Special Study

EBRD – Italy Western Balkans Local Enterprise Facility (LEF)
(Western Balkans)

(A private sector investment operation)

September 2012

Evaluation Department (EvD)

European Bank
for Reconstruction and Development

EvD produces thematic or sectoral level evaluation reports in the form of Special Studies. These provide valuable insights to strengthen operational outcomes and institutional performance; they consider larger issues and generate more widely applicable findings for a wider audience. The larger scope of these studies facilitates the use of innovative and robust evaluation methods. This study forms part of EvD's 2011 Work Programme and was elevated in status from an Operation Performance Evaluation Review reflecting the higher level issues considered and resulting findings and recommendations.

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Abbreviations

AREF	Albania Reconstruction Fund
ESD	Environment and Social department
EU	European Union
EvD	Evaluation department
FDI	Foreign Direct Investment
GoI	Government of Italy
IFRS	International Financial Reporting Standards
IISF	Italian Investment Special Fund
IRR	Internal Rate of Return
KREF	Kosovo Reconstruction Equity Fund
LEF	EBRD-Italy Western Balkans Local Enterprise Facility
MSME	Micro, Small and Medium sized Enterprise
OCE	Office of the Chief Economist
OE	Operation Evaluation
OECD	Organisation for Economic Co-operation and Development
OL	Operation Leader
SBIC	Small Business Investment Committee
SME	Small and Medium sized Enterprise
TC	Technical Cooperation
TI	Transition Impact

Defined terms

the Bank	European Bank for Reconstruction and Development.
the OE Team	Staff of the Evaluation department and the independent sector consultant who jointly carried out the post-evaluation
the Operation	€250 million Local Enterprise Facility
the Operation Team	The staff in the Banking department and other respective departments within the Bank responsible for the operation appraisal, negotiation and monitoring, including the OPA.

Executive summary

The EBRD-Italy Western Balkans Local Enterprise Facility (LEF) is a framework operation intended to increase the Bank's support for smaller private sector projects in the Western Balkans. LEF combines EBRD resources with bilateral donor support from the Government of Italy (GoI). First approved in 2006, LEF has been replenished three times to a facility limit of €250 million of EBRD funds and coverage extended to include Croatia, Bulgaria, Romania and Turkey. GoI has supported LEF with €6 million of TC funds and a €20 million subordinated co-investment facility. This evaluation mainly considers LEF implementation in the Western Balkans.

LEF sits firmly within the Bank's approach to the Western Balkans and individual country strategies to work with the corporate sector. LEF builds on the experience of previous Italian-supported initiatives in the region and its operations are complementary to European Union policy. There are numerous other EBRD, multilateral and bilateral IFI or donor supported initiatives active in the region, some of which overlap with LEF and other EBRD activities.

LEF has achieved the objective of establishing a portfolio of operations to EBRD standards of due diligence, transparency and integrity. LEF clients are typically early stage businesses operating at EBRD financing standards for the first time. This confers transition elements around transparency and governance, added to and complemented by transition impacts flowing from investment projects. The great majority of projects are meeting their transition impact expectations.

LEF equity investments are rare examples of institutional equity investment – there are almost no comparable sources of finance. LEF loans are differentiated from local market norms by the thoroughness of preparation, structuring around business fundamentals (rather than just security cover) and transaction terms such as tenor. Both the countries in which LEF operates and the nature of the projects are at the higher end of the EBRD's risk spectrum and this remains a challenge to both ongoing management and eventual impacts.

The LEF approach presents an effective model within the EBRD for implementing smaller projects. The approach features an intensive project origination and monitoring process involving LEF-specific personnel, access to donor and bank funds for implementation, due diligence and post investment support. Project risks are high but the intensive monitoring process has been a particularly valuable initiative in raising and responding to issues early. Impairments and non-performing investments are so far contained and substantially below the 25 per cent impairment rates often found in banks in the region.

At the operational level, LEF is not a mass market facility. There are few potential clients in the Western Balkans that are both able to meet EBRD eligibility criteria and are of sufficient size to absorb LEF finance. As the facility reaches maturity in the Western Balkans, a realistic transaction rate may be 1-3 per annum per country. This is nevertheless a valuable engagement for the Resident Offices (ROs) which had almost no transactions with Western Balkans corporate clients prior to LEF. The intensive business model approach is not readily scalable in terms of cost effectiveness at the lower average operation size, which implies continuing financial support from the EBRD or donors will be required.

LEF donor funds have been pivotal to mobilising EBRD resources for LEF. Approximately two thirds of donor support has been directed to supplementing EBRD resources, covering staff costs and expenses. This funding established the resources needed to develop the project pipeline and has been important for maintaining EBRD costs within reasonable bounds – financial viability of the framework to the Bank would be questionable without this support. The Bank's experience has been that exits from small investments in difficult environments are particularly challenging and it may be some years before there are successful equity exits. A full financial picture will only become clear in perhaps four to five years.

LEF is at a critical juncture and there are some major challenges ahead. LEF by design did not address the challenges of developing equity investment capabilities in the region. For various reasons, equity uptake from LEF in the market has been slow and approximately two thirds of LEF operations in the Western Balkans are debt finance.

