GLOBAL
ENVIRONMENT
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Global
Small and Medium Scale Enterprise Program

Project Document
June 1996

THE WORLD BANK

GEF Documentation

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Environment Division
Technical and Environment Department
International Finance Corporation

The International Finance Corporation (IFC) is the private sector lending arm of the World Bank Group. IFC is the largest source of multilateral finance for private investment projects in eligible GEF recipient countries. The World Bank has a special responsibility as documented in the GEF Instrument for mobilization of private sector involvement in support of GEF's global environmental objectives. The Bank has engaged IFC in the mobilization of private sector financial participation, technology and management skills in support of GEF. IFC administers a GEF program through the World Bank. The program is administered by the IFC Environment Division's Special Projects Unit within the Technical and Environment Department. For further information on the IFC GEF Program please contact:

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SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

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SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

GRANT AND PROJECT SUMMARY

Recipients:	Institutions that provide financing and environmental services to small and medium scale enterprises
Beneficiaries:	small and medium scale enterprises - global
Amount:	US $ 4.3 million
Terms:	Loan (administered by International Finance Corporation)
Financing:	Financing to Intermediaries is 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$

GLOBAL

SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

Executive Summary

1. The IFC/GEF Small and Medium scale Enterprise Program ("SME Program") is a GEF Pilot Phase initiative being managed by the International Finance Corporation ("IFC"). The total funding provided by the Global Environment Facility ("GEF") for this project is US $ 4.3 million. Of this amount US $ 3.7 million has been made available to finance projects developed by small and medium scale enterprises ("SMEs") which address one or both global environmental objectives of Program. (Remaining funds are allocated for administration of the Program until July 1, 1997, technical assistance to the SMEs and Program evaluation.) The global environmental objectives of the SME Program are the sustainable use or preservation of biological diversity and the reduction or absorption of greenhouse gases.

2. The financing for eligible SME projects will be provided through Intermediaries selected by IFC. These Intermediaries are selected based on their experience with SMEs and their financial and environmental expertise.

3. The Intermediaries selected by the SME Program receive a long term low interest rate loan from IFC (up to 10 years at 2.5% p.a. in dollar terms). Intermediaries are permitted to use the proceeds of the Program loan for two purposes; to fund loans or equity investments in SME projects and to pay fees to themselves for identifying, analyzing, structuring, financing and monitoring the SME projects.

4. The Program definition of an SME is an enterprise with assets valued at less than US $ 5 million equivalent. The maximum amount of Program funding which can be provided by an Intermediary to an SME for any one project is the incremental cost of that project. There is also an overall Program limit to the amount of financing which any one SME can receive from an Intermediary of US $ 250,000.

5. Through June 1996 a total of four Intermediaries have been selected by IFC for participation in the Program and two more are under active consideration. The total funds committed to the selected Intermediaries or under consideration is US $ 3.7 million, the full amount made available by GEF's Pilot Phase[1] for financing SMEs through the Program.

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[1] As noted earlier the funding for the SME Program was provided during the Pilot Phase of the GEF. The SME Program is also a pilot or experimental activity. In order to reduce possible confusion on the part of the reader where the phrase "pilot phase" occurs in this document it generally refers to the initial activity of the SME Program rather than the GEF.

6. The SME Program has been developed to accomplish a number of objectives including the GEF objective of engaging and leveraging private sector participation in global environmental issues. The SME Program obtains this private sector participation by building on IFC's private sector experience, deal flow and financial expertise. The intended result is the development of SME projects that address the GEF objectives while at the same time demonstrating a commercially viable activity. The SME Program is considered a pilot or experimental activity by IFC which it hopes may be extended and expanded by subsequent GEF funding.

Program Background

7. The GEF Pilot Phase project, known as the IFC/GEF Small and Medium Scale Enterprise Program or SME Program, was approved by the GEF Participants in July 1994. The SME Program was allocated US $ 4 million.

8. The IFC's Environment Division in the Technical and Environment Department is responsible for implementing the SME Program.

9. On March 16, 1995 the funding available to the SME Program were increased by US $ 300,000 by the GEF CEO. IFC had requested additional funds from GEF to cover the costs anticipated in identifying potential SME projects, in analyzing and structuring financing for these projects, for training SME staff to follow GEF criteria and objectives, and for operating budget sufficient until June 30, 1997.

10. Funds totaling US $ 4.3 million were transferred from the GEF Trust Fund to IFC for use by the SME Program in February, 1996. Final approval for the SME Program by IFC Management occurred on December 11, 1995.

Program Objectives

11. **General objectives:** Since it was first described in the Work Program for the Pilot Phase of the GEF the SME Program has had two sets of objectives - financial objectives and global environmental objectives. It is the challenge of the SME Program in its pilot phase to attain the global environmental objectives of the GEF in a manner which is consistent to the full extent possible with the financial objectives and perspectives of IFC, a commercial private sector financing institution.

12. **Global Environmental Objectives:** The SME Program was charged by the GEF with the objective of providing financing to SMEs to be used for projects that address one of two global environmental priorities;

- biodiversity: the preservation or sustainable use of biological diversity, and

- climate change: the reduction or absorption of greenhouse gases as a means of reducing global warming.

13. Examples of typical projects which the SME Program expects to finance prepared for the prospective participants is provided in Section 10.

14. The amount of financing that can be provided to any one SME project was limited by two considerations neither of which was explicitly defined by GEF in the Work Program document; first, by the size and definition of an SME, and second, by the incremental cost of the project itself.

15. In the documents approved by IFC for the pilot phase of the Program, SMEs were defined as commercial entities with an asset value less US $ 5 million and greater than US $ 100,000. (In the implementation of the pilot phase both of these limits have selectively been relaxed somewhat if in the opinion of IFC there were significant benefits to be gained by doing so.)

