

EXECUTIVE SUMMARY

1. In April 2004, the Board endorsed IFC's five strategic priorities: (i) strengthening the focus in frontier markets; (ii) building long-term partnerships with emerging global players in developing countries; (iii) differentiating through sustainability competencies; (iv) addressing constraints to private sector growth in infrastructure, health and education; and (v) continuing to emphasize local financial markets development through institution building and by the use of innovative financial products. Over the past year, these priorities have become more relevant than ever as the demand for private sector solutions to development issues increased, and private companies sought out international financial institutions that could meet a broader array of requirements. Despite strong economic growth and increased liquidity in some emerging markets, private companies in both middle income and frontier countries continue to have vast unmet financing and advisory needs. This paper reviews IFC's external environment and the progress it has made in the implementation of the above strategic priorities and proposes that IFC aim at a quantum growth in its activities during the FY06-FY08 period.

2. Developing countries enjoyed strong growth in 2004, and private capital flows continued to expand. The majority of these flows, however, were concentrated in the largest economies, with about 90 percent of the increase from 2003 to 2004 going to Brazil, Russia, India, China and Mexico, while there continued to be substantial regional disparity within these countries. A number of large developing countries experienced more liquidity in their financial markets and interest rate spreads on their sovereign debt have narrowed. However, there are still vast needs for development financing in both middle income and frontier countries. Capital flows measured as a percent of GDP show that net private capital flows are significantly below levels of the mid-1990s. At the longer end of the maturities, 85 percent of private capital flows to developing countries last year went to sovereign and public sector entities, leaving a substantial gap in meeting the long-term financing needs of the private sector.

3. With the shift in the external environment, the need for IFC to play a counter-cyclical role to supply short and medium term liquidity into emerging markets is diminishing, while the demand for IFC's long-term financing and value-added services is increasing. Companies in middle income markets are looking to IFC as a "partner of choice" who can provide them with long term finance along with advisory services and global expertise. These companies have begun to recognize the importance of good corporate governance and the need to address environmental and social issues in order to develop stakeholder support and reduce business risks. They also recognize the risk of a significant regional or global downturn and look to IFC as a long-term partner who will stand by them through the inevitable swings in the business cycle.

4. In frontier countries, where access to long-term financing remains scarce, IFC plays an important role in providing needed financing to the private sector as well as in addressing countries' broader private sector development issues such as the investment climate and sectoral constraints to private investment. The challenge here is for IFC to scale up support for small and medium enterprises, promote viable partnerships between governments and the private sector, particularly in areas such as infrastructure, and assist in building the capacity of both the private and public sectors, in close cooperation with the World Bank, to ensure long-term success.

5. Over the past few years, IFC has positioned itself well to respond to these diverse demands. IFC has embarked on an ambitious change process to strengthen its operational and risk management capabilities. IFC's efforts centered on building a corporate culture with a client focus and a more efficient, agile and global organizational structure. Specifically, IFC: (i) implemented a major reorganization to sharpen client focus by accelerating the decentralization process and moving senior staff to the field; (ii) achieved a 5 percent workforce reduction in FY03 to cut costs and streamline the organization; (iii) established a comprehensive risk management function to address the increasing

complexity of IFC's business; and (iv) developed innovative HR programs to enhance core skills and drive a performance culture. While the change process is not complete, IFC has been able to successfully adapt to rapidly changing market conditions, and its results have been positive including significant growth in business, record profitability, a healthier portfolio, and an increased focus on development impact.

6. In the last year, IFC made substantial progress in implementing its strategic priorities. With strong donor support, IFC made better use of its technical assistance facilities to address investment climate issues, and deliver support to small and medium enterprises (SMEs) in frontier countries. IFC increased its South-South commitments by 17 percent, helping emerging market clients invest in other developing countries. IFC successfully differentiated itself through its sustainability agenda as it continued to enhance its environmental and social standards and policies. The Corporation tested innovative models of public-private partnerships in order to bring creative solutions to the substantial infrastructure needs of developing countries. IFC has made progress in its pilot program on sub-national financing and determined that the sub-national business line has the potential to be both profitable and have a high development impact. IFC also developed a whole range of structured finance products that are making the Corporation even more relevant to clients and expanded its activities in building local financial markets through both technical assistance and investment.

7. Below are highlights of some of the key achievements of IFC in FY04:

Frontier Countries IFC continued to put emphasis on addressing the financing and investment climate needs of its frontier countries, particularly as they affected small and medium enterprises. Examples of key developments included the following:

- The Africa Project Development Facility (APDF) was restructured into a new model, PEP-Africa, designed to support project development, help improve the investment climate, and enhance support for SMEs.
- PEP-MENA was launched and is seeking to address some of the main constraints to greater private sector investment in the region, support SME development and assist in the recovery of post-conflict countries.
- Joint IDA/IFC teams have completed the design and begun the implementation of the IDA-IFC micro, small and medium enterprise (MSME) programs in Nigeria, Kenya, Uganda, Burkina Faso and Mali.