The challenges ahead include how to integrate the new Western Balkans SME Platform concept in a way that builds on the experience of LEF to date. LEF, by design, has not addressed capacity building or market development in equity finance but the issue remains. Mobilising direct equity investment in SMEs remains a challenge even in developed markets but there should be some expectation among stakeholders that, having supported the development of a project portfolio, the experience can be leveraged to generate market related impacts. The slow uptake of equity in the Western Balkans under LEF highlights that the "equity gap" is not likely to be addressed by supply of finance alone and it is likely that fresh approaches will be required to address the business environment of the Western Balkans. The way this experience is applied in the Western Balkans may be very different to that of the later countries added to the LEF operation (Bulgaria, Romania and Turkey) where the approach has not yet been differentiated.

The evaluation makes the following recommendations:

– Target higher level transition objectives that contribute to addressing access to finance issues

LEF has been replenished three times. On each occasion, transition impact objectives have been restated as residing at the level of the individual framework projects and no higher level or systemic transition objectives were set for the overall framework. The challenge remains how to leverage the development of a project portfolio into sustainable private sector investment mechanisms. Finalisation of the SME Platform concept and expansion of LEF to new countries of operations presents the opportunity to identify how EBRD engagements in smaller projects can be structured to impact on higher level or systemic transition challenges such as access to finance, the enabling environment for venture financing and fostering the establishment of venture funds.

– Potential overlaps between EBRD activities and international partners should be identified and management arrangements clarified to ensure complementarity between initiatives

The boundaries and complementarities for EBRD activities in the Western Balkans were last reviewed at Board level in the 2008 Action Plan for Western Balkans, Serbia and Croatia (SGS08 143 Add 1). There have been many developments since then and international coordination is a rising concern as the potential for overlaps and competition between international agencies is a very real possibility. The opportunity should be taken to update and clarify the strategic context in the Western Balkans, the areas the EBRD will address and the coordination arrangements to manage internal and external overlaps.

– Articulate the objectives and approach to countries added to LEF since 2010

The geographic expansion of LEF to Turkey, Bulgaria and Romania occurred under very different circumstances and took LEF to countries facing very different issues to those of the Western Balkans but a differentiated approach has not been developed. The strategic objectives of LEF in these later countries should be revisited and any refinement of the approach presented to the Board.

1. Introduction and evaluation approach

1.1 Overview of LEF

The EBRD-Italy Western Balkans Local Enterprise Facility (LEF) is a regional framework of the Bank with authority to provide equity, quasi equity and debt financing to private sector businesses. The initial geographic coverage was limited to the Western Balkan territories of Albania, Bosnia and Herzegovina, FYR Macedonia, Serbia and Montenegro, including Kosovo.[1] As a framework, project approvals were conducted under the delegated authority of the LEF Investment Committee.[2]

In the intial approval of LEF, the case was made that commercial banks were not addressing the requirements of Small and Medium sized Enterprises (SMEs) for loan finance and that equity finance through private equity funds did not exist due to the small market and company size. The intention was that LEF would be equity orientated but also flexible to provide debt and hybrid financing for expansion, modernisation, acquisitions and working capital purposes. The earlier KREF and AREF programmes[3] had mixed results using externally contracted investment management. An alternative approach was needed if the EBRD was to have a direct role in financing SMEs in the region, which necessitated the Bank establishing its own management team.

The facility initially targeted direct investments in the range of €1 million - €4 million, a transaction size that would usually be below the EBRD's threshold levels and addressed through financial intermediation. The Bank's standard approaches to due diligence and documentation (English law substantive agreements) were to apply. It was recognised from the outset that the small size and early stage of development of SMEs in the region would require intensive engagement both during project preparation and post-investment. A key feature from the outset was therefore donor funding for contracted staff to work specifically on LEF transactions. There were no transition objectives for the framework as a whole, rather, transition impacts were to be generated at the company level on the back of investment projects.

The facility was made feasible by donor contributions from the Government of Italy (GoI), which provided:

– grant funds to support headcount and operating expenses for dedicated LEF staff, reporting to the EBRD Director for the Western Balkans
– grant funds to defray some of the client's incremental transaction costs under the EBRD business process – legal, financial, technical and environmental due diligence
– a risk participation facility through the Italian Investment Special Fund (IISF) to co-invest with the EBRD on a first loss basis (initially up to 30 per cent of the investment amounts).

The first approval in February 2006 provided a facility of €30 million, comprising €20 million EBRD funds and €10 million co-investment finance, supported by €2 million of grant funding for operating expenses and project facilitation. Following several replenishments, the most recent completed in December 2010, the facility amount has reached €250 million EBRD commitment alongside €20 million IISF plus a cumulative TC commitment of €6 million.[4]

[1] Whenever referred to in this document, Kosovo should read as "Serbia (Kosovo, under UNSCR 1244)".
[2] Delegated approval authority later passed to the Small Business Investment Committee.
[3] Kosovo Reconstruction Equity Fund (KREF) and Albania Reconstruction Fund (AREF). BDS98 096 (Add 1 and 2).
[4] Since increased to €7 million after the study cut-off date.

