

OEG Findings

April 2003

ANNUAL REVIEW OF IFC'S EVALUATION FINDINGS: FY 2002 ENHANCING IFC'S RESULTS IN RESPONSE TO THE MILLENNIUM CHALLENGE

OEG's sixth *Annual Review* draws mainly from the evaluations of 194 mature IFC investment operations selected as representative of all those approved by the Board in 1994-96. The *Review* profiles the results of these operations, identifies patterns in their outcomes, and provides relevant lessons for improving corporate results. This year, the *Review* also assesses how IFC is contributing to the Millennium Development Goals (MDGs) through its strategic priorities, investment operations, and non-investment activities.

The main message of the Review is that IFC's pursuit of its frontier strategy – if well executed – is likely to increase its contribution to achievement of the Millennium Development Goals.

Overall, the *Review* found that development and investment outcomes were mostly better within IFC's strategically targeted groups. The strategy's full potential will only be realized, however, to the extent: (i) frontier countries improve their investment climates; (ii) World Bank Group units make determined and mutually reinforcing efforts to help them do so; and (iii) IFC improves the consistency of its work quality and tailors its instrument choices wisely to country conditions and needs.

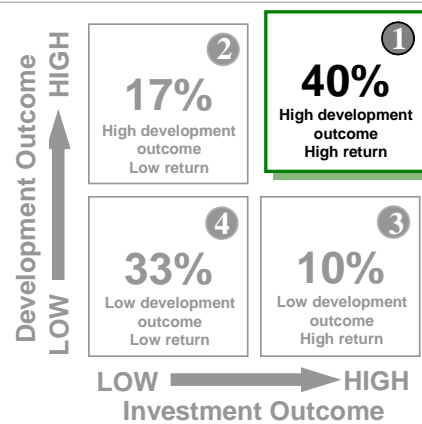
How IFC evaluates investment operations

Each year IFC evaluates a random sample of investments that have reached early operating maturity. Within statistical limits, the sample is representative of each year's entire approvals, and for this *Review* comprises 56% of all investments approved in 1994-96. Self-evaluations of investment operations are undertaken by IFC's investment department staff. They complete the research and analysis necessary to rate each operation on 10 indicators using a four-point scale based on corporate guidelines (these are accessible at: <http://www.ifc.org/oeg/>). OEG then independently verifies each rating (or re-rates it as appropriate) to ensure that evaluation standards are applied consistently throughout IFC, and synthesizes its findings in the *Annual Review*.

Win-win outcomes

Win-win outcomes refer to those operations that achieve good project development impacts while also yielding a minimally acceptable gross profit for IFC. 40% of the evaluated operations achieved this result (fig. 1). Win-win outcomes signify fulfillment of IFC's mandate at the individual investment level, since these operations contribute both to IFC's development objectives within a country and to its own financial capacity for future development reach.

Figure 1:
Combined
development and
investment results



Note: 194 mature operations evaluated 1999-2001.

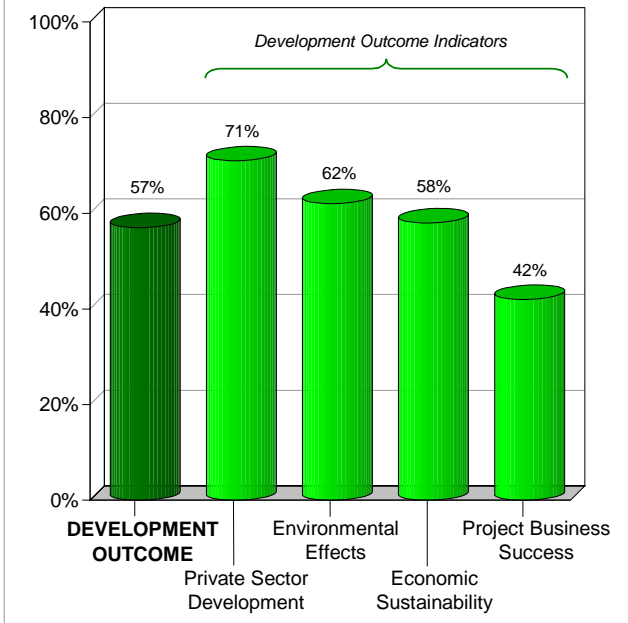
Results on the ground

The development impacts of IFC's projects are evaluated on multiple attributes of their contribution to a country's economic development. Overall, 57% of operations were judged to have made satisfactory contributions to development, based on a synthesis of their performance ratings in the four underlying indicators (fig. 2). From the highest- to lowest-rated indicator, significant findings are:

- *Private sector development:* IFC projects contribute to private sector development by creating sustainable enterprises capable of growing and attracting future finance both to the project company and more widely to the sector and the country. They

also stimulate other private enterprises through competition and linkages or improvements in the regulatory or enabling environment.

