

OEG Findings

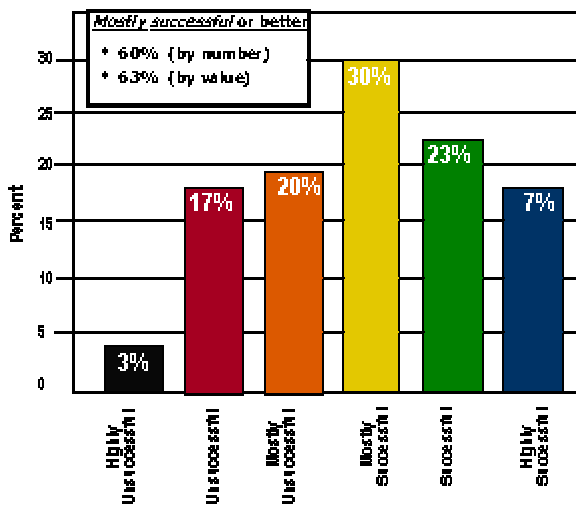
April 1999

Annual Review of IFC's Evaluation Findings: FY98

This is the second Annual Review under IFC's new evaluation system, and findings are integrated with those of the first year. The findings represent the independent views of IFC's Operations Evaluation Group (OEG). They indicate that for the 30 evaluated operations:

- the overall outcome ratings were mostly successful or better for 60%, comprising 63% of disbursed IFC investments
- project development impact was the highest rated of the four evaluated dimensions
- 60-70% of IFC's operations deliver both high development impacts and profitable returns
- projects in high-risk countries had better results than those in low-risk countries
- there is a strong association between a high IFC's effectiveness rating and those operations that deliver high impacts and profitable returns
- over the long run, pursuit of the corporate strategic emphasis on high-risk countries and targeted sectors is likely to yield better IFC results; however, the crisis makes it important to take forceful action to address the sources of controllable performance shortfalls.

FIGURE 1: CY97 OUTCOME RATINGS



Scope and Sample

The *Annual Review* is an analysis of investment assessment reports (IARs) prepared by IFC's investment departments during CY97 on a random one-third sample of 30 operations approved by IFC's board in CY92. In some analyses, these results are combined with the CY96 sample of 30 IARs that covered CY91 approvals.

Within statistical limits, CY97's sample of seven financial markets operations and 23 non-financial markets operations has a performance profile that is representative of IFC's operations approved in CY92.

Overall Outcome

Each IAR rates an operation's outcome based on indicators on four dimensions of performance:

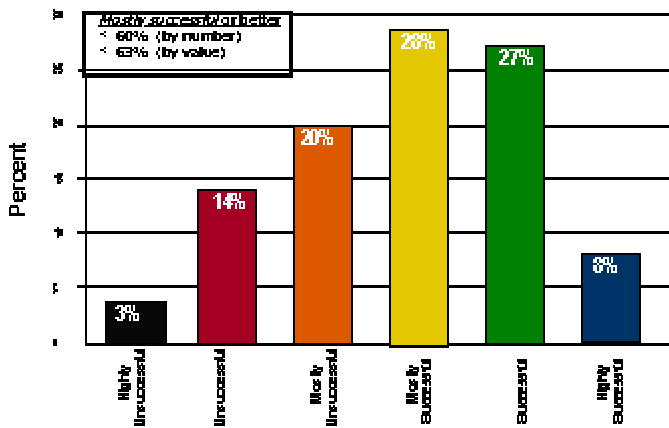
- (1) project and company business success
- (2) project development impacts
- (3) IFC investment profitability
- (4) IFC's effectiveness.

Each performance dimension has two or more standard indicators, so that 12 aspects of performance are rated on a four-point scale: *unsatisfactory*, *partly unsatisfactory*, *satisfactory*, and *excellent*.

An operation's outcome rating is a bottom-line assessment of its relative performance and contribution to IFC's purpose and objectives on a six-point scale from *highly unsuccessful* to *highly successful*.

In this year's sample, eighteen of the 30 operations, 60%, were *mostly successful* or better (the "success rate"), and 40% were *mostly unsuccessful* or worse.

FIGURE 2: CY97 AND CY96 COMBINED SAMPLE



The *mostly successful* or better group comprised 63% of disbursed IFC investments in FY98 and 69% for the two-year combined sample.

Because these IARs were completed before the financial crisis, ratings of some operations would be lower today.

Project and Company Business Success

The most direct results of IFC's work, and the core of its development mandate, are the projects and companies it finances. Projects that meet their objectives attract further private investment, foster development, and

strengthen the companies that own them. Companies that perform well commercially, and as corporate citizens, serve as good role models of private sector development and are likely to sustain the project's positive impacts.

Project and company performance may be closely related, but they are not identical: good companies can have bad projects, and vice versa, so the two are evaluated and rated separately.

In the 30 operations assessed in FY98, project business success was rated *satisfactory* or *excellent* in only 14 of 30 operations, whereas company performance was *satisfactory* or *excellent* in 21 of 30 operations. The six *excellent* projects had in common:

- strong, committed sponsors

- high country and/or project risk.

Where performance was less than *satisfactory*, the principal reasons were market shortfalls, weak sponsors or management, and weak cost competitiveness.

Project Development Impacts

Economic development results from productive investments that allow people to use their human and physical resources more efficiently to improve living standards. IFC evaluates four indicators of a project's development impacts, considering the project's contribution to:

- growth of productive private enterprise and/or efficient financial markets
- growth of the economy
- improved living standards
- environmental sustainability.

"Development impacts" was the highest-rated of the four performance dimensions, with the highest proportion of *excellent* and the lowest proportion of *unsatisfactory* ratings.