1.2 LEF replenishments

A series of fine-tunings accompanied the replenishments (Table 1).

Table 1: Summary of LEF Board approvals

Approval	EBRD (€m)	IISF (€m)	TC GoI (€m)	New country	EBRD investment size	IISF Co-fin project limit
February 2006	20	10	2		€1m -€4m	Up to 30%
January 2008	30	5	2		No minimum / up to €6m	Up to 50%
January 2009 Renamed 'EBRD–Italy Local Enterprise Facility'	100	5	2	Croatia, Turkey	No minimum / up to €8m	New flexibility allowing reinvestment of reflows and substitution of IISF by Bank funds
December 2010	100			Bulgaria, Romania	No minimum / up to €10m	
Total	250	20	6			

Source: EBRD Board documents

The effect of fine-tuning was to:

- extend geographic coverage outside of the Western Balkans
- increase project scope for larger projects, up to €10 million of EBRD investment
- increase the direct project participation potential of IISF but reduce the overall ratio of IISF first loss participation (that is, increase the leverage of donor support) on much more flexible terms for the EBRD.

1.3 Evaluation approach

This document for the most part utilises the standard EvD assessment criteria and rating scales, tailored for the framework aspects. A summary of the evaluation approach is presented in Annex 3.

The main elements of the evaluation approach comprised:

- review of core project documents and supporting material (including credit, project and transition monitoring reports and Western Balkan strategic papers)
- interviews with key stakeholders in the EBRD and the Italian authorities
- selection of four focus countries and a sample of 13 projects for desk and field review. Review of project documentation for the project sample against facility objectives. Mini evaluation assessments of sample projects and light desk review of a larger sample for objectives and transition impact
- field interviews with stakeholders in the focus countries such as local banks, the European Commission and other agencies with interest in SME development.

The data cut-off for sample selection was the team portfolio report at February 2011. At the cut-off, LEF project commitments stood at €161.0 million (including IISF first loss co-financing of €16.2 million). Annex 3 includes sample analysis. At the cut-off no projects had been disbursed in Romania, Bulgaria or Turkey (although two projects were signed) and only one equity project had been disbursed in Croatia in 2010, which was too early for evaluation. This evaluation therefore focuses primarily on LEF implementation in the Western Balkans where LEF has its origins.

2. Overall assessment

To date, LEF is rated "*Successful*" (Table 2). The rating reflects the achievement of objectives, principally the establishment of a viable portfolio of qualifying projects and the related project transition impact. The portfolio by nature is high risk and the LEF team has tailored approaches to reflect this. Losses have been contained, reflected in a Bank handling rating of *"Good".*

Table 2: Ratings summary

Overall rating	*Successful*
Transition impact	*Good*
Achievement of objectives	*Good*
Additionality	*Verified in all respects*
Project financial performance	*Marginal/Satisfactory*
Bank handling	*Good*
Environmental performance / change	*Satisfactory/Some*

There are no comparable sources of equity finance in the region and LEF debt operations are distinguished from local market practice by their longer tenors, grace periods and reflection of underlying business drivers (rather than collateral cover). Additionality is rated as "*Verified in all respects*" and project financial performance is rated "*Marginal to Satisfactory"* and reflects that approximately 25 per cent of operations are financially vulnerable and under the intensive management process. Credit and equity losses have so far been contained and have not deteriorated despite the difficult 2012 economic environment. This bodes well but it will be some time before the financial performance of underlying clients, and therefore the sustainability of the LEF business model to the EBRD, becomes clear.

3. Project rationale and relevance

LEF is grounded in a strong rationale and relevance at multiple levels.

3.1 EBRD engagements in the region

All country strategies associated with the first Board approval for LEF articulate the importance of SMEs, low levels of financial intermediation for SMEs and the absence of equity investment funds. Availability of finance for SMEs, particularly equity, was among the priority issues to be addressed by the EBRD. LEF is fully consistent and compliant with the country strategies.

The relevance of LEF has been sustained since first approval to the time of writing, despite a period of sustained economic growth in the Western Balkans (around 5 per cent per annum for most of the mid 2000s) and expansion of bank credit, growing Foreign Direct Investment (FDI) and remittances.

Access to finance continues to be a significant issue for SMEs. The Access to Finance chapter of the

2009 SME Policy Index Report for the Western Balkans[5] discussed how, "Increasing domestic bank lending to the private sector, particularly SMEs, is an important challenge to the financial sector". The report refers to the need for "banks to shift to cash-flow based lending for small loans, as opposed to established collateral based lending" which in itself is consistent with the LEF banking approach. On equity finance the report identifies that "to supplement the low levels of bank lending, promotion of new financial instruments such as…private equity funds…is an important challenge". The positive background factors have since stalled or reversed and the financial crisis has deepened access to finance issues.

The case for geographic expansion of LEF developed mainly out of other considerations. Croatia was added under crisis response in the second replenishment. Turkey was added in the context of SME support in less developed regions, as envisaged by the "Request by Turkey to Become a Recipient Country of the EBRD: Strategic Overview" (CS/FO/08-18[Final]) report. LEF was the first EBRD operation to be approved for Turkey. Bulgaria and Romania were added in the third replenishment, also on the basis of crisis response. In none of these cases was the rationale explained in detail in the Board Document or how the objectives and approach would be tailored for the very different business environments in these countries compared to the Western Balkans.

