payment of these fees and the Advisory Panel will approve or disallow the fees. Where allowable these fees will be negotiated to ensure that to the extent possible they do not exceed the actual incremental cost to the recipient. If any portion of a project loan is to be forgiven or converted to a grant in order to achieve the GEF benefit this amount will have to be justified by the project sponsor on the basis of a baseline comparison analysis acceptable to the Advisory Panel.

46. The incremental cost of the SME Program as a whole is the sum of the technical assistance expenses, the fees paid to the Intermediaries and the estimated cost of the additional risk incurred by the Intermediaries. All other funds (except those for administration, contingencies and inflation) will be repaid. The actual amount of incremental cost funding provided by the GEF in this case will depend on the performance of the SME Projects financed. The fees (estimated maximum value of \$1.1 million) will be paid out as long as the target number of projects are identified, analyzed, financed and monitored. If the estimated cost of the incremental risk turns out to be the maximum allowable level, 50% of funds advanced, \$5.5 million would be expended in this manner. Negotiation will significantly reduce this incremental cost item, however. The final incremental cost of the additional risk is estimated to be in the range of \$3.5 - 4.0 million. Therefore the total SME Program incremental cost funding is forecast to be \$6.1 - 6.6 million (\$1.5 million for technical assistance, \$1.1 million for fees and \$3.5 - 4.0 million for the cost of additional risks).

47. Of the \$12 million requested for lending to Intermediaries and projects, \$7.4 - 6.9 million will be repaid and will remain at the end of the forecast 10 year operation of the SME Program. Based on the experience of the Pilot Phase, the balance, the \$4.6 - \$5.1 million expended in fees and as the incremental cost of additional risk to the Intermediaries, will have leveraged approximately \$40 million in total financing to GEF eligible SME projects. IFC strongly believes that this is an efficient use of GEF funds and that without this innovative incremental cost funding the objectives of the proposed expansion would not be accomplished.

ISSUES, ACTIONS AND RISKS

48. The risks associated with the proposed extension of the SME Program are the same as were considered prior to the implementation of the pilot phase of the Program. These risks are significantly reduced however due to the experience gained to date from the operation of the Program.

49. Among the risks to be considered in the proposed replenishment request are the following:

- **deal flow risk:** There is a risk that the number of SME projects which meet the GEF requirements while at the same time demonstrating a basic level of financial viability will be lower than anticipated. The funding requested from GEF is to be staged, however, and if the demand for the SME Program funds does not manifest itself the second tranche of funds will not be released to the Program. Based on the relative speed with which the SME Program was able to identify Intermediaries prior to October 31, 1996 and the strategies for expansion, it is considered probable that the target of 100 SME projects will be attained.
- **program operating expense risk:** The funding required for administration of the SME Program over the full term of the project financings depends on the forecast operating

expenses and the anticipated interest income that the Program will earn from Intermediaries on the loans provided. The estimates for both the expenses and the income potential are considered conservative and realistic.

- **image/public relations risk:** Although the SME Program has been designed to finance projects which are expected to produce a positive environmental benefit, there may be parties which will criticize IFC and GEF for these efforts. Projects that are environmentally focused can be very divisive. There is not always agreement on the best approaches to take in all circumstances. As a result, whether the projects are successful or not, some NGOs or other third parties may attack IFC and/or GEF for attempting to finance these activities. The need to experiment and the need for well documented examples of effective techniques for financing GEF eligible SME projects outweighs the potential risk to IFC's or GEF's reputation, however. In addition, IFC will always ensure that all Intermediaries and projects comply with IFC and World Bank policies and guidelines with respect to Environmental Reviews.

INSTITUTIONAL FRAMEWORK AND PROJECT IMPLEMENTATION

50. The basic features of the SME program as it is currently structured will continue in the extension phase. The Program will continue to provide loans to Intermediaries on attractive terms to offset the risks and to cover the costs of the activities that they are being asked to carry out. The Intermediaries will continue to provide debt or equity to SME projects with rates of return in excess of the cost of funds from the Program. Intermediaries will analyze projects according to the instructions developed by the Program. New features that will be added in the expansion of the SME Program include the proposed relationship with IFC's Project Development Facilities (discussed in paragraph 32 of this proposal) and the negotiation process to minimize the incremental cost of the additional risk to the Intermediaries.

51. The SME Program during its pilot phase of operation has prepared the ground and planted the seeds for the proposed extension. Time has been invested during the first year of operation to ensure that the Program can control the quality and quantity of the SME projects which are now beginning to be presented. It is important the SME Program build on this foundation and harvest the results of the first phase of activity.