Figure 2: Success rates for project development outcomes and underlying performance indicators



- *Environmental impacts:* IFC evaluates its projects' environmental effects together with their social and health and safety impacts (ESHS effects). Projects were rated *partly unsatisfactory* in cases where either there was material non-compliance with required standards, but which had been or was in the process of being addressed; or where the company had failed to report their environmental performance, which was symptomatic of inadequate environmental risk management. In 6% of projects, ESHS effects were *unsatisfactory* because of material and unmitigated environmental damage.
- *Economic sustainability:* Economic growth, while not mentioned specifically among the MDGs, nevertheless underlies their achievement and its primacy cannot be over emphasized. IFC measures a project's economic sustainability by its economic rate of return, also taking into account whether there were net gains or losses by non-financiers, non-quantifiable impacts (e.g., multiplier effects) and contributions to widely held development objectives such as direct poverty reduction, social or gender equality, concern for child labor and regional or rural development. OEG estimated that the evaluated real sector projects generated \$1.6 billion of net benefits (in present value terms)

for other members of society besides the owners and financiers who themselves incurred a net loss on their investments.

- *Project business success:* 42% of projects were judged business successes, based on their after-tax financial rates of return compared with corresponding costs of capital, or for a financial sector project, whether they met expected contributions to the intermediary's profitability, financial condition and business objectives. The low success rate reflects the commercial risks that are inherent in the projects IFC chooses to finance, and the rigor of the standard. However, even where projects fell short of satisfactory benchmarks, almost all the companies themselves remained viable going-concerns.

IFC's investment outcome

Fewer operations (50%) yielded satisfactory investment outcomes for IFC than those with successful development impacts (57%), a consistent relationship across all OEG *Annual Reviews*. Investment outcomes are synthesized from either one or two underlying indicators (one for loans, the other for equity as relevant) that address an investment operation's gross contribution performance. There was a high variance in success rates between the loan and equity indicators, reflecting the inherent risks of equity investments in comparison to the relative security (but capped returns) of loans.

IFC's aggregate equity returns on all investments approved in 1994-96 reflect the difficult economic environment in most developing countries. However, they compare well to the performance of emerging markets generally: IFC outperformed the index worldwide and in four out of five regions.

In most cases, outcomes have been better in IFC's strategic groups

IFC's corporate strategy focuses its priorities on frontier markets, high impact sectors (domestic financial markets, infrastructure, information and communication technology, health and education), and support for small and medium-sized enterprises. Overall, the evaluated investment operations within the current strategic priority groups performed better than average.

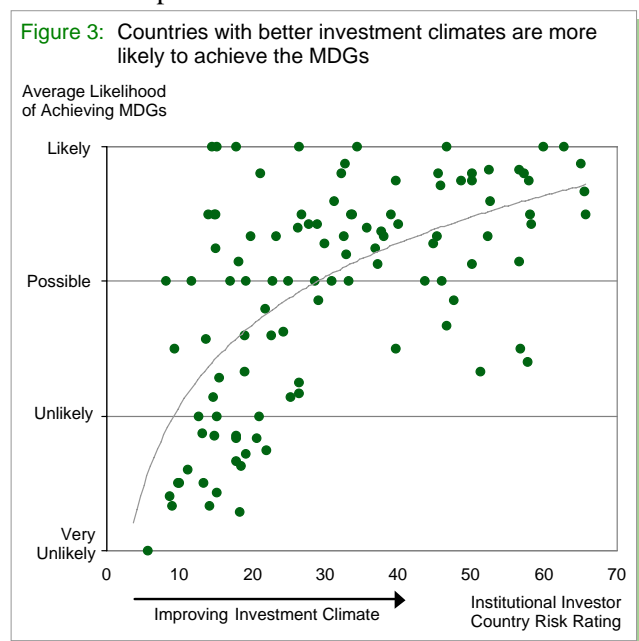
The success of IFC's frontier strategy will depend on improving investment climates