The EBRD has multiple initiatives available in the Western Balkan region including the Micro, Small and Medium sized Enterprise (MSME) Financing Framework; the Private Sector Support Facility for Western Balkans; the Western Balkans and Croatia Financing Framework; several initiatives under sustainable energy financing as well as investment in the multilateral European Fund for Southeast Europe and a leading participation in the Western Balkans Investment Framework (WBIF). In addition, there are numerous and substantial multilateral and bilateral initiatives operating in the Western Balkans. LEF is certainly complementary to the range of initiatives present in the region but EBRD activities at times overlap internally and with international programmes. It is beyond the scope of this paper to map this complex range of programmes.

The EBRD 2008 Action Plan for Western Balkans, Serbia and Croatia (SGS08 143) presented a strategic profile of the EBRD's multiple instruments in the region and the rationale for EBRD initiatives in the process of finalisation. There have been many significant developments since the 2008 report, the most recent being the proposed West Balkans SME Platform (the Platform).[6] The Platform will see EBRD coming more to the forefront as an international coordinator in the region, especially for SME activities. The Platform will include specific components and TC budgets for the type of capacity building not previously contemplated for LEF. It would therefore be opportune to revisit and expand the 2008 document and present to the Board the overall architecture and coordination of engagements in the region by the EBRD and international partners.

3.2 European Union policy context

All countries at initial LEF approval had 'pre candidate' status with the European Union. While there is no specific chapter of the *acquis communautaire* relating to SME issues, all Western Balkan governments have adopted the European Charter for Small Enterprises (the Charter), itself a key component of the Lisbon Agenda. The Charter deals with the SME policy environment in signatory countries and Dimension

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[5] See SME Policy Index 2009 Progress in the Implementation of the European Charter for Small Enterprises in the Western Balkans. A collaborative report of the European Commission (DG Enterprise and Industry), the OECD PSD Division, the European Training Foundation and the EBRD.

[6] See BDS11 299 Western Balkans SME Platform (the Platform). The Platform co-mingles investment funds and donor support from multilateral and bilateral development partners in a Luxembourg listed vehicle. The LEF team will act as Investment Adviser for a component of the Platform.

7 of the Charter concerns Access to Finance. While LEF is not a policy instrument, its design is wholly consistent with the policy objectives of the Charter and the challenges identified in the 2009 SME Policy Index Report (see 3.1 above). The European Union attaches great importance to investment formation in the region and the private sector investment objectives of LEF are complementary to European Union policy objectives in the region. Finalisation of the Platform (BDS11 299) generates closer linkages as the Platform accesses donor support from the Instrument for Pre-Accession Assistance, via the WBIF.

3.3 Bilateral donor support

Bilateral support from the Government of Italy stems from its long-standing regional strategic interest and many shared trade and social policy objectives with Western Balkans countries. Parts of the region are active locations for Italian companies, often SMEs, in off-shore manufacturing. There has been a long and deep involvement by the GoI in providing bilateral donor assistance in the region. The SME focus of LEF also sits well with a heightened interest in SME development on the part of the Italian authorities, which was also the case with the earlier KREF and AREF initiatives. LEF was specifically designed to learn from and build on the earlier experience in the region through AREF, KREF, bank credit lines in Bosnia and Herzegovina and an Italian risk sharing facility in Serbia and Montenegro.

4. Achievement of objectives

Achievement of objectives is rated as "*Good*" (Table 3). Portfolio development has been timely, fully committing the first two replenishments, and over 70 per cent of projects are achieving their objectives. About 10 per cent (of a 33 project desk sample) are failing to meet their objectives, usually because of commercial and credit issues, with the remainder in the balance. There are inevitably some failures with the generally high risk profile of projects available to LEF but the portfolio is widely distributed and the higher risks have been contained. The range of projects with satisfactory or better achievement of objectives is consistent with the Bank-wide *ex post* evaluated average of 73 per cent for projects evaluated in 2010 and 83 per cent for the period 2006-10.[7]

Table 3: Summary of objectives

Objective	Achievement
Portfolio development	Achieved
Project level achievement of objectives	Achieved
Overall achievement of objectives	Good

4.1 Objective setting

Board documents do not express an explicit facility level objective for LEF. However, there are multiple statements to the effect that the overarching objective is to increase the number of EBRD operations with SMEs in the target countries. Portfolio performance was identified in the first Board document as the key

[7] Annual Evaluation Report 2011 (draft).

facility level indicator but “performance” was not defined. Two performance criteria were identified at the project level, again without expansion of a performance metrics, namely performance of individual investments and improvements in corporate governance attributable to LEF, which is a transition objective rather than an operation objective.

For this report the overall portfolio objective is assessed against facility commitments and development of the LEF project portfolio. Achievement of project level objectives are assessed against performance of the field sample, nuanced by a light desk review of a wider project population.