SCHEDULE A: PROJECT BUDGET

(all figures in US\$ 000's)	Total	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Average SME Program loan portfolio		2,000	3,900	6,120	8,500	10,300	11,100	9,900	7,200	4,200	1,300
Funds loaned to Intermediaries and projects	12,000	2,000	2,000	3,000	3,000	2,000					
Technical Assistance Funds											
To Intermediaries	750	100	100	100	100	100	100	100	50		
Monit. & evaluation	250	50	10	10	10	10	10	50	10	10	80
Dissemination	500	25	35	45	50	50	50	50	50	50	50
Administration expenses:											
Salaries		250	275	285	235	235	235	200	200	105	10
Travel and accom.		92	92	87	72	72	72	72	72	40	10
Equipment purchase		15									
Office and furn. rental		15	15	15	15	15	15	15	15	15	7
Communications		15	15	15	15	15	15	15	15	15	5
Supplies		6	6	6	6	6	6	6	6	5	1
Total Admin. expenses	3,062	393	403	408	343	343	343	308	308	180	33
Admin. expenses as % of loan portfolio		20%	10%	7%	4%	3%	3%	3%	4%	4%	3%
Inflation and contingencies	937	43	67	90	101	109	128	133	150	97	19

SCHEDULE B: SUMMARY OF DISBURSEMENT ARRANGEMENTS

GLOBAL SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM REPLENISHMENT

GEF Trust Fund Disbursement Schedule (US\$ 000)

<u>IFC Fiscal Year</u>	<u>1996</u>	<u>1999</u>
Annual	8,250	8,250
Cumulative	8,250	16,500

1996
Should read
1998
according to
Jannison.

SCHEDULE C: TIMETABLE OF KEY PROCESSING EVENTS

GLOBAL SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM REPLENISHMENT

Time taken to prepare: 5 months

Prepared by: Douglas Salloum, Task Manager

IFC Management Approval anticipated: January 1997

Project becomes effective: January 1997

Annex 1: Summary of Uses of Pilot Phase Funds

Annex 2: Summary of Intermediaries and Projects Selected

Annex 3: Pipeline of Opportunities

Annex 4: Interim Review

Annex 1: Summary of Uses of Pilot Phase Funds

1. The GEF Council during the Pilot Phase of the GEF provided a total of \$ 4.3 under the management of IFC to be used for financing the incremental costs of small and medium scale enterprises whose activities address the biodiversity and climate change conventions. These funds were budgeted by IFC as follows:

Administrative expenses:	\$ 312,500
Technical assistance:	\$ 105,000
Legal expenses and contingencies:	\$ 82,500
Funds for lending to Intermediaries:	<u>\$ 3,800,000</u>

Total Pilot Phase funding **\$4,300,000**

2. As of October 31, 1996 these funds have been expended, committed or are in the process of being committed as follows:

	expended or disbursed	committed but undisbursed	activities which will be expended or committed prior to Jan. 31/97	balance forecast at Jan. 31/97
Administrative expenses	\$ 183,000	\$ 0	\$ 50,000	\$ 79,500
technical assistance	\$ 4,377	\$ 0	\$ 33,000	\$ 67,623
legal, evaluation and contingencies	\$ 15,809	\$ 6,000	\$ 8,000	\$ 52,691
loans to Intermediaries	\$ 950,000	\$1,950,000	\$ 900,000	\$ 0

3. It is forecast that the balance of funds for administrative expenses, technical assistance and legal costs will be disbursed by June 30, 1997.

4. There is a lag of 12 - 18 months from the time that the funds are committed to an Intermediary until they are fully loaned to or invested in acceptable SME projects. (After selection by the SME Program the Intermediary must complete the loan documentation process which typically takes 2 - 3 months. Then specific projects must be identified, analyzed and structured according to the procedures prescribed by the Program). Of the \$ 2.9 million committed to the five selected Intermediaries approximately \$ 143,000 has been disbursed to fund approved projects as of October 31, 1996. Additional funding to specific projects valued at \$ 600,000 is currently under review by the Intermediaries. Full disbursement to acceptable SME projects of the \$ 3.8 million made available from the GEF during the Pilot Phase is expected by June 1998.

Annex 2. Summary of Intermediaries and Projects Selected

Name of Intermediary	Country or countries of operation	Size of Loan from SME Program	Number of projects Intermediary has committed to finance	Forecast total financing for SME Projects	Projects Approved by SME Program	Amount of SME Program funding approved for Projects **	GEF Focal Area/ Operational Program
Environmental Enterprises Assistance Fund	Indonesia, The Philippines, Mexico and Central America	\$ 800,000	6	\$ 4,800,000			
CARESBAC-Polska S.A	Poland	\$ 600,000	4	\$ 3,600,000	<u>Agroplon</u> - flax compacter and hedge planting	\$ 135,000	climate change/ renewable energy
FUNDECOR	Costa Rica	\$ 500,000	2*	\$ 1,500,000	<u>Vincente Paniagua</u> - buffer zone native species tree plantation	\$ 6,213	biodiversity/ forest eco-system
					<u>Edgardo Rojas</u> - FSC certified sustainable forestry	\$ 1,757	biodiversity/ forest eco-system
El Sewedy Elect. Supplies	Egypt	\$ 500,000	6	\$ 1,000,000			
World Wildlife Fund Inc.	Papua New Guinea	\$ 500,000	5	\$ 625,000			
Totals		\$ 2,900,000	23	\$ 11,525,000		\$ 142,970	

* FUNDECOR will be financing up to 150 separate projects of two basic kinds - sustainable forestry and reforestation - both on a very small scale

** These projects, described in paragraph 17 of this Document have been approved by the SME Program Review Committee and Advisory Panel consistent with the procedures outlined on page 9 of this Project Document

INTERIM REVIEW

IFC/GEF SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

July 29, 1996

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prepared by: Frank Vorhies, Environmental Economist
Biodiversity Programme
IUCN - The World Conservation Union

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prepared by: José M. Ruisánchez