16. In principle, the amount of financing that the SME Program can provide to a business for a project is limited to that portion of the total proposed SME project cost which directly relates to the global environmental benefit. This portion of the total project cost is the "incremental cost" of the project (that portion of a project cost over and above a business as usual baseline that generates global environmental benefits but which the private sector will not finance now or in the foreseeable future). Needing a practical definition that could be applied to SME activities (without elaborate or expensive calculation or research) the SME Program, at least for the pilot phase, has proposed that incremental cost is the portion of an SME project which the private sector will not finance now or in the foreseeable future. A methodology for determining the amount of financing that the commercial financial sector will provide for any SME project is outlined in Section 8.

17. As a final constraint, applied after the incremental cost has been calculated, the SME Program has set US $ 20,000 as the minimum and US $ 250,000 as the maximum amount that any one SME project can receive. During the pilot phase the lower limit has been relaxed on occasion but not the upper value.

18. **Financial Objectives:** The IFC is a commercial lender and investor to the private sector in developing countries and has a significant stake in maintaining this market driven private sector rigor. IFC provides commercial financing - not grant funding - to assist small and medium scale enterprises to be sustainable over the long term. In consequence, IFC determined that the SME program would be designed with the following features to maintain, as much as possible, the discipline and approach of commercial transactions while recognizing the "incremental nature" of the funding provided:

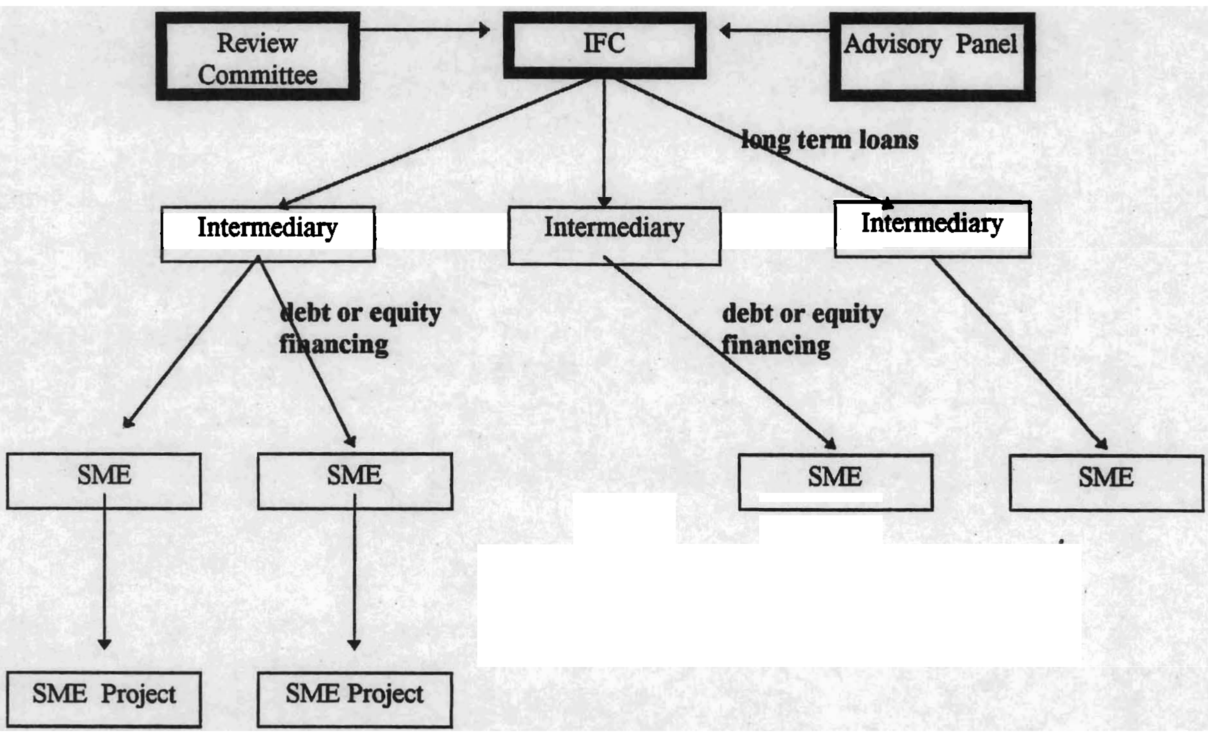
- only debt or equity would be available to participants in the Program. SME program funds should not be used for grants,

- in order to maximize both the efficiency and the reach of the SME Program during its pilot phase, Intermediaries would be selected by IFC which will in turn identify, analyze, structure, finance and monitor the individual SME projects. (In an expansion phase of the Program, if approved by GEF, direct financing to SMEs perhaps with the involvement of IFC's Project Development Facilities may also be used),

- the commercial nature of the SME projects can be enhanced by maximizing the leverage of the SME Program funds and by ensuring that the projects have a minimum forecast internal rate of return.

Program Structure

19. Organizational Structure of the SME Program



20. **The Loan to the Intermediaries:** The relationship between the SME Program and the Intermediaries is that of lender and borrower. IFC is the lender of record. Using the funds provided by the GEF, IFC enters into loan agreements with the selected Intermediaries. Major features of the loans provided by the SME program include the following:

- term: up to 10 years,

- interest rate: 2.5% p.a.,

- currency: US dollars,

- repayment: grace period of up to 2 years (depending on the term of the loan) with graduated principal payments weighted toward the final years of the loan,

- fees allowed borrower: the borrower is allowed to use a portion of the loan proceeds to cover costs incurred in identifying, analyzing, structuring and financing the SME projects (structured as a Closing Fee for each SME Project which receives financing) as well as for monitoring the projects on behalf of the Program (a Monitoring Fee). Prospective Intermediaries provide quotations with respect to the fees that they will require when submitting a proposal to the Program and if accepted these fees become a feature of the loan agreement between the Program and the Intermediary,

- incentive for commercial financial structures: Intermediaries are allowed to retain 50% of all capital amounts recovered from the SMEs. In other words if an Intermediary lends to an SME and the SME repays the full amount of this loan the Intermediary is allowed to reduce the debt to IFC by an amount equal to 50% of the funds recovered. The same treatment is provided for equity investments by Intermediaries in SMEs,

- the loans to the Intermediaries generally are unsecured.