4.2 Portfolio level objectives

LEF reports on portfolio development to the Board on a regular basis either through Activity Reports or under the replenishment requests. The portfolio development objective has been achieved:

- Facilities have been committed within a short period of each Board approval. At the February 2011 data cut-off LEF had signed aggregate commitments of €161.0 million[8] (Table 4).

Table 4: All operations committed at February 2011

€ million	LEF total	EBRD	IISF
Equity	47.6	41.4	6.2
Debt	98.5	89.9	8.5
Convertible	15.0	13.5	1.5
TOTAL	161.0	144.8	16.2

Note: These figures include two operations in Turkey in the process of signing and three other 2011 signed operations not ready for evaluation: one each in FYR Macedonia, Serbia and Kosovo. Source: LEF data.

Operations were widely distributed in the Western Balkans region (Table 5). The portfolio is diverse by sector and investees, with approximately 44 operations (as at February 2011). Some clients have both debt and equity or more than one operation.

Table 5: Distribution of LEF operations and EBRD funds committed 2006-10

# of operations	2006	2007	2008	2009	2010	# of Ops	Total €m	Op Av €m
Albania		2	3	2	3	10	25.9	2.6
Bosnia & Herzegovina		2	1	2	2	7	22.7	3.2
Croatia					1	1	4.0	4.0
FYR Macedonia		2	1	2		5	12.2	2.4
Kosovo		1	1	3	3	8	23.1	2.9
Montenegro			1	2		3	9.6	3.2
Serbia	3		1	1	5	10	29.6	3.0
Total	3	7	8	12	14	44	127.1	2.9

Note: In 2006 three projects in Serbia were in the Kosovo region. Source: Team data and DTM Annual Business Volume.

[8] Two operations were in the late stages of signing.

The average size of transactions has remained small as intended, despite the progressive rise in the maximum commitment size to €10 million (EBRD funds). The average EBRD operation size was €2.9 million. Excluding Croatia, where LEF has only completed one project, there is very little variance in the average project size by country (a range of €2.4-3.2 million), which is wholly consistent with the smaller project objectives of LEF. The LEF pipeline does show a growing number of larger operations, particularly in newer LEF countries, but not to the exclusion of smaller operations.[9]

LEF represented a small part of the EBRD's annual business volume over 2006-10 in the Western Balkans, just under 3 per cent by value. This understates the value of LEF to the ROs in reaching the private sector. LEF provided 13 per cent of all projects in the Western Balkans over the period (rising to 18 per cent for 2010) or 20 per cent of all projects if Croatia is excluded.[10]

For some ROs, LEF was the primary instrument for engaging with private sector businesses and consistently accounted for over 25 per cent of all operations signed (Table 6).

Table 6: LEF as a % of all operations in the Western Balkans 2006-10

	2006	2007	2008	2009	2010
Albania	0%	33%	33%	29%	38%
Bosnia & Herzegovina	0%	12%	8%	14%	15%
Croatia	0%	0%	0%	0%	8%
FYR Macedonia	0%	25%	20%	22%	0%
Kosovo	NA	33%	25%	33%	60%
Montenegro	NA	0%	25%	22%	0%
Serbia	11%*	0%	9%	7%	21%
Total	4%	10%	14%	16%	18%

Note 1: 2006 Serbia operations relate to Kosovo region. Note 2: 11 LEF projects that were "de-commitments" for the IISF have been deducted from both LEF project numbers and total projects for each country. Source: LEF team data and DTM.

The equity orientation of LEF has not developed as fully as anticipated. Approximately 40 per cent of commitments (by value and number) were in equity or convertible debt. The team attributes the slower than anticipated uptake of equity to the crisis. Bank finance became scarcer as local commercial banks applied tighter screening criteria and shortened loan maturities, impacting on business liquidity. The flexibility of LEF to provide either debt or equity was seen as a positive feature in response to changing market circumstances. Market shifts aside, the equity and quasi equity projects that LEF has developed are rare examples of third party, "private equity" type investment. Debt financing is perfectly in keeping with the objectives of LEF and debt projects have been effectively used by LEF to leverage the type of transparency, governance and engagement more usually found through equity investment. However, this does mean a distancing from the implicit objective of the EBRD that a portfolio of successful equity projects completing the equity cycle to exit would generate demonstration effect and a supply of seasoned opportunities that would help stimulate development of equity investment in the region.

It should also be recognised that LEF is approaching a period of maturity in the Western Balkans. The markets are small and in some cases there might only be 50-100 businesses that could support a LEF

[9] The number of projects shown in Table 5 have been adjusted to exclude 11 projects involving the cancellation (so called "de-commitment") of IISF first loss participation and replacement with EBRD own funds. The adjustment in Table 5 is intended to give a better reflection of new projects in the region in keeping with the objectives of LEF. The EBRD corporate planning department counts de-commitments as additional projects in the scorecard, recognising the extent of team inputs required to get to the point where the first loss cover can be given up.

[10] Croatia is managed organisationally within the EBRD as part of central Europe rather than Western Balkans, mainly reflecting its more advanced transition status.

project of €3-4 million. By the time the population is screened for those businesses that are in acceptable activities that can also meet integrity and transparency requirements, that are willing to work with the EBRD and have supportable projects, there may only be a flow of one to three projects a year in some countries. This is significant because it indicates that the challenges for developing SME finance in the region are not just related to the supply of finance.