EXECUTIVE SUMMARY

1. The purpose of this review is to provide opinions on the potential for the SME Program as it is currently structured to attain its GEF and financial objectives. Opinions are also provided on issues relating to IFC's intention to request additional support for the Program from the GEF.
2. The environmental aspects of the review have been carried out by Mr. Frank Vorhies of IUCN-The World Conservation Union, and the financial aspects by Mr. José M. Ruisánchez, in June/July 1996.
3. Overall, the IFC/GEF Program is a very well structured, innovative pathbreaking program. It is sure to provide new lessons and insights on funding projects for the global environment, as well as having a positive impact on the global environment. The Program's structure is sound and suitable and its resources are being used effectively. IFC is acting diligently in the execution of the Program.
4. The innovative aspects of the \$ 4.3 million Program are: to engage IFC's cooperation in pursuing GEF objectives of climate change and biodiversity through viable projects of SME's; to channel funds to SME's through intermediaries, mostly NGO's; and to maintain an R&D-type approach that permits the accumulation of lessons on how to blend GEF objectives with the capacity of the private sector to implement sustainable projects based on commercial practice. Noteworthy is the small size of the Program, the intermediaries, the SME's and their projects.
5. Aside from being of GEF relevance, the Program requires the SME projects to be commercially viable, defined as having a minimum IRR of 4%. The GEF usually provides grants and has no minimum IRR requirement. The Program's minimum IRR requirement is nevertheless compatible with GEF objectives. The Program's concessional loans call for a mechanism that relates the minimum interest rate charged by the intermediary with the project's capacity to repay the loan. The IRR is a reasonable proxy for the latter, and the 4% level seems an appropriate level at which to initiate the Program. As the Program evolves, the 4% floor could be adjusted as appropriate. This minimum IRR requirement should be handled as a practical tool and an indicator in the context of the Program's analysis of a project's financial viability.
6. The Program's approach to the complex concept of incremental cost is a practical and innovative application of that concept to concessional rather than grant financing. Experimentation with "incremental cost financing" appears quite appropriate in this pilot phase, especially as a source of useful information for both IFC and the intermediaries in managing the financing of SME projects. As with others, this indicator should not replace judgment in ensuring that a project makes good sense from the GEF's perspective.
7. The decision to work through intermediaries is sound, as it permits reaching a larger number of (smaller) SME's, enhances timeliness in Program implementation, increases efficiency in the utilization of Program resources, and reduces risk. The Program's criteria and controls for the selection of intermediaries are sound, and the selection process is well structured and

functions reasonably well. It should be noted, however, that the selection process has resulted in the Program's working with 4 (and, soon, maybe 5) NGO's who are quite different from the typical IFC intermediary. While this is commendable, care should be taken to ensure that IFC's traditional sponsor quality is maintained; and that the Program has adequate budget resources to provide the necessary technical assistance. It is also suggested that the intermediaries (and not only their projects) be assessed from a GEF perspective. A variety of kinds of intermediaries in channeling the Program's funds is likely to enrich the prospects for generating good lessons for GEF/private enterprise cooperation.

8. The Program's definition of an SME is congruent with IFC practice. The Program should be commended for fostering the support of a size of enterprise which is well under its maximum size of \$ 5 million. Limiting the amount per intermediary and per SME seems a good incentive to keep the size of firm small; and appears adequate for generating a sizeable and varied sample of projects to be financed by the Program.

9. Given that the Program seeks the commercial viability of GEF- oriented projects, and that it works with private SME's, it is appropriate that it provides loans and equity investments rather than grants. Also, loans and equities --rather than grants-- fit well with IFC's experience in financing private firms; and permit familiarization by NGO's with these traditional instruments of private sector funding. Similarly, the Program's incentives to its intermediaries are responsive to the extra cost and risks of pursuing GEF objectives and are output/success oriented, which is sound. Ideally, and eventually, the incentives should be refined to relate them with the costs and risks of the intermediary as well as with the GEF impact of the SME projects.

10. It is suggested that the Program consider the introduction of a standardized framework for the forecasting, monitoring and reporting of the SME project's global environmental benefits. This framework would reflect the appropriate Convention and would be joined by a guide to assist the intermediaries in its application. A similar comment can be made in relation to the financial aspects of SME projects. Key is not to encumber intermediaries with paperwork that yields little in Program insights and lessons.

11. The structure of the Advisory Committee or Panel, involving experts who review the GE aspects of SME projects and report through remote communication, is quite acceptable. Suggestions are: to foster the development of a guide for the intermediaries to standardize the presentation of GE aspects of projects; and a companion guide for the members of the Committee to facilitate their work. The Committee's members should have adequate incentives to devote the time necessary to provide substantive advice to the Program.

12. The overall operating structure now in place appears adequate for the remainder of the pilot phase. It appears to function in a smooth way and it harmonizes the many aspects and complexities of the Program. This reflects good cooperation between the two IFC departments that oversee the Program's implementation, as well as good work on the part of the Task Manager and the other persons involved. Sufficient Program resources should be available for ensuring adequate monitoring and supervision of the Program, for identifying good practices and capturing the lessons, and for disseminating the Program's results. Also, there should be resources to provide intermediaries with the necessary technical assistance and support in

problem solving. With proper expansion/deepening, there is no conceptual or practical reason why this structure cannot work well in the expanded Program that is envisaged.