21. **<u>Selection of the Intermediaries:</u>** Generally the institutions selected as Intermediaries during the pilot phase of the SME Program are ones which either a) had recently approached IFC for financing but which due to the small size of the projects or the perceived risk of the activity IFC was unable to support, or b) were identified during discussions IFC staff held with NGOs, business groups and governments to identify prospective Intermediaries. All prospective Intermediaries were required to submit a proposal to the Program outlining the intended use of the funds, required fees, number and size of SME project financings anticipated, etc. All proposals submitted are reviewed by the IFC staff. If the Intermediary meets the Program requirements a loan operation is presented to an IFC Review Committee for selection. If the Review Committee of the Program concurs with the recommendation IFC's Management approves the selection.

22. Four general criteria are used to select the Intermediaries. In certain circumstances if a potential Intermediary is strong in three of the four areas and has a viable plan to overcome a deficiency in the fourth the entity may be recommended for selection. The four criteria of the Program for the selection of Intermediaries are:

- financial viability: the Program is providing loans with terms of up to 10 years in duration. The Program must be comfortable with the prospects for the survival of the proposed Intermediary and will focus on the sources of income and the expense structure of the institution in the analysis of this issue,

- experience with SMEs: the prospective Intermediary must have experience at working with SMEs, preferably in the area of commercial activity. The prospective Intermediary must have a clear plan for the use of the Program funds and a pipeline of opportunities that meet the Program criteria,

- financial technical experience: it is necessary that the Intermediaries to the Program be able to analyze and structure commercial financings with the proposed SME clients. In house or contracted finance experience is critical,

- environmental technical experience: the Intermediaries must be able to provide environmental reviews of the proposed SME projects and to be able to forecast the GEF benefit anticipated from project.

23. Analysis of SME projects by Intermediaries: Once selected the Intermediaries must identify and analyze prospective SME projects and then summarize these projects in a standard format report submitted to the SME Program. Initially all Intermediaries are considered Qualified Intermediaries and the SME projects that they develop are approved by the Review Committee. At a later date the Intermediary may be acknowledged as an Authorized Intermediary after which time it need only advise the SME Program of how funds have been applied. The Review Committee will consider authorizing an Intermediary to use Program funds once it is assured that the Intermediary is capable of and committed to attaining the Program objectives without direct supervision.

24. In the analysis of a prospective SME project the Intermediary must consider four issues and must summarize briefly these issues in the report provided to the Program. These issues are the following:

financial analysis: the proposed SME project must demonstrate a minimum level of financial return. The Program has defined this as an IRR (before the proposed financing form the Intermediary) of 4% p.a. in US dollar terms. The Intermediary must provide a summary of this financial analysis,

- GEF benefit: the SME project, to be eligible for Program funding must provide a benefit in terms of at least one of the global environmental objectives; i.e., either global warming reduction or the sustainable use or preservation of biodiversity. The Intermediary must provide a forecast or description of the benefit that will result from the proposed use of Program funds,

- incremental cost analysis: the Intermediary must confirm in a manner outlined by the Program that the amount of Program funds being provided does not exceed the incremental cost portion of the total SME project cost,

- environmental review: the Intermediary is considered a Financial Intermediary ("FI") by IFC for the purposes of environmental reviews. The Intermediary must provide IFC with an acceptable plan for these reviews and must in the report on each SME project activity comment on how the plan has been implemented.

25. The details of the report that Intermediaries must submit to the Program, including the methodology for calculating the incremental cost portion of the SME project cost, are provided in Section 8.

26. Monitoring by Intermediaries of SME projects: Intermediaries are required to report on the use of the Program funds on a six-monthly basis. The focus of these monitoring reports is both financial and environmental. The Intermediary must advise the Program that the funds have been advanced to the SME, that the proposed project has been initiated, that the project is functioning as designed (or not), that the SME is current (or not) on its financial obligation to the Intermediary, etc. The details of the monitoring reports are provided in Section 9.

27. **Advisory Panel:** An Advisory Panel has been created to advise IFC with respect to GEF eligibility issues concerning the actual SME projects proposed by the Intermediaries. This advice has been focused on two issues; projection of the global environmental benefits and the calculation of the incremental cost portion of the project. The Intermediary provides a report with each proposed SME project financing and the Advisory Panel provides its advice based on this report.

28. The Advisory Panel consists of a minimum of three individuals; the World Bank Global Environment Division Chief, GEF who acts as Chair of the Panel and two individuals from the GEF Scientific and Technology Advisory Panel ("STAP") roster. One of the STAP experts is chosen for their expertise in global warming issues, the other for biodiversity experience.

29. The Panel meets approximately every six months to review Program procedures and activities but carries out its reviews of the SME project reports as they are presented to the Program remotely. Each SME project submitted by the Intermediaries is sent to the Panel members for review and comment.