4.3 Project level objectives

At the project level, investment objectives are adequately defined and counterparts meet the profile described in the Board document, such as "good competitive position with an existing or potential long-term comparative advantage in the production and marketing of a product; attractive value or growth drivers" (BDS 06 011).

All of the 13 field sample operations achieved their investment objectives. In two cases there were relatively minor and probably resolvable issues around the projects.[11] A summary of field sample findings is presented in Annex 4. To balance the positive bias of the field sample, desk reviews of monitoring reports were completed for a further 20 projects. The great majority of projects are achieving their objectives (Table 7).

Table 7: Fulfilment of project objectives

	# of projects	%
Satisfactory or better	24	73
Uncertain	6	18
Not achieved	3	9
TOTAL	33	100

Three projects were the subject of impairment and their objectives will not be achieved. Six projects were under stress and it is not yet known whether they will fulfil their objectives in these circumstances, hence being classed as "uncertain". However, a share of vulnerable projects may still meet their objectives, implying a success range of 73-91 per cent of projects achieving satisfactory or better fulfilment of objectives (assuming no major increase in the rate of failures). This range is consistent with the Bank-wide *ex post* average of 73 per cent for projects evaluated in 2010 and 83 per cent for the period 2006-10.

5. Transition impact

Transition impact of LEF is "*Good*". Transition impact at the facility level is effectively an aggregation of TI at the project level. The majority of projects are achieving satisfactory or better transition impact (a range of 65-88 per cent depending on project outcomes), which is consistent with *ex post* results overall for the EBRD. A proportion of projects are going beyond company level transition and impacting positively with backward linkages in their sector.

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[11] In one case, incorrectly specified equipment resulted in incompatible product dimension for downstream processing, leading to 10 per cent production wastage. In another case, access could not be gained to a factory's wastewater treatment (new installation to EU standards as part of the project) and operation data was not provided. The OL has confirmed the plant is operational and access just could not be gained on the day due to building works.

As LEF reaches a stage of maturity and the platform concept approaches finalisation, the opportunity should be taken to align transition objectives more closely with the access to finance issues not addressed by LEF in its current design.

5.1 Facility level

A consistent set of transition impact objectives has existed at the facility level since inception through to the €100 million replenishment in December 2010. The transition approach focuses on three indicators (expanded in Annex 5):

- competition and market expansion
- restructuring (demonstration effect)
- setting standards for corporate governance.

Indicators and benchmarks were not reconsidered or differentiated for the extension of LEF to Croatia, Bulgaria, Romania and Turkey, where the context and intervention logic were very different.[12]

A progressively more rigorous approach to TI and stronger engagement with the Office of the Chief Economist (OCE) is evident over time. The January 2009 replenishment introduced quantified performance benchmarks at the facility level to be applied to the €100 million third approval onwards and tracked through the Transition Impact Monitoring System (TIMS). All facility level benchmarks were set for 2012 fulfilment (Table 8).

The establishment of quantified benchmarks at the facility level for LEF has added clarity to transition objectives. However, the issue remains that facility level impacts continue to rest on aggregation of project level impacts and do not target the access to finance issues that create the market gap in which LEF is operating. Finalisation of the SME Platform and expansion of LEF to new countries of operations presents the opportunity to identify how EBRD engagements in smaller projects can be structured to impact on higher level or systemic transition challenges such as access to finance, the enabling environment for venture financing and fostering the establishment of venture funds for sustainable capacity building.

Broadly defined transition objectives have featured for individual LEF projects since the outset. For earlier projects, indicators were largely descriptive and without benchmarks. The requirement for individual quantified and time-bound transition benchmarks was introduced for all projects under the third approval onwards. Project level transition benchmarks were made subject to OCE endorsement for each operation proposed, ensuring tie in with the aggregated benchmarks.

One TIMS report has been finalised since the introduction of the new benchmarks (November 2010, report 4), which shows all benchmark indicators to be on track (population of 26 tracked projects, see also Table 8). The TIMS report rates TI potential as "*Good*", at high risk (reflecting portfolio risks). The next report will benefit from longer seasoning of the portfolio and proper reflection of crisis impact. No change of rating is expected.

[12] In a comment on this paper, the EBRD Office of the Chief Economist makes the point that "LEF is primarily a facility helping smaller enterprises overcome barriers for growth, in particular through corporate governance and business conduct improvements and restructuring. While it is certainly true that objectives such as market expansion and competition are more easily targeted in the Western Balkans, corporate governance challenges for SMEs can be found in the extension countries as well."

Table 8: TIMS - November 2010

Objective/benchmark:	Status
Objective 1 : Competition and market expansion – 2012	
1.1 Implement at least four transactions supporting the entry of an additional domestic market player	NYA*
1.2 Implement at least two transactions involving a substantial improvement of supplier contracts	On track
1.3 Implement at least four transactions substantially upgrading the quality of goods and services	On track
Objective 2 : Demonstration of successful restructuring – 2012	
2.1 At least six transactions involving substantial operational, managerial and financial restructuring and/or expansion of the company into new business segments	On track
2.2 At least four transactions introducing a new, replicable product or technology	On track
2.3 At least six transactions introducing innovative financial structures and/or instruments not readily available otherwise	On track
Objective 3: Setting standards for corporate governance and business conduct – 2012	
3.1 At least six transactions involving a substantial upgrade of business conduct	On track
3.2 At least four transactions substantially simplifying the company ownership structure	On track
3.3 At least four projects substantially improving company environmental compliance/performance	On track

*Not yet applicable.