Within the development impact ratings, living standards ranked highest, followed by environmental impacts with 75% of the sample rated *satisfactory* or *excellent*, then growth of productive private enterprise, and growth of the economy (proxied by the project's economic rate of return).

Environmental performance of financial markets projects was weak, due mainly to intermediaries' poor monitoring of subproject environmental compliance and IFC's lack of diligence in applying its procedures to ensure sustainable intermediary performance.

IFC's Investment Profitability

IFC's ability to finance future investments and fulfill its development mandate depends on its profits from past investments. There are three distinct indicators of the profitability of each IFC investment: its gross contribution (separately evaluated for loans and equity investments), its profit contribution, and its return on capital employed. Each is evaluated and rated according to standard corporate benchmarks that reflect corporate investment policy. (Under its disclosure policy, IFC does not release partial information on its investment portfolio's performance.)

IFC's Effectiveness

Three indicators of IFC's effectiveness are evaluated:

- (1) project screening, appraisal, and structuring
- (2) supervision and administration
- (3) role and contribution.

IFC assigns these ratings by company outcomes with expectations at approval, and considering the reasons for material variances. In this dimension, a rating of *satisfactory* reflects the high professional standards expected for IFC's sustainability; thus *excellent* is reserved for exceptional performance in the case of (1) and (2) or pioneering or unusually strong contribution in the case of (3). A *partly unsatisfactory* rating denotes a



materially flawed performance in at least one area, and *unsatisfactory* denotes seriously flawed performance in several areas.

For FY98, this dimension received *satisfactory* or *excellent* in 67% of its ratings and *unsatisfactory* in only 11%.

IFC was more effective in larger investments, whose ratings were 74% *satisfactory* or *excellent* compared with 59% for smaller investments.

IFC was also more effective in nonfinancial markets operations than in financial markets operations (68% *satisfactory* or *excellent* vs. 48%).

Good front-end work is closely associated with project success. For the two-year sample, where IFC's screening, appraisal, and structuring were rated *satisfactory* or *excellent*, 31 out of 33 outcomes (94%) were *mostly successful* or better, but where it was *partly unsatisfactory* or *unsatisfactory*, only seven out of 27 (26%) were *mostly successful* or better. Good front-end work increased the chances of a *successful* outcome by 68 percentage points among these 60 operations.

IFC's Strategic Focus

IFC's corporate strategy is to increase its development effectiveness by seeking more projects in high-risk countries and in targeted sectors judged likely to have higher development impacts. The strategy centers on avoiding low-impact and low-return projects and on using profitable, low-impact projects to cross-subsidize unprofitable operations with high development impacts.

The strategy considers prospective projects in a four-way categorization, according to their development impact and returns to IFC, as illustrated in figure 3.

IFC would always pursue those operations in category 1, avoid those in category 4, and use investments in category 3 to cross-subsidize those in category 2.

The 60 IARs show that :

- Nearly 60% of the operations, representing 70% of IFC's disbursements, deliver both high impacts and profitable returns. These operations are cross-subsidizing the unprofitable projects.
- For most operations in the sample, there is no trade-off between development impacts and IFC's profits. As one increases, so does the other.
- Category 4 outcomes are costly to IFC. Shifting a single operation's outcome from the unprofitable, low-impact category to the profitable, high-impact category would, on average, raise IFC's expected profits on the 60 operations by 18%.
- There is a strong association between IFC's effectiveness - particularly in appraisal - and projects that are profitable and deliver high development impacts. Only 8% of the low-impact, unprofitable projects had satisfactory appraisals and structuring.

The findings on prospects for moving the portfolio toward higher-risk countries and targeted sectors are mixed:

- The projects in high-risk countries had significantly greater development impact ratings and higher

profits for IFC than projects in low-risk countries. Based on average returns, shifting one project from a low-risk to a high-risk country would raise the expected profits on the 60 evaluated operations by 6.1%.

- Except for infrastructure and possibly mining, projects in the targeted sectors are not, on average, materially better than those in the other sectors, and they are somewhat less profitable. Shifting one project from a nontargeted sector would on average lower the expected profits on the 60 IAR projects by 1.5%. This finding, however, does not reflect on the targeted sectors' potential since the weaker results were associated with IFC effectiveness shortfalls. These findings can be addressed.

In summary, the evaluation findings suggest that the strategy's operational focus is likely to yield better long-term results. However, the crisis makes it important to take forceful action on the controllable sources of IFC's performance shortfalls by applying the IARs' lessons and pursuing the Review's recommendations.

Lessons Learned

A central objective of evaluation is to learn from the operations' successes and shortfalls. This year's IARs provided 210 lessons for inclusion in OEG's on-line data base, the Lessons Retrieval Network (LRN). As in previous years, most lessons - this year 86%- related to IFC's precommitment processes: screening (15%), appraisal and project structuring (54%), and negotiations and agreements (17%). The other lessons (14%) relate to supervision and evaluation. This profile points to the criticality of quality at entry into the portfolio for achieving successful outcomes.

By subject matter, the IARs' lessons were closely aligned with the causes of less than *satisfactory* IFC effectiveness ratings:

- market and sector performance
- sponsors and management quality
- financing and investment structuring.

Collectively, they comprised 69% of the lessons reinforcing the ratings patterns for IFC's effectiveness in identifying priorities for management follow-up.

This year's lessons also reflect IFC's focus on improving client service, with 25% relating to client service quality (versus a 14% average since CY90).

RECOMMENDATIONS

Four themes for improved effectiveness emerge from these and related OEG evaluation results; the full report offers specific recommendations for addressing them:

- managing IFC's activities to increase the proportion of operations having high impacts and profitable returns
- aligning at-approval expectations with the strategic objectives, success standards, and measures of results
- sharpening IFC's skills and tools and better applying its knowledge
- improving results in specific substandard performance groups.