South-South Transactions An important new trend that has the potential for great development impact is the rise in South-South investments. With its global reach, IFC is well-positioned to assist these companies from the South to expand. In FY2004, IFC completed a number of such transactions including the following:

- IFC helped a large producer of ceramic tiles from the United Arab Emirates to expand into India and Iran.
- IFC promoted the use of improved technology and higher environmental standards in pulp and paper mills in China, by facilitating the entrance of South African and South Korean paper companies into the Chinese market.
- IFC provided long-term financing otherwise unavailable from the local financial sector in Madagascar to help an investment from a Sri Lankan sponsor set up a large apparel manufacturing factory in Madagascar in joint venture with local partners.

Sustainability In the past year, IFC has advanced its sustainability agenda by improving its policies and procedures and reaching out to clients. Key milestones included:

- Public consultations started on revised safeguard and disclosure policies.

- Over 400 staff and IFC clients were engaged in a pioneering training program to learn to balance economic growth and sustainability issues.
- IFC mainstreamed sustainability by co-locating more than 60 percent of environment and social specialists in the investment departments, and integrating sustainability throughout the project cycle.

Infrastructure There is a clear need for broader solutions to meet the infrastructure requirements in emerging markets. IFC has been designing new ways to meet these challenges:

- IFC provided advisory services to the Moroccan government on structuring and implementing the first Public-Private Partnership (PPP) irrigation project in the world, which successfully attracted private sector participation through a highly competitive and transparent bidding process.
- IFC supported a project in China to expand gas distribution infrastructure. The project has significant environmental benefits by substituting coal and petroleum energy with natural gas, and consumer benefits by increasing the access to natural gas and lowering energy prices.
- IFC provided local currency financing for the first PPP in the power transmission sector in India.

Financial Markets IFC continued to focus on strengthening local capital markets and institutions while broadening local access to innovative products and services. In particular:

- IFC increased its volume of local currency financing, by issuing, for example, a guarantee of a local currency bond by a leading microfinance institution in Mexico, and a guarantee on local currency and US dollar bonds for the largest private university serving mostly lower-middle income students in Peru.
- IFC also increased its investment in housing finance. Examples include support for a housing finance company in India to introduce new mortgage products, and the establishment of the first private specialized housing finance company in Egypt.

8. Looking forward, there are substantial opportunities for IFC to increase its investment volume and development impact by scaling up and accelerating the implementation of its strategic priorities. Growth opportunities include:

- reaching new clients in frontier countries and the frontier regions of the larger emerging economies;
- taking a more systematic approach to South-South business development;
- building on the Corporation's current experience and synergies within the World Bank Group to target market needs in infrastructure, especially in the areas of public-private partnerships
- developing the pilot on sub-national finance into a mainstream activity. IFC is now working with the IBRD to scale up its efforts in sub-national finance on a global basis and is proactively developing business;
- expanding the Corporation's activities in the areas of Micro, Small and Medium Enterprise (MSME) finance, housing and trade finance, and developing the domestic financial markets to reduce excessive reliance on banking sector finance; and
- supporting the sustainability efforts of the agribusiness and natural resources businesses and more actively promoting renewable energy and energy efficiency.

9. IFC will continue to pay particular attention to: (i) the development of local currency financial products through guarantees and use of derivative markets when available; (ii) greater synergies between its investment and technical assistance activities; and (iii) the combination of concessional finance with commercial investments in order to tackle the challenges of infrastructure and SME development in the frontier markets. In this regard, IDA-IFC collaboration is becoming much more significant as a means to catalyze public-private partnerships.

10. While IFC will capitalize on its strengths to seize these market opportunities, there are also signs of stretch in the Corporation's investment staff capacity to generate and supervise additional business.

Implementation of IFC's strategy, which focuses on becoming an integrated finance and service provider, is resource intensive. While IFC has a strong capital base upon which to leverage a greater volume of investments and has increased its internal absorptive capacity for growth with a platform of strong controls and risk management, the number of investment staff executing the Corporation's strategy has remained basically flat over the past five years. To have a larger development impact over the long-term, IFC needs the ability to generate a greater number of projects which continue to be innovative and complex in nature. To grow the portfolio, provide integrated value-added services, and expand its development impact, IFC will need to increase the resources in its investment related areas.

11. There are three main areas where IFC needs to increase its resources, processing capacity, business development and portfolio management. As the investment program continues to grow, IFC will need to recruit more investment related staff in order to appraise and structure complex deals, as well as oversee project development work, identify sustainability issues and coordinate advice on corporate governance and other issues. IFC's growth strategy includes expanded geographic coverage to more frontier countries and frontier regions of larger countries, in order to bring in a wider clientele and address the needs of underserved populations. Local and international staff will be needed to conduct business development from these locations. Finally, resource limitations are arising in the areas of project supervision and compliance functions that are essential for sustaining the quality of the portfolio. As financing local companies requires much more in-depth portfolio supervision, IFC must continue to maintain an adequate level of regionally based supervision.

12. Directors are particularly requested to give Management their views on the following elements of the strategy: the growth strategy proposed by Management; IFC's approach to engage more actively in promoting a non-sovereign lending window for IDA to address challenges in infrastructure and SME finance in frontier markets; and the budget framework outlined in this paper.