Results to Date

30. **Intermediaries selected:** As of June 1, 1996 four institutions have been selected as Qualified Intermediaries to the Program. The names, the size of the loan and terms of the loans are summarized following in the order that they were approved:

- Environmental Enterprises Assistance Fund ("EEAF"): a small business investment group domiciled in the U.S. with an environmental focus and activities in Indonesia, the Philippines, Mexico and Central America. The loan is for 10 years and the amount is US $ 800,000,

- CARESBAC - Polska: a small business venture capital fund in Poland. The loan is for 10 years and the amount is US $ 600,000,

- FUNDECOR: a Costa Rican non-profit organization that provides forestry services to small land owners in a buffer zone around national parks. The loan is for 10 years and the amount is US $ 500,000,

- El Sewedy Electrical Supplies Co.: a private Egyptian company located in Cairo in the electrical equipment supply business with an interest in providing financing for energy efficient lighting retrofits as an energy service company (ESCO). The loan is for 5 years and the amount is US $ 500,000.

31. In addition to the four Intermediaries approved to date (June 1, 1996) there are two others under active consideration. One is a small business environmental venture capital fund to be incorporated in southern Africa (US $ 800,000 loan) and the other is an international NGO which is proposing to finance projects with the participation of indigenous groups in Papua New Guinea (US $ 500,000).

32. As of June 1, 1996 three of the loan agreements have been executed. A fourth loan agreement is expected to be finalized in June 1996. Disbursement to the first of the Intermediaries is anticipated during June 1996 with subsequent disbursements during July and August 1996. The two remaining candidate Intermediaries will be presented to the Review Committee in June and July 1996 and disbursements, if approved, will likely occur in September or October 1996. Additional information on each selected Intermediary is provided in Section 6.

33. The total financing approved or currently under consideration is US $ 3.7 million. This represents the total amount of financing available for Intermediaries and SME projects during the pilot phase of the Program.

34. The structure and administration of the IFC/GEF SME Program is being reviewed by an experienced team of independent consultants during June and July 1996. The reviewers are being asked the following question:

- Has the SME Program been designed and implemented in such a way that both its financial and its global environmental objectives are likely to be accomplished?

35. As a significant portion of total Program funds are not expected to have been provided by the Intermediaries to SMEs by the time of the Interim Review takes place the reviewers may not be able to provide a thorough review of the actual operational success of the Program.

Descriptions of selected Intermediaries

36. Environmental Enterprises Assistance Fund (EEAF)

Structure:

- independent non-profit venture capital organization created in 1990 in the United States,
- provides debt, equity and training to environmental entrepreneurs in developing countries,
standard form of finance is combination of subordinated loans and convertible debt (80% of typical financing) plus straight equity,
- Program funds will be used to finance projects where other sources of financing have been difficult to obtain (primarily the Philippines and Indonesia).

Ownership/Control:

- control of management and investment decisions is through a volunteer Board of Directors.

Management:

- investments are made through three affiliated operations structured as for profit companies and staffed by local nationals; one each in Indonesia, the Philippines and Costa Rica,
- local offices identify, analyze and supervise investments,
- Washington DC office is responsible for fund raising and donor relations, and reviews all financing proposals developed by the local operations before they are presented to the Board for approval,
- EEAF staff (at all offices) are experienced in venture capital finance. Staff also includes environmental specialists.

Size and funding:

- total assets on a consolidated basis approx. $ 3.0 million,
- funds for investments provided by long term loans from USAID, Calvert Social Investment Funds and MacArthur Foundation.

Example of EEAF projects financed to date (prior to participation in the SME Program) include small hydro, rural PV, recycling of agricultural wastes, ecotourism, organic farming, and co generation facilities in Cost Rica, the Dominican Republic, Indonesia, the Philippines, El Salvador, Honduras and Poland.

Project Pipeline:

- 27 SME projects currently under review,
- 4 SME projects approved and not yet disbursed.

37. CARESBAC - Polska

Structure:

- venture capital investment company incorporated in Poland in 1991,
- provides debt and equity to Polish SMEs,
- standard form of finance is combination of subordinated loans and minority position of common equity (generally 65% equity and 35% debt),
- works with volunteer executives (primarily from US firms) to improve value of investments,
- Program funds will allow CARESBAC to invest in environmental activities of SMEs, which is seen as a new area of opportunity for the company.

Ownership/Control:

- controlling shareholder is Small Enterprise Assistance Funds (SEAF) a non-profit based in Washington DC which has set up SME venture capital funds in Russia (2 funds) and in Bulgaria,
- other major shareholder is European Bank for Reconstruction and Development (EBRD) with 40% of current paid-in capital.

Management:

- offices in Warsaw and three regional centers,
- total staff of 19 persons (7 ex-patriates) including five teams of investment officers/analysts, expected to be fully staffed by Polish nationals by mid 1997,

- investment decisions made by Supervisory Committee; consisting of SEAF President, a representative of EBRD, a Polish lawyer and two Polish businessmen,
- monitoring and technical assistance provided to investees is a strength of CARESBAC approach.

Size and funding:

- total assets after f/x losses, write offs and operating losses approx. US $ 5.0 million,
- committed funds from USAID, EBRD and OPIC total US $ 16.8 million,
- currently operating on a self-sufficient basis (1995 net income estimated at US $ 100,000),
- although some operating inputs are underpriced or subsidized (volunteer executives, for example) the supply of these inputs are considered secure.

Projects financed to date (prior to participation in SME Program):

- 23 separate Polish SMEs have been approved for investment,
- 50% of SMEs financed with USAID funds are in agri-business.

Project Pipeline:

- 31 SME projects currently under review,
- 4 SME projects approved and not yet disbursed.

Environmental Experience:

- limited internal environmental technical experience but sincere commitment to increasing capacity in this area,
- will use outside consultants initially to prepare GEF benefit forecasts and environmental reviews.

38. FUNDECOR

Structure:

- FUNDECOR is a non-profit foundation incorporated in Costa Rica,
- provides and supervises sustainable forest management plans and manages reforestation projects for small land owners (most often with less than 100 ha.) within the ACCVC (Area de Conservacion de la Cordillera Volcanica Central), a well defined Conservation Area surrounding five national parks in the center of Costa Rica,
- proposes to use proceeds from SME Program loan to provide advance payments to land owners for timber grown in sustainably managed forests

and tree plantations. Proposed use of SME funds would have both biodiversity preservation and climate change impacts.