Frontier markets feature high corruption, poor governance and political instability. The *Review's* findings suggest that steady improvement in these

countries' investment climates is essential for the sustainability of IFC's frontier strategy. For example, operations approved in 1994-96 in countries then rated as high-risk have performed best in those countries that subsequently improved their investment climates and graduated from the high-risk group. By contrast, operations in countries that remained high-risk – or worse, deteriorated to become high-risk environments – had relatively disappointing development and investment results.

Improving investment climates is essential for achieving the MDGs

Similarly, it is the countries that have established attractive investment climates that are on track to achieve the MDGs (fig. 3). In the 1990s both IFC approvals and private capital flows generally, were concentrated in these countries. In contrast, today's remaining frontier countries, which are targeted by IFC's strategy (predominantly low-income or high-risk countries), have made less progress and feature greater challenges. The Monterrey Consensus and the World Bank Group's Private Sector Development Strategy provide a framework for helping these countries improve their investment climates.



IFC work quality is the key to getting good results, especially in high-risk situations

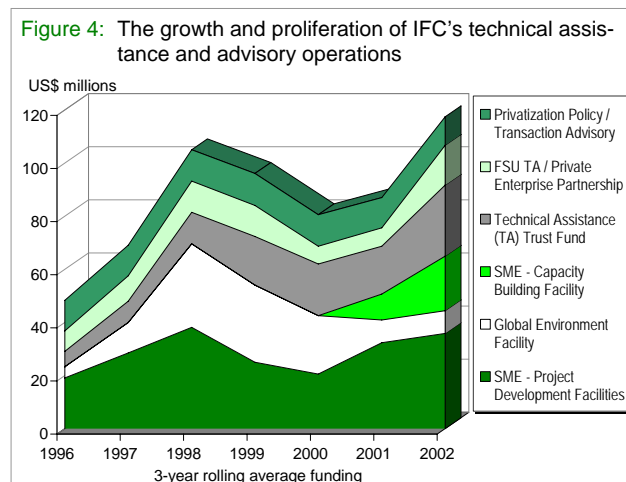
Viable investment opportunities are scarcer in high-risk countries, while country and project-risk profiles are more daunting. So the success of IFC's frontier strategy will depend on sound due diligence and

effective risk management. This and past *Reviews* have shown IFC work quality to be strongly associated with outcome quality. Where IFC work quality was consistently good over the life of an operation, the proportion of evaluated operations with win-win outcomes was substantially higher at 65%, and the proportion with low outcomes in both development and investment dimensions was just 7%.

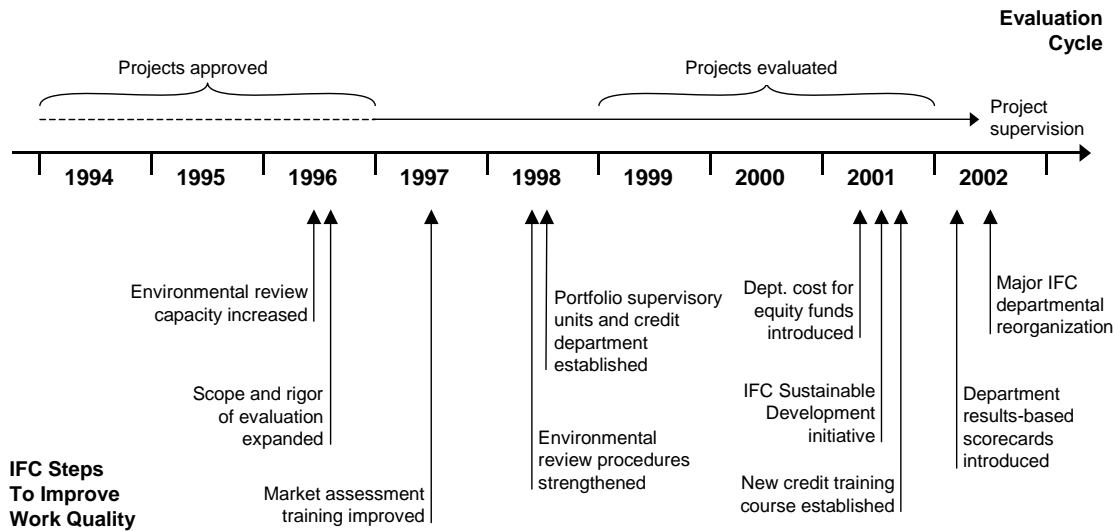
High-risk environments call for wise use of IFC's instruments