The transition impact approach at the facility level aggregates aspects of transition performance of individual projects. There are no wider anticipated market impacts on the availability of finance or market practice, nor in the market failure space in which LEF has been operating.

5.2 Project level

Twelve of the 13 field sample projects were seen to be meeting transition objectives to at least a satisfactory level or better. The one case where transition objectives were not being achieved was an early equity investment (2006) where the commercial development plan was founded on weak assumptions (low achievement of transition in competition and market expansion) and the majority shareholder had failed to develop the management or governance structures of the business (low achievement of setting standards).

Commercial vulnerability of LEF projects remains a persistent threat to transition. Only one of the 13 field sample projects had an EBRD risk rating of 6 at the January 2012 credit report, all the others were higher risk.

Taking a wider sample for light desk review (the 26 projects tracked at the last TIMS), EvD estimates 65 per cent of projects have achieved, or are on track to achieve, their transition objectives (Table 9).

Table 9: EvD transition estimate for 26 projects under TIMS 4

Transition	# of projects	%
Satisfactory or better	*17*	65
Uncertain	*6*	*23*
Not achieved (business failed)	*3*	*12*
TOTAL	*26*	*100*

A significant proportion of uncertain projects have the potential to achieve their transition objectives. This potential is largely related to overcoming financial and commercial challenges. Three businesses have failed and it is estimated that six have heightened risk – of these, one is failing to achieve corporate governance modernisation and one has ceased operations in the Western Balkans but still operates successfully in the EBRD region. The other four vulnerable projects are mostly delayed because of financial and commercial issues and may still fulfil their transition objectives.

In a difficult operating environment a good majority of LEF projects are meeting their transition impact objectives and a share of vulnerable projects may still meet their objectives, implying a range of 65-88 per cent of projects achieving satisfactory or better TI. This range is consistent with the EBRD-wide *ex post* average for projects with satisfactory or better transition impact of 76 per cent for projects evaluated in 2010 and 81 per cent for the period 2006-10. Difficult cases aside, a portfolio of projects that are achieving transition objectives has been established.

The range of clients in the LEF portfolio makes it difficult to generalise about transition impact. The portfolio includes SMEs from the manufacturing and service sectors as well as four financial institutions. However, the majority of companies in the LEF portfolio fit the profile envisaged by the Board documents of dynamic manufacturing and service SMEs with potential for development. This characterisation was true of the field sample and the following perspectives are informative regarding the transition impact that can flow from engagement with the EBRD.

– Most companies are at an early stage of development. The process of engagement with the EBRD has itself impacted on standards of business conduct. LEF projects are being implemented at EBRD standards of due diligence and structuring, with forward looking covenants (which is sound banking but not market practice in the focus countries). This process was new to most clients , above market standards and has challenged businesses to improve management accounting and reporting and undertake better corporate housekeeping relating to transparency of ownership and title to assets. LEF companies generally undervalue the impact of this discipline as local banks have lower requirements but companies that have been through the EBRD process successfully will be better equipped to manage their banking funding relationships in future..

– Introduction of International Financial Reporting Standards (IFRS) accounting prepared by firms acceptable to the EBRD has been a consistent Bank requirement and complements the direction of local law in the focus countries. In some cases this has led to more rigorous treatment of accounting systems and practices. A pragmatic approach has been adopted by the EBRD, for example, accepting qualified accounts one year followed by clean accounts the next.

– Most companies and projects are at the lower end of the EU definition of SME (although above micro). Despite their small scale and the challenges of limited markets, most are among sector leaders in their territory and are achieving significant backward linkages, especially in agriculture (milk supply chain, animal husbandry and potato farming) but also in other areas such as wastepaper collection, access to supermarket space for agricultural produce and providing modern retail space for SMEs. Despite their small size in Bank terms, LEF projects often have disproportionate visibility locally resulting from engagement with leading businesses in their respective sectors.

– All businesses in the sample face challenges of overcoming small market size and expanding export sales. With one exception, all companies that received post-investment technical assistance have had positive impacts from the support and valued the role of the bank in identifying and mobilising appropriate consultants. Where applicable, EBRD Board nominee engagement was also praised for the quality of engagement in both board functioning and commercial expertise.

6. Bank handling and role of donor funds

LEF provides an effective model for engagement with early stage SMEs. This is seen in the portfolio development and transition impact of underlying projects. The approach is characterised by an intensive pre and post-investment management process. The approach benefits from the on-the-ground presence of EBRD LEF resources. The establishment of a portfolio of EBRD projects in the Western Balkans capable of achieving transition objectives is indivisible from the role of donor funding. Bank handling is rated as "*Good*".