Ownership/Control:

- controlled primarily by professional management but with volunteer Board of Directors appointed by government of Costa Rica,
- budget and operating expenses are controlled by an independent Technical Committee and a private sector Trust Fund agent under a Trust Fund Agreement. The endowment provided by USAID under this agreement is currently valued at US $ 10.6 million the real income from which is sufficient to cover operating expenses.

Management:

- offices in San José and Puerto Viejo with total staff of 25 persons, all Costa Rican nationals (20 professionals). Most of professional staff are foresters and engineers.

Size and funding:

- major asset is endowment of US $ 10.6 million. All other assets total approximately US $ 1 million,
- operating budget is funded completely by income from endowment and government incentives for sustainable forestry and reforestation. FUNDECOR is not dependent of income from incentives, however and can manage on real interest income on endowment alone.

Projects financed to date (prior to participation in SME Program):

- 130 separate agreements with small land owners for natural forest management plans (105 agreements for a total of 12,750 ha.). or reforestation projects (25 projects for a total of 718 ha.).

Project Pipeline:

- up to 200 land owner clients will benefit from the proposed loan resulting in 1000 ha. of reforestation and the preservation of 3000 ha. of natural forest,
- FUNDECOR could use additional financing from SME Program within two years and the form of financing under development here has potential to be a model for the region.

Environmental Experience:

- excellent experience in preservation of biodiversity, natural forest management and in reforestation with native species,
- FUNDECOR's CARFIX project has been certified by United States Initiative on Joint Implementation as a seller of tradable certifiable carbon offsets.

Financial experience:

- FUNDECOR has experience in analyzing and controlling the underlying technical and market risks inherent in natural forest management and reforestation.

Certification for Sustainable Forestry:

- FUNDECOR will obtain certification from third party accredited by Forest Stewardship Council with respect to the sustainable nature of forestry activity as condition of loan from SME Program.

39. El Sewedy Electrical Supplies Company

Structure:

- El Sewedy is a family owned business started in the 1940 in Cairo, Egypt.
- the primary business is the sale and distribution of electrical material; lighting, cable, transformers, automation equipment and power distribution and control systems.
- the sale of energy efficient compact florescent lamps("CFLs") to a range of local businesses, including hotels, is an existing business activity that El Sewedy hopes to expand with the proposed SME Program loan.

Ownership/Control:

- the El Sewedy family

Management:

- the company is very experienced and well established both in the wholesale and retail electrical supply business in Egypt,
- El Sewedy has four of its own retail outlets and a large group of distributors with whom they have worked for years.

Size and funding:

Projects financed to date:

- El Sewedy has been selling electrical supplies for 50 years in Cairo. Recently it has begun to develop the energy efficiency market through the sale of efficient lighting (CFLs and other products) and through turnkey design of energy efficient projects by SEGA, an energy efficiency consulting division of the company,
- El Sewedy knows the market for energy efficient lighting in Egypt where approximately 40,000 CFLs were sold in 1995 - primarily in small lots.

Project Pipeline:

- El Sewedy intends to sell CFLs to selected businesses to enable them to convert completely to energy efficient lighting. This kind of wholesale conversion has not occurred in the Egyptian market despite the energy and operating cost savings which result because CFLs are a relatively new product and their initial purchase price is high relative to incandescent bulbs.
- El Sewedy is proposing to finance the sale of the conversion of commercial buildings (hotels, offices and showrooms) to energy efficient lighting by using a combination of their own funds and funds from the proposed SME Program loan. The loans which El Sewedy will provide to their clients will be for two years and therefore the SME Program loan to El Sewedy will be shorter than in other cases - 5 years rather than 10,
- the company intends to finance at least 6 transactions from the proposed loan within the next year and has three projects already prepared. These projects represent the sale of some 14,000 CFLs and will result in the saving of approximately 170,000 KWH of energy per month for the 2.5 to 3.5 year life of the bulbs. El Sewedy and SEGA have carried out a number of feasibility studies for this financing and the company would likely begin with hotel conversions.

Environmental Experience:

- environmental reviews and GEF GHG emission offsets will be performed for IFC by an independent local consulting firm Terra Consulting, which is familiar with World Bank Group environmental procedures and guidelines.

Exception to Program criteria:

Some of the businesses which El Sewedy intends to retrofit with energy efficient lighting will exceed the Program definition of an SME. There are several very positive features of the proposed loan to El Sewedy, however, that in the opinion of the Review Committee outweigh this one consideration. These include the clearly private sector nature of El Sewedy activities and the current lack of financing for this kind of activity in Egypt.

Instructions to Intermediaries

40. **SME Project Approval Procedure:** As a pre-requisite to approval, all Intermediaries must prepare an Evaluation Report for each SME Project to be funded by the Program. As part of the Evaluation Report the Intermediary must apply a four part evaluation process, separately described in these procedures as the SME Project Evaluation Template (the "Evaluation Template"). An Evaluation Report along with a copy of the Intermediary's own analysis/evaluation of the SME Project shall be submitted for each SME Project;

- in the case of Qualified Intermediaries, the Evaluation Report will be submitted to IFC staff in order to obtain Program approval for the proposed SME Project financing,
- in the case of Authorized Intermediaries, the Evaluation Report will be submitted to IFC staff for each SME Project financed, for information and monitoring purposes.