13. A \$ 4.3 million Program is too small to permit a proper accumulation of GEF private sector experiences and an adequate base for launching a sustainable GE fund. Additional support from the GEF would increase the Program's base to \$ 15 to \$ 20 million. Success at this level should permit evolving into a self-financing environmental investment fund. A larger Program may permit identifying projects which are suitable for such a fund and others which are likely to require concessional financing. Thus IFC may well pursue different types of instruments in order to fit GEF objectives to the commercial viability of SME projects.

14. The GEF through IFC can open debt and equity markets for the global environment. Just as GEF money is "greening" the world in which IFC lives, the IFC can assist in "commercializing" the world in which GEF lives. To date, grants have made up the bulk of flows for the global environment, and there is much that IFC can do in complementing those flows with loans and equities. Similarly, governments and NGO's have been the main players in the GE arena, and IFC can help private enterprise to develop complementary roles in support of biodiversity and climate change. The Program's focus on debt and equity financing and IFC's reputation as the prime source of private development funding provide an ideal combination of elements for the GEF to support. IFC in partnership with the GEF has an opportunity --as the leading multilateral private sector financial intermediary-- to provide leadership in mainstreaming the environment into the world of private financial markets.

ENVIRONMENT STRUCTURE REVIEW

15. The purpose of this review is to provide opinions with respect to the potential for the SME Programme as it is currently structured to attain the GEF objectives. Specifically, as requested, the review comments on the issues outlined in points 1 to 5 below. Section 6 provides additional opinions on issues relating to the IFC's plan to request additional support for the Programme from the GEF.

16. Overall, the IFC/GEF SME Programme is a very well-structured, innovative, path-breaking programme. It is sure to provide new lessons and insights on funding projects for the global environment, as well as actually having a positive impact on the global environment.

17. The SME Programme requirement that SME projects have a minimum level of commercial viability (defined by the Programme as 4% p.a. IRR in real terms).

18. The bulk of the funding provided by the GEF is in the form of grants to the national governments of eligible countries. Nevertheless, the *Instrument for the Establishment of the Restructured GEF* does expect that "private sector entities" will also be engaged in "GEF project preparation and execution." In addition, the *Instrument* sees the GEF as "a mechanism . . . for the purpose of providing new and additional grant and concessional funding." Thus debt financing of private enterprises to meet the objectives of the GEF is an appropriate use of GEF funds.

19. With grant funding, there is no expectation that the money will be repaid. With concessional funding, however, the expectation is that the principal plus interest will be repaid. The GEF does not have any set requirements about the rate of interest or the length of the repayment period for the loan. If money is to be lent, however, it must be lent for the purpose of encouraging the private entity to engage in activities which they otherwise probably would not have in order to benefit the global environment. Thus the financial package of the loan, including the rate of interest and the term of the loan, would probably have to be more attractive than what is available in local commercial financial markets. In this sense, the funding is intended to be concessional.

20. The GEF, of course, also does not want its grants used to subsidise normal commercial operations. Just as grant funding is, for the most part, inappropriate for private enterprises, concessional funding at zero or very low interest rates is also inappropriate for private enterprises. The challenge facing the SME Programme is to set the interest rate at a level below the commercial rate so as to provide an incentive for the private concern to refocus its activities to the benefit of the global environment, while at the same time not to set it at so low of a rate as to provide a subsidy to normal commercial operations.

21. In order to set an appropriate rate of interest for the concessional loan, it may be necessary to project the both the internal rate of return (IRR) of the SME project as well as the commercial risk-adjusted, commercial cost of capital. Thus from a GEF perspective, a method for

determining the appropriate rate for a concessional loan requires calculation of the IRR and the cost of commercial financing. This technique is discussed in more detail in the next section.

22. The GEF does not, however, call for a minimum IRR or concessional loan rate. Nevertheless, the SME Programme has decided to limit eligibility to SME Projects with at least a 4% IRR. The Intermediary is also required to set its lending rate no lower than 4%. Are these requirements compatible with GEF objectives? The short answer is yes.

23. A further question might be asked. Why 4% and why not 2% or 6% or some other rate? If the SME project expects an IRR of less than 4% it is hardly a commercially viable project. Increasing the rate higher than 4% will reduce the number of eligible projects for consideration. In this pilot phase of the SME Programme, a cut-off rate of 4% seems an appropriate rate at which to initiate the programme. As the Programme evolves, the 4% floor could be adjusted - probably upwards - as appropriate.

24. The technique outlined in the Programme with respect to the calculation of the incremental cost component of the SME project costs; i.e. is this approach a reasonable one considering the size of the financings and the SMEs involved? Does it represent a practical application of the complex concept of incremental cost?

25. The GEF Secretariat has spent a considerable amount of effort on making the incremental cost concept operational for funding GEF-eligible projects. For example, in 1993 it published a working paper on "The Incremental Cost of Climate Change Mitigation Projects." It also has a working paper on "Incremental Costs of Conserving Wetland Biodiversity." These papers, however, focus on the application of incremental costs to grant-financing of projects.

26. The SME Programme is offering debt and equity finance for projects, and thus is attempting to apply the concept of incremental cost to concessional rather than grant financing. In so doing, it is experimenting with a technical measure of incremental cost derived from a comparison of the commercial cost of capital and the internal rate of return (IRR) of a possible SME project. Thus the SME Programme is engaged in "incremental cost financing" of SME projects related to the stated GEF objectives.