In addition to direct investments, IFC is increasingly using non-investment instruments (technical assistance and advisory services) funded jointly with bilateral partners, to help generate viable investment opportunities and to create investment climates conducive to sustainable private investment. OEG country reviews found that IFC used these instruments to particularly good effect in Russia and Vietnam in the 1990s. In line with IFC's frontier strategy, these instruments are now mainly targeted at frontier countries, and their potential for helping them achieve the MDGs far exceeds their cost.

Having expanded since the mid-1990s (fig. 4), non-investment operations now account for a significant portion of IFC's resource consumption. Yet there is currently no comprehensive self-evaluation system for such activities to allow judgments of outcome quality, identify lessons and performance trends, feed this knowledge back into the front-end processes, and provide accountability to donors.



Note: In addition to those above, the following seven facilities have been approved or have become operational over the past 18 months: Frontier Privatization Fund; South Asia Enterprise Development Facility; North Africa Enterprise Development Facility; Corporate Citizenship Facility; Environmental Opportunities Facility; Sustainable Financial Markets Facility; and IFC-Netherlands Carbon Facility.

Figure 5: Recent quality management steps have had limited potential influence on this *Annual Review's* outcomes

PROGRESS AND RECOMMENDATIONS

As IFC's frontier strategy leads it increasingly into high-risk situations, the success of IFC's investments will depend largely on sound due diligence and the effective management of risk – at project appraisal, in structuring and during supervision. In response to the recommendations of past *Annual Reviews* and its own analysis of portfolio results, IFC has taken significant, plausible steps to strengthen its capacity, core processes, strategy and incentive structures (fig. 5), but most of these post-dated the approvals of the evaluated sample and thus had limited potential impact on their outcome quality.

This year's recommendations have four objectives: improving IFC's work quality; pricing and structuring IFC's investments to reflect better the associated risks and costs; using IFC's instruments wisely to enhance investment climates; and mainstreaming self-evaluation across all IFC's instruments and processes.

In summary:

- IFC should ensure that its appraisal rigor and execution quality are commensurately strong where operations feature multiple risk factors. More generally, and in pursuit of its sustainability agenda, IFC should ensure that it always adds value in its operations, particularly in middle income markets.
- Where appropriate, IFC should use sweeteners to increase the return on loans, and consider the use of subordinated convertible debt as an alternative to equity investments. Other than in cases where there is a compelling development impact potential, IFC should ensure that there is every prospect that all costs will be fully recovered on its loan investments, through adequate structuring of fees and interest margins.
- At the country level, IFC should continue to tailor its choices and sequencing of investment and non-investment instruments wisely in response to prevailing investment climate conditions and opportunities to add value.
- IFC should establish self-evaluation systems for all of its non-investment operations to ensure that its efforts to improve investment climates are informed by past experience. IFC should mainstream these and other evaluations of past strategy and portfolio performance in updates to country assistance strategies and sector strategies.

OEG *Findings* is designed to inform World Bank Group managers and staff of new evaluation findings and recommendations. It is produced by IFC's Operations Evaluation Group, which is an independent unit directly accountable to IFC's Board of Directors through the Director General, Operations Evaluation of the World Bank Group. OEG *Findings* is distributed to IFC's Board of Directors and staff as well as to interested parties outside the World Bank Group. The views expressed here are those of OEG and should not be attributed to IFC or its affiliated organizations. OEG *Findings* is distributed free of charge by IFC, 2121 Pennsylvania Avenue NW, Washington, DC 20433, USA. For more information, contact IFC's Corporate Relations Unit at Tel. (1-202) 473-7711 Fax: (1-202) 974-4384 or consult OEG's website at <http://www.ifc.org/oeg>.