41. IFC staff will receive all proposed SME Projects from Qualified Intermediaries and present those which address the Program objectives to the Review Committee. The Review Committee may decline, approve or request additional information for any SME Project presented. When reviewing the SME Projects submitted the Review Committee will focus primarily on the compliance of the Qualified Intermediary with the Template requirements. For example, the Review Committee will not decline an SME Project submitted by a Qualified Intermediary on the basis of what the Review Committee may consider an unacceptable risk/return profile. Grounds for declining an SME Project from a Qualified Intermediary will include the following:

- the activity to be financed does not address the GEF objectives or the GEF impact is considered to be negligible,
- the amount of Program funds to be loaned or invested by the Intermediary exceeds the incremental costs of financing the GEF objectives,
- either the incremental cost or the GEF forecast impact has not been correctly calculated.

42. As part of the decisions by the IFC Review Committee a confirmation must be available that the Intermediary is competent to carry out IFC's FI environment review

requirements and/or that the Intermediary has received training in IFC's FI environmental review process. In addition, IFC Staff must confirm that the Intermediary has been trained in the SME Project Evaluation Template and the Program monitoring requirements.

The SME Project Evaluation Report

43. A brief Evaluation Report (2 - 3 pages) must be prepared by the Intermediary for each SME Project that is recommended for Program funding (in the case of Qualified Intermediaries) or that is approved by the Intermediary for Program funding (in the case of Authorized Intermediaries). Each Report will contain four brief sections summarizing the following information:

- the SME: a description of the entity which will receive the financing in terms of location, ownership, total assets, number of employees (current and forecast after the proposed SME Project investment) and principal activity.
- the SME Project: a brief summary of the activity being financed.
- the proposed financing: total Project financing, portion to be funded by Program funds, other sources of financing and amounts and description of financing proposed (terms of loans, equity features, etc.).
- the Evaluation Template analysis summary: each of the four Requirements of the SME Project Evaluation Template (described below) must be summarized.

SME Project Evaluation Template

44. **Requirement 1:** Financial viability of the SME Project: Every Intermediary must evaluate the financial viability of each SME Project considered for financing from Program funds and in each case the SME Project must evidence a realistic expectation for a positive return on funds invested or loaned. To comply with this requirement each Intermediary shall prepare the following for each SME Project financed by SME Project funds:

a base case cash forecast for the period of the proposed financing that shows a minimum IRR of 4.0 % p.a.,

a review of the risks that would affect recovery of capital and interest payment/capital gain and a summary of how these risks have been offset or why they were ultimately accepted.

45. **Requirement 2:** Contribution to GEF objectives: SME Program funds may only be used to finance activities which will produce a benefit in terms of reducing or absorbing greenhouse gases (climate change projects) or in preserving or increasing biological

diversity (biodiversity projects). For each SME Project considered by an Intermediary for financing from Program funds the following must be prepared:

- for climate change projects: a forecast of the greenhouse gas mitigation that will result from the Project financing,

- for biodiversity projects: a description of how the Project will protect a specific body of land or water or species of plant or animal life. The alternative use of the natural environment which this Project will forestall or replace must be described. The Intermediary shall quantify the impact of the Project whenever possible.

46. **Requirement 3:** Incremental cost: SME Program funds may only be used to finance the incremental costs of implementing the GEF objectives over and above the cost of "business as usual". One practical definition of "business as usual" is that business activity which can be financed by commercial funds. Commercial funds includes any for profit lender or investor (including the SME owners through their own equity), banks, venture capital funds, leasing companies, etc. In many cases there will be a need for a mixture of commercial and Program funds in order to finance a particular SME Project. The Intermediary will calculate the maximum allowable portion of the total SME Project financing which can be funded by the Program in the following manner:

- the Intermediary must calculate the risk adjusted cost of capital as well as the IRR for the specific SME Project,

- if the risk adjusted Project cost of capital exceeds the forecast IRR then a portion of the total Project financing can be financed by Program funds. In this case, the Intermediary may use Program funds up to an amount such that the weighted cost of financing provided to the SME Project is equal to the forecast IRR. For the purposes of this calculation the Intermediary shall assume that all non-Program funds are provided at the risk adjusted Project cost of capital and all Program funds at the effective interest rate offered by the Intermediary to the SME,

- in certain cases it may be argued that the risk adjusted Project cost of capital is too high to attract any commercial financing. In these cases the total Project may be financed by Program funds,

- if the risk adjusted Project cost of capital is less than or equal to the forecast IRR then no Program funds can be used to finance the Project.

47. **Requirement 4.** Environmental review: For each SME Project proposed by a Qualified Intermediary or financed by an Authorized Intermediary an environmental review process must be carried out so that SME projects using GEF funds comply with applicable host country environmental, health and safety requirements and applicable

World Bank environmental policies and environmental, health and safety guidelines. This process must be carried out by the Intermediary and will consist of the following steps:

- the Corporate Environmental Checklist must be completed for each SME Project,

- if the checklist indicates that an environmental analysis is required (e.g. an environmental audit) then the Intermediary will require that the SME carry out this analysis and then review and report on that analysis to the Program,

- a copy of the Corporate Environmental Checklist must be submitted to IFC along with the other required documents.

Monitoring Reports

48. The Intermediaries are required to provide to the Task Manager the following information with respect to the SME Projects financed using SME Program funds:

49. **Completion/progress reports:** The completion/progress reports are due semi-annually and shall reflect the situation with respect to the Intermediary's activities as of the end of March and September of each year. This reports are to be received by IFC 15 days after the end of the month summarized, i.e. April 15 and October 15. Each completion/progress report will provide the following information as of the date of the report for each SME Project approved:

- date and amount of funds drawn from the Designated Account for disbursement to each Approved SME Project and for the payment of fees.

  date and amount of funds advanced to the SME for an Approved SME Project.

- operating status of Project (construction begun, construction complete, tested and operating to specifications or tested and not operating to specifications).

  operational impact of financing to SME Project (increase in SME assets and employment, if any).

- status of GEF objectives (not achieved, achieved and continuing or achieved and not continuing).