27. The Programme's approach to the complex concept of incremental cost is a practical and innovative application that may provide useful information for both the IFC and the Intermediaries in managing the financing of SME projects. It will thus also provide lessons for the GEF on the application of incremental costs to concessional financing of GEF projects. How useful this approach actually will be, however, can only be judged after it has been tested. Thus in this pilot phase, it is quite appropriate that such a technique be applied and studied.

28. The SME Programme is focusing its incremental cost assessment primarily at the level of disbursing the funds to SME projects. It is not trying to apply an incremental cost assessment to either the decision of the GEF to provide a grant to the IFC for the overall IFC/GEF SME Programme or the decision of the IFC to provide a loan to an Intermediary who in turn will invest in SME projects.

29. There are, however, important incremental cost aspects of both the grant to the IFC and the loans to the intermediaries. In addition to motivating SME projects to support GEF objectives, the GEF grant is also motivating the IFC and the intermediaries to support GEF objectives. Thus the grant is having an incremental impact at three levels. At least in descriptive terms, this should be noted in the monitoring and reporting on the SME Programme.

30. The Programme criteria and controls for the selection of the Intermediaries, including the analyses carried out by the Task manager and the approval process.

31. The SME Programme expects the Intermediaries to be: (1) financially secure, (2) experienced with investing in small and medium scale enterprises, (3) familiar with debt and equity financing, and (4) knowledgeable about climate change and biodiversity conservation. Very few, if any, organisations meet all four of these criteria. Thus the SME Programme is catalysing the development of such Intermediaries.

32. It will consider organisations that have the first two criteria and at least one of the latter two. The Programme then looks for outside support to help the potential Intermediary in the area(s) where it is weak. The IFC is best positioned to help Intermediaries lacking financing skills and thus is best suited to focus on Intermediaries with environmental expertise. This bias, however, is quite acceptable in the pilot phase as it means that GEF money will be used to expose environmental and conservation organisations to debt and equity markets for financing GEF objectives.

33. The approval process for the Intermediary is well structured, but perhaps could be strengthened by ensuring that someone reviews the applications from a GEF perspective. This implies not only reviewing the environmental qualifications, but also the appropriateness of the Intermediary in terms of GEF criteria for eligibility. For example, a large “northern” NGO or venture capital company may not be seen by some as an appropriate intermediary for a GEF project. Including a person with a GEF perspective on the Review Committee would help to ensure that GEF as well as IFC objectives are met in the selection process.

34. The ability of the Intermediaries to forecast and monitor the specified global environment benefits deriving from the SME Programme financing.

35. As explained in the GEF paper on “Incremental Costs,” the GEF was established “to provide new and additional resources for the agreed incremental costs of measures to achieve agreed global environmental benefits.” This paper further explains that “To estimate the incremental costs it is necessary to quantify costs, but is sufficient merely to identify benefits.” Thus the Intermediaries must be able to explain how the SME projects are achieving agreed global environmental benefits, but they need not attempt to assess the economic value of these benefits.

36. An appropriate approach to forecasting and monitoring the specified global benefits would be to assess the SME projects in terms of the Convention on Biological Diversity and the Convention on Climate Change, as well as in terms of the decisions of the Conferences of the Parties to these two Conventions. For example, the above-mentioned paper suggests that “if the Conference of the Parties to the CBD deems a particular ecosystem or species worth protecting

in the global interest, then the incremental cost of a GEF project that protects it is the incremental cost of achieving that agreed global environmental benefit.”

37. This would imply that at the very least that the Intermediaries identify and monitor the expected global benefit in terms of the concerns, objectives, policies, and instruments of the Conventions. For example, the Convention on Biological Diversity is “concerned that biological diversity is being significantly reduced by certain human activities.” Its objectives are conservation, sustainable use and the equitable sharing of the benefits of conserving and using biological resources. Furthermore, the Convention calls for new policies and instruments relating to such matters as identification and monitoring, in-situ conservation, ex-situ conservation, incentive measures, public education and awareness, access to genetic resources, technology transfer, and financial resources.

38. If the Intermediaries were asked to assess the SME projects in terms of the appropriate Convention(s), this would provide a standardised framework for their forecasting, monitoring and reporting. The SME Programme should consider developing a basic guide or checklist to assist the Intermediaries in this respect.

39. The role of the Advisory Committee.

40. The Advisory Committee, also referred to in the documentation as the Advisory Panel, has been set up to advise the IFC on the GEF eligibility of proposed SME projects. It consists of a World Bank/GEF member who acts as the Chair plus two members of the GEF Science and Technology Advisory Panel. One of the STAP members is an expert on climate change and the other on biological diversity. This structure is quite acceptable.

41. As the Panel members are expected to review numerous SME projects and present their reviews through remote communication (email, fax, post), it is important that a well-structured reporting procedure is used. If the Intermediaries are to use a standard guide or checklist, as suggested in the previous section, then a companion guide or checklist should be designed for use by the Advisory Panel. The Panel could then use this list to identify quickly projects approved, projects rejected, and projects that require further discussion among the Panel members.