- financial status of SME and Project (interest and fees received by Intermediary to date, capital recovered to date, capital and/or principal outstanding, SME current on obligation to Intermediary).

- For each SME Project approved the Intermediary will continue to provide the completion/progress report information until the financial obligation of the SME to the Intermediary has been satisfied or else written off.

50. **Environmental report:** the first environmental report is due at the same time as the audited financial statements (below) in the year following the first SME Project disbursement and annually thereafter until the Intermediary has fulfilled its loan obligation to the Program.

51. **Audited financial statements:** within 120 days of the end of each fiscal year the Intermediary shall provide to IFC a copy of its complete financial statements for that period together with an audit report in form satisfactory to IFC.

Biodiversity and Climate Change Definitions and Project Examples

52. **Biodiversity Definition:** Biological diversity[2] or biodiversity is threatened by some forms of development and protected or used sustainably by others. Forests and other natural habitats are under threat from increased population, pollution, and expansion of cropland and urban settlement. Although natural habitats are undervalued in commercial markets, the products represented by biological diversity have many ecological, human health, and food production values. In response to the threat, a variety of activities have been undertaken to protect and sustainably use biological resources. These actions culminated in the signing of the Convention on Biological Diversity (CBD) by 157 countries at the UNCED conference in Rio de Janeiro in June 1992. The Convention requires signatory countries to protect species by protecting natural habitats. The problems recognized by the Convention will not be solved unless the private sector contributes its vast technical, managerial, and financial resources and expertise.

53. **Biodiversity Markets, Technologies, Products:** Conservation activities, government policies, and market demands for certified sustainable[3] products are expanding markets for the following types of businesses that sustainably use or protect biodiversity:

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[2] The term biological diversity, often shortened to biodiversity, is used to describe the number, variety, and variability of living organisms. Biodiversity therefore embraces the whole of "Life on Earth." Decline in biodiversity includes all those changes that have to do with reducing biological heterogeneity, from individual members of a species to regional ecosystems.

[3] The term sustainable or sustainable development means that a practice, process, system or product allow people to meet their current needs while passing along to future generations certain stocks of environmental capital, such as productive topsoil, clean air, fertile forests, abundant fish stocks or genetic diversity of both plants and animals.

alternative agriculture (organic farming, aquaculture, and use of underutilized species),

- sustainable forestry (selective logging certified by an independent organization following Forest Stewardship Council guidelines, mixed species tropical hardwood plantations),

- nontimber products from forests (NTFP) and wildlands (such as nuts, fruits, and palm oils),

ecotourism,

- pollution control and other activities that restore or take development pressure off of biodiversity resources,and

- other activities that sustainably use or protect biodiversity.

54. Biodiversity Project Examples:

- alternative and certified organic agriculture, preservation of crop varieties, and development of underused species or agricultural products

- timber from sustainable forest management

- non-timber products from forests and wildlands

- ecotourism

55. **Climate Change Definition:** Renewable energy and energy efficiency projects offer global greenhouse gas reduction potential. Controlling greenhouse gas emissions is going to require large sums of capital. It is not expected that government sources will be able to meet this need for capital and ways must be found to generate new, largely private sector investment in low and no greenhouse gas emission technologies. Also, the large demand for energy in developing countries has created a growing role for the private sector in both the supply and financing of power systems. However, the shortage of investment funds, the absence of investment expertise targeted to renewable energy and energy efficiency systems, and financing institutions' lack of familiarity with such transactions creates a situation where opportunities for technically sound, economically sensible, and environmentally, superior energy production and use may be missed. It may be difficult for an SME's renewable energy and energy efficiency projects to obtain financing or to attract interest from investors because renewable energy and efficiency projects tend to be smaller transactions, require more time and support to bring them to investment quality, and often involve new technologies or new markets. As a result, project development and institutional costs tend to be higher. Renewable energy systems,

energy efficiency and loss reduction activities require investments in management, training, and consumer awareness, and institutional changes (such as the rate-basing of demand-side management investments) that are more institutionally complex than turn-key thermal power plants. This then puts renewable energy and energy efficiency projects, many of which are relatively small (e.g., 1 - 20MW), at a competitive disadvantage, and such projects may not attract the attention of utilities, investors, financial institutions, large power or infrastructure private equity funds and governments.

56. **Climate Change Markets, Technologies, Products:** Renewable energy and efficiency projects involve a wide range of technological alternatives available or potentially available to SMEs. The costs per kilowatt hour of smaller scale photovoltaic, wind, and other renewable technologies are approaching that of fossil fuel based power for similar sized applications especially for off-grid, rural, and decentralized power system. Such projects help to meet the demand for increased energy services, especially to the poor; use of local fuels such as sugar cane waste rather than imported fuels offers job production and foreign exchange benefits; and demand-side management and end use conservation projects can be implemented quickly and where appropriate in stages targeted to reducing peak loads.

57. Climate Change Project Examples:

- renewable energy: grid and off-grid power generation from wind, biomass from agricultural or wood wastes, run-of-the-river mini-hydro, geothermal, and solar photovoltaic, and solar water heating systems. (Use of methane gas from landfills),

- energy efficiency: energy efficient equipment, energy efficient buildings, energy service companies (ESCOs) implementing energy, efficiency improvements and demand side management programs,

- transportation: less polluting transit technologies such as fleet vehicles or buses fueled by natural gas or electricity; and

- carbon sequestration.

Additional notes re: Incremental Costs

58. The IFC/GEF SME Program, at least until more rigorous arguments are developed, will apply the following logic with respect to the issue of incremental costs and the determination of what portion of a particular SME Project is eligible for Program funding. The SME Program proposes as a starting point the following statement:

- incremental costs are those costs related to the SME Projects which commercial sources will not generally fund.