42. Because the SME Programme is path-breaking - loans and equity financing instead of grants, enterprises instead of governments, small and medium scale instead of large, use of Intermediaries - it is quite important that the Advisory Panel pay close attention to the projected global environmental benefits of proposed SME projects. Thus consideration should be given to ensuring that the members of the Advisory Committee have sufficient incentives to devote the time and effort needed to provide substantive advice to the Programme.

43. Issues relating to the intention of the IFC to request additional support for the Programme from the GEF.

44. If the SME Programme becomes successful, it could evolve into a self-financing environmental investment fund. Start-up costs and the incentives to the Intermediaries as well as to the SMEs in terms of concessional rates and retained earnings, however, are high. Though

there may be room for improving the returns from the SME projects to the Programme (or Fund), clearly \$4.3 million is too small a capital base. Thus it makes sense to request additional support from the GEF to increase the base to \$15 or \$20 million.

45. In making this request, the IFC should, however, think carefully about whether it wants to consider this to be its last request for support for the SME Programme, or just the last request for support for a broad-based SME Programme. If the Programme proves successful, then more targeted programmes - focusing on SME projects, for example, in nature-based tourism or sustainable harvesting of wild resources - might be developed. These could also be “kick-started” by support from GEF.

46. In its request for additional support, the IFC may also want to emphasise and, if possible, show the impact of GEF funding on the operational strategy of the IFC. As stated above, GEF funding is encouraging the IFC to move into financing global environmental benefits. Thus the GEF through the IFC is opening up debt and equity markets for the global environment. With the increasing interest within the environmental community in the impact of private sector capital flows on the global environment, the GEF-IFC relationship could be quite significant.

47. Just as GEF money is “greening” the world in which the IFC lives, the IFC can assist in “commercialising” the world in which the GEF lives. The vast majority of international capital flows for the global environment are in the form of grants - multilateral, bilateral and non-governmental - to governmental and non-profit agencies responsible for conservation and environmental management. Though there is indeed an important role for grant or donor funding, there are also other ways of moving money for environmental purposes.

48. The Programme’s focus on debt and equity financing and the IFC’s well-established expertise in the global debt and equity markets can help the GEF, as well as other multilateral, bilateral and non-governmental organisations, learn how to operate in commercial financial markets in order to generate additional investments in the global environment. Thus the IFC in partnership with the GEF has an opportunity - as the leading multilateral private sector financial intermediary - to provide leadership in mainstreaming the environment into the world of private financial markets.

FINANCIAL STRUCTURE REVIEW

49. This report covers part of an independent review of the SME Program and provides an opinion on the potential of the Program as it is currently structured to attain its financial objectives. A companion part of the review focuses on the Program's potential for achieving its GEF objectives and has been done by Mr. Frank Vorhies of IUCN. The review work was carried out at IFC with the assistance of Mr. Doug Salloum and his colleagues during the week of June 24, 1996. The terms of reference for the review are dated May 22, 1996. Below, the topics at the beginning of each paragraph refer to the topics in the terms of reference.

50. Persons met in connection with this part of the review were: Mr. Kenneth Newcombe of the World Bank; and IFC's Mrs. Farida Khambata and Messrs. Andreas Raczynski, Martyn Riddle, Hanny Assaad, Roy Karaoglan and Doug Salloum.

51. Essence of the SME Program. The Program seeks to attain GEF's climate change and biodiversity objectives through its support for commercially viable projects of SME's. The Program is innovative in that neither the GEF nor the IFC has tried this kind of approach before. Other salient characteristics of the Program are:

- (a) IFC is acting as the Program's Executing Agency rather than directly providing funding or advice, which are its predominant forms of doing business.
- (b) GEF is pursuing its environmental objectives through cooperation with private SME's and through the use of loans and equity investments, rather than grants.
- (c) The Program reaches SME's through six intermediaries which, with one exception (Egypt's El Sewedy), involve NGO's. It is unusual for IFC and NGO's to cooperate in this fashion.
- (d) Two of IFC's departments are sharing the oversight of the Program's **implementation**. The Capital Markets Department looks over the Program's financial aspects while the Technical and Environmental Department focuses on the environmental matters. The Program's Task Manager receives guidance and review inputs from both departments. In addition, there is an Advisory Panel that provides GEF-type review inputs on SME projects.
- (e) The Program's overall size is small compared to the typical IFC project, yet the Program is ambitious as to its geographic range and the variety and number of SME projects which it supports.
- (f) The size of the SME projects supported by the Program is small compared to the typical IFC SME line of credit.

- (g) The Program is R&D in nature in that its main goal is to learn how to blend GEF objectives with the capacity of the private sector to implement sustainable projects based on commercial/market principles and practices.

52. The essence and salient characteristics of the Program are quite challenging. On the other hand, the resources and approach used by IFC, as well as its commitment and dedication to the Program's success, appear to be up to that challenge.

53. Decision to work through intermediaries rather than to finance SME's directly. The main considerations are as follows:

- (a) Working directly with small and medium enterprises is time-intensive and calls for very good knowledge of the local environment and ways of doing business. Given the \$ 4.3 million size of the Program, it would not have been cost or time effective for IFC to try to reach SME's directly. Working through intermediaries permits IFC to tap into their client networks (thus saving time) and their knowledge of the local business environment (a more efficient/cost effective approach).
- (b) The tendency when working directly with enterprises is to gravitate toward the medium size firms and away from the smaller ones. By working through intermediaries, the Program can reach many more/smaller enterprises than would have been the case with the direct approach. This increases the Program's sample size of SME's and enhances the chances to learn good lessons about how to pursue GEF objectives through the private firms.
- (c) The chosen approach permits IFC to work with NGO's and to amplify its knowledge of how to cooperate with them.
- (d) Risk can be minimized through the choice of suitable intermediaries. IFC's experience is that the risk is lower when working with intermediaries than directly.
- (e) IFC has a track record of institution building in working through intermediaries. The Program can tap into this IFC know-how for the benefit of intermediaries who work with small firms and in GEF matters. The result should be a much greater GEF-type impact than if IFC were working directly.

54. IFC should ensure that the Program has the necessary focus and resources to capture and disseminate the lessons and to carry out such institution building tasks. Some considerations follow:

- (a) So far, the priority has been assigned to the tasks connected with the design and launching of the Program (e.g. structure, procedures, identification of intermediaries). This is considered appropriate.

- (b) As the Program enters its disbursement stage, the focus should be on the tasks related to monitoring, lesson extracting and institution building. These tasks are always time/resource consuming and particularly when launching an innovative project and when working with small enterprises.
- (c) Also, one must anticipate that there might be problem situations which require much effort for their resolution. It is not clear whether the Program has made budget provisions that are commensurate with these tasks.

55. Decision to provide loans and equity and not grants to the SME's. The main considerations are as follows:

- (a) Grants and a commercial approach seldom mix well. From a conceptual (private sector) perspective, there is good logic in designing the Program on the basis of loans and equity instruments rather than through grants.
- (b) The bulk of IFC's business is related to the making of loans and equity investments. In the SME Program, IFC is doing what it knows best.
- (c) Loans and equity instruments facilitate accountability, transparency, the measurement of results and the administration of SME projects.
- (d) On the other hand, one must recognize that innovation can be risky and that working with small firms has a high transaction cost. The design of a success fee appears well suited to providing the necessary incentive in a commercially oriented way.
- (e) The use of loans and equity investments facilitate the familiarization of NGO's (and the GEF) with the traditional instruments of private sector funding.

56. The World Bank Group has learned that lower-than-market interest rates in their development credit lines can be distorting to intermediaries and disrupting to local financial markets. At issue, then, is whether a lower-than-market interest rate to the Program's intermediaries constitutes the wrong kind of mechanism to help defray the unusual costs of the Program (e.g. innovation, GEF, transaction). The considerations in this regard are as follows:

- (a) The Program is small and the amounts involved in the case of each intermediary are very small. This means that there is little potential for the distortion/disruption mentioned above.
- (b) The Program is costly, risky and time consuming for each intermediary and hence requires some form of offsetting compensation. The package of a rate of interest, closing and monitoring fees, plus an incentive fee appears reasonable.
- (c) An alternative (to the low interest rate) could be to charge a market interest rate to the intermediary and to provide some sort of lump sum grant as a subsidy to help cover those costs. This and other design alternatives may be considered in a

further stage of the Program, but care should be observed not to complicate the Procedures unnecessarily.

- (d) While there are many alternatives that can be tried, it appears that the chosen approach is easy to understand and straightforward to implement.

57. Program's criteria and controls for the selection of intermediaries.

- (a) The four main criteria for selecting intermediaries (i. e. experience with SME's, financial viability of the intermediary, capacity for financial analysis, capacity for environmental capability) are congruent with the Program's objectives.
- (b) A review of the files shows that the four criteria have been used in a careful way. The analysis of the Task Manager for the selection of the intermediaries appears adequate.
- (c) There is also evidence that the controls have worked in that the Task Manager has rejected certain candidates and the Review Committee has provided inputs to ensure that a proper choice is made.
- (d) In selecting intermediaries, it appears sound to uphold that the first two criteria cannot be compromised; while one can strengthen the intermediary regarding the other two criteria through adequate training and support. This principle should not be compromised. Some comments:
 - (i) In the case of FUNDECOR, consideration should be given to ways (e.g. technical assistance, alliances) of building this institution's capabilities, since this is the first time this forestry NGO makes loans.
 - (ii) In the case of WWF, a similar comment is in line. It may be that the SPPF's involvement in the structuring of the WWF's SME projects will suffice. The Program should be alert to ensuring that such is the case; and also that the WWF's access to top financial talent is adequately used.
- (e) It is appropriate to have an absolute limit (currently US\$ 1 million) per intermediary to ensure a balanced portfolio and sample of experiences. When evaluating an intermediary, the analysis may benefit (as IFC usually does) from relating the size of the Program loan to the size and capital of the intermediary.
- (f) The Program's intermediaries are quite different from the usual IFC intermediary, especially as to their nature (i.e. NGO's rather than financial institutions) and size. IFC seeks sponsor quality as a key element for the success of its investments. Often, a large size is assumed to be a sign of quality. NGO's haven't qualified previously. The Program is to be commended for pursuing quality intermediaries

without letting their NGO nature or their size be an impairment. This might be another area for lessons to be learned from the Program.