59. This means that "business as usual" for the SME is a financial opportunity for existing financial institutions; banks, local investors and the owners through their equity. The Program will only finance those SME Projects or those portions of SME Projects which local commercial sources are unwilling or unable to support.

60. Given this basic definition

- What is meant by commercial sources of financing?

- How is it determined whether a Project should be able to attract commercial financing and how much commercial financing should the Project have?

61. The first question is easily answered, at least in theory. Commercial financing is financing that would be attracted by the forecast return on an investment, in consideration of the risk involved. In more technical terms, commercial financing should be available for Projects which demonstrate an internal rate of return (IRR) equal to or greater than the Project risk adjusted cost of capital.

62. As for the second set of questions, IFC has proposed that the Intermediaries carry out the following analysis for each SME Project to determine the theoretical proportions of commercial and Program financing. A number of variables were defined:

63. The risk adjusted cost of capital for the proposed Project - R_r. This is what the SME would have to pay to attract commercial financing to the Project. There will be no universally accepted value for the risk adjusted cost of capital for a particular SME Project but any calculation of this figure will have to consider the following elements:

- a risk free investment rate in US $ (in the country of the investment), plus

- an adjustment for term (if the risk free rate is for a shorter term than the proposed Project financing), plus

- a currency risk premium (if the financing will be in local currency), plus

- a risk premium for the Project itself.

64. For example, an Intermediary may state that the proposed SME Project has a risk adjusted cost of capital of 20% p.a. This means that the Project would have to have an IRR equal to or greater than 20% in order to attract commercial financing. The Intermediary would have to justify this figure to the satisfaction of the Program. A typical argument might be along the following lines:

- a fully secured US $ short term loan in the country of the SME Project is available at 7 % p.a.,

- there is no long term debt market but the Intermediary has decided to offer a four year fixed rate loan and therefore an additional 3 % p.a. term adjustment is justified,

- the Intermediary will provide local currency but since the debt to the Program is in US $ an additional cost of 4% is required, and

- due to the nature and size of the proposed Project the Intermediary contends that an additional 6 % p.a. risk premium would be required to attract financing from commercial sources.

65. Any discussion with respect to the risk adjusted cost of capital will tend to focus most on the Project risk premium. There may be cases when the Intermediary will argue that there is <u>no</u> risk premium sufficient to attract capital to this Project and at times we may accept this position. In these cases R_r would be infinite - but for the purposes of the proposed analysis we recommend that the upper limit on R_r be 100%. An R_r value of 100% would indicate a Project that could never attract commercial capital. The smallest and most risky SME Projects might be in this situation.

66. **<u>The IRR for the Project:</u>** This is a standard investment calculation and should be based on the Intermediary's base case forecast. (The IRR of the Project is the discount rate at which the funds invested equal the present value of the future cash flows). In theory, if the IRR of a Project is equal to or greater than R_r the Project will be able to attract financing from commercial sources. The Intermediaries have been advised that the minimum acceptable base case IRR for any SME Project is 4 % p.a.

67. **<u>The cost of capital offered by the Intermediary - R_i</u>** This is the cost to the SME for the debt and/or equity provided by the Intermediary. The lowest rate that the Intermediary should offer is its own cost of Program capital - 2.5 % p.a.

68. Once the Intermediary has calculated the IRR and the R_r for the Project the following analysis can be carried out:

- If IRR > R_r there is no need for Program funds: In this case the forecast Project return is sufficient to attract funds from commercial sources. The SME Project is forecasting a return in excess of the commercial risk adjusted cost of capital in which case other, non-Program, financing should be available.

- If IRR< R_r but > 4.0 % , a mix of Program and commercial funds is required: In this case the forecast return is not sufficient to meet the hurdle rate of commercial funders. Commercial funds will not be attracted to the Project and there is a case for the use of Program funds. The Intermediary will have to use Program funds up to an amount which results in a cost of capital to the Project equal to the forecast IRR. In other words, if the IRR is lower than the commercial cost of funds the Intermediary will have to combine low cost Program funds with more expensive commercial sources to finance the Project. Program funds are available to the Project at R_i - the financing rate offered by the Intermediary. All other funds will cost R_r (this is a simplifying assumption and ignores the fact that some non-commercial sources may accept less than R_r). Logically, we would expect that if R_r is high or IRR is low (indicating high risk and low return, respectively) commercial funders will not fund the full Project cost but they may finance a portion. As a corollary to this statement, if risk is high or forecast return is low we would expect the portion of funding that the Project requires from the Program to be high. The attached tables illustrates how the incremental cost as a percent of the total Project cost varies with different values for IRR and R_i.

- If IRR < 4.0 % the Project should not be financed.

Schedule A

GLOBAL

SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

Project Budget

	Year 1	Year 2	Total
Operating Expenses			
Salaries			
Task Manager	85,600	100,000	185,600
Equipment	2,300		2,300
Office Expenses	8,000	8,000	16,000
Travel	54,300	54,300	108,600
Total operating expenses	**150,200**	**162,300**	**312,500**
Technical Assistance	52,500	52,500	105,000
Contingency, legal and eval.	41,250	41,250	82,500
Total Program Budget	243,950	256,050	500,000
Advances to Financial Intermediaries for SME Projects	1,000,000	2,800,000	3,800,000
Total	**1,243,950**	**3,056,050**	**4,300,000**

Schedule B

GLOBAL

SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

Summary of Disbursement Arrangements

GEF Trust Fund Disbursement Schedule
(US$ 000)

IFC Fiscal Year	1996	1997
Annual	3,550	0
Cumulative	3,550	3,550

Schedule C

Global

SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

TIMETABLE OF KEY PROCESSING EVENTS

Time taken to prepare:	10 months
Prepared by:	Douglas Salloum, Task Manager
IFC Management Approval granted:	December, 1995
Project became effective:	March, 1996