- (g) IFC also seeks in its intermediaries (and projects) the presence of private sector investors with a significant cash exposure at risk alongside IFC. Thought should be given to finding some sort of equivalents when the Program works with intermediaries of an NGO type.
- (h) The Program should include the greater budget resources that are needed when working with small intermediaries (as well as with small SME's/projects). Also to learn how to work more effectively with the NGO's. The resulting benefits should help to compensate for those costs and likely complications. (cf. 5 (f) above)
- (i) The Program might benefit from a lesson that IFC has learned in the past: that one should not trade sponsor quality for geographic diversification.
- (j) EEAF, CARESBAC and WWF are all NGO's which are based in the USA. The Program should remain open and sensitive to supporting non-Part 1-countries NGO's, such as FUNDECOR.
- (k) At least 3 of the Program's 6 intermediaries have been funded previously by USAID. The evaluation work detected no particular bias in the analysis for the selection of the intermediaries nor in their approval process. The Program should continue to remain open to selecting all kinds of intermediaries.

58. It appears striking that not a single financial intermediary has been selected of the IFC traditional type, i.e. a bank or some other sort of for-profit financial institution. The considerations in this regard are as follows:

- (a) It appears sound to have given priority to the environmental over the financial capabilities of intermediaries, on the assumption that they are likely to have a better chance of attaining the GEF objectives.
- (b) On the other hand, the Program should ensure that any weakness on the financial capabilities side (which environmental NGO's may have) is adequately addressed through technical assistance and other instruments.
- (c) In the past, IFC has used technical partners as an instrument to transfer specialized knowhow to greenfields projects. This type of instrument may inspire ways of building up the financial capabilities of the Program's intermediaries, if necessary.
- (d) The Program's sample will be enriched by including some of the more traditional financial institutions as intermediaries. This way one can test the assumption that institutions that are for-profit can be properly trained on environmental matters. Also, the credibility and demonstration effect of these institutions among banks and other traditional intermediaries is likely to be very high.

- (e) A case can be made that the for-profit traditional type of intermediary is likely to have a special advantage in coming up with breakthroughs that can push the attainment of GEF objectives in a commercial/sustainable direction. This is another reason for including them in the Program.
- (f) In the case of EEAF, its subsidiary is a for-profit venture capital fund for environmental investments. The Program may consider supporting directly this kind of intermediary rather than the parent, which is a non profit NGO.

59. The Program's definition of an SME is one with assets of less than US\$ 5 million equivalent. Considerations in this regard are as follows:

- (a) This definition is in line with other IFC projects.
- (b) From conversations with the Task Manager and a review of Program documents it appears that most SME's which are funded by the Program will have assets of US\$ 1 million or less. This is unusual (and commendable) for an IFC or World Bank credit line.
- (c) It appears to make sense for the Program to retain the flexibility of going up to US\$ 5 million if necessary.

60. In the application of the SME definition it appears that, to date, the one exception to the size guideline has been in the El Sewedy project, where large hotels and other businesses can receive the Program's benefits. Also, there seems to be little design work or risk in that project relative to other Program projects. Hence the 50% incentive may be generous, especially when considering that it would be received by the intermediary after just a couple of years. For the future, it is suggested that the Program consider flexibility in setting the incentives to try to fit them to the characteristics of each project.

61. The Program's limit per SME of US\$ 250,000 suggests the following considerations:

- (a) Since the amount per intermediary averages about US\$ 600,000, this means that in theory one could have only about 2 SME's per intermediary, which is on the low side.
- (b) Even on this low side, reaching about 12 to 15 SME's would be commendable for a Program of this small a size.
- (c) The fact is that in most cases the intermediaries intend to have more than 2 or 3 SME's; and are committed to funding a minimum number of SME projects.
- (d) While retaining the flexibility, the Program should encourage its intermediaries to have as many small SME's participate in the Program as possible.

62. The Program's other limitation per SME is related to the incremental cost of the Project and is reviewed below.

Annex 3. Pipeline of Opportunities

Institution or project	Country of operation	Potential Focal Area/Operational Program
E and Co. and/or International Solar Energy Society	Africa, N. Africa, India, Pakistan, Bangladesh	climate change/renewable energy - small scale energy projects for rural poor including PV
Soprin-ADS Inc.	French Africa	climate change/energy efficiency, energy conservation - small scale ESCOs
Appropriate Technologies Ltd.	West Africa, Nepal, India, Pakistan	climate change/energy efficiency, energy conservation - efficient charcoal stoves
Savé Valley Conservancy	Zimbabwe	biodiversity/arid and semi-arid eco-systems - re-stocking native wildlife on a private reserve
SEBRAE	Brazil	climate change/energy efficiency, energy conservation - small scale energy projects
Ground Source Energy PVT Ltd.	Sri Lanka	climate change/renewable energy - geothermal tea drying and withering
Development Alternatives	India	climate change/renewable energy - rural biomass electrical generators
Solar Electric Light Fund	India, Viet Nam, China and Sri Lanka	climate change/renewable energy - commercial small scale solar systems
Andes Pharmaceuticals	Colombia	biodiversity/forest eco-system - bio-prospecting
Pharmacogenetics/Smithsonian	Ecuador	biodiversity/forest eco-system - bio-prospecting
South Pacific Project Facility:		
Mt. Gahavisuka	Papua New Guinea	biodiversity/mountain eco-system - eco-tourism resort
Fishing Cooperative	Solomon Islands	biodiversity/coastal, marine and fresh water eco-systems - sustainable village based fishing