6.1 Management and resources

The implementation model for LEF is intensive. The evaluation found projects are run to EBRD standards (due diligence, business plan preparation, transparency, integrity, analysis, structuring, use of English law) with companies that have usually had little, if any, experience of working to these standards. Operation Leaders are often working with companies that have poorly developed accounting and management information systems (MIS) capacity. This places significant demands on bankers both during project development and post-investment where the experience of working to continuous financial and non-financial covenants is also new to the client and thus requires constant vigilance.

Banks in the region spoke highly of the LEF approach. Project preparation may require several months of LEF banker input, compared with the three days typically available to one of the private sector corporate bankers interviewed. The structured finance approach, based around business fundamentals, earnings and cash flow or valuation, also distinguishes LEF. The field sample found appreciably higher banking technical standards than the market, where corporate banking still focuses on the level of collateral cover and the availability of non-business assets.

Prior to LEF, the EBRD had established very little project presence in the Western Balkans (see Section 4). Establishment of the LEF team in the field with a focus on numbers of suitable projects rather than business volume was crucial to development of the project pipeline.[13] The management structure creates a unified reporting line to the Director of Western Balkans for the 12 LEF and Western Balkan staff assigned to LEF. This allows LEF bankers to work flexibly with sector teams either as lead on a project with sector team support or in complementing the resources under a sector team lead. Approximately 65 per cent of all commitments from the donor funds have been allocated to staff and field implementation costs (see Table 10 and Annex 6 for an overview of TC activities).

[13] A proportion of LEF projects have very little LEF team involvement. Projects are booked under LEF to access the delegated authority for small projects and sometimes access the risk participation of the IISF.

Table 10: Distribution of LEF TC commitments to December 2010

	€m	%
Staff, travel etc	*3.96*	65
Due diligence and project TC	*2.09*	*35*
TOTAL	*6.05*	*100*

Source: Bank TC records

The resource structure was strengthened in 2010 following the emergence of some difficult cases. Corporate Equity support was mandated for all new equity cases and, significantly, a LEF monitoring team was established under the responsibility of LEF bankers and a portfolio manager. Additional EBRD funded resources were made available through Corporate Equity, mainly to support nominee directors in equity projects.

The monitoring team sits at the pinnacle of a tailored process featuring a focused monitoring report, intensive client contact and regular site visits with a view to early client engagement on problem issues. Credit and corporate recovery are also involved early and attend the monthly monitoring meetings for difficult cases. The LEF team has become known among its problem cases for pursuing recoveries to the end rather than writing balances off. The overall approach has helped contain the level of portfolio losses to three cases.

6.2 TC for due diligence and post-investment support

Approximately one third of donor funds, a little over €2.0 million, have been committed to due diligence and post-investment support (Table 11). There is inevitably some attrition in the portfolio for operations that do not proceed. Cancelled operations account for approximately 22 per cent of LEF project support TC commitments.

Table 11: LEF Operation TC call-offs to December 2010

TC linked to Ops	Call-offs	Committed €	Disbursed €	Average €
Completed	*54*	*1,455,052*	*904,224*	*26,945*
Pipeline	*8*	*166,740*	*20,613*	*20,843*
Cancelled	*17*	*470,773*	*347,416*	*27,693*
TOTAL	*79*	*2,092,565*	*1,272,253*	*26,488*

Source: Bank TC records

Legal due diligence and contracting of external lawyers is the largest component of operation support TC, accounting for approximately 60 per cent of commitments. Field interviews identified the EBRD approach to transactions as more comprehensive than local practice with higher standards of due diligence, documentation and execution. Even "plain vanilla" loan operations have more complex structures than their local counterparts (such as financial and non-financial covenants, reporting and access to information requirements), which increases both the number of legal issues that need to be addressed and the extent of the legal documentation.

The EBRD also requires the appointment of outside legal counsel, meeting the standards of the EBRD in particular to assist with local legal issues. The average TC commitment for legal support is around €20,000 (rising to an average of €30,000 for completed transactions only). Transaction costs for a secured term loan locally would be around €3,000. For the reasons given, this is not a like for like comparison but sets a benchmark for what clients perceive as reasonable legal expenses. LEF clients commented that legal expenses would likely have been a blocking issue as they perceive the benefit of this process only inures to the EBRD.[14]

Post-investment support represents only around 7 per cent of the donor commitment, about €150,000. To this should be added post investment support from the EBRD's own funds (around €220,000 of contracts outstanding), usually related to Board nominees (five equity investments and one debt operation). Post investment TC supports the Bank's transition objectives and is reflected in the transition section of this report.

6.3 Financial impact of donor funds on the EBRD

The intention from the outset was that donor funds would be used to offset the cost to the EBRD of allocating dedicated resources to smaller projects. The costs of smaller projects are reflected in the profit and loss of LEF.[15]

As at 31 December 2010 LEF had accumulated an operating deficit of €13.94 million. The full financial discussion is presented in Annex 7. For reasons discussed in the Annex, this probably overstates the position but is a necessary starting point for analysis. After recoveries from donor funds the deficit was reduced to €9.02 million.

The LEF team were asked to prepare a financial scenario in support of this evaluation to identify what Internal Rate of Return (IRR) and related assumptions the portfolio would need to generate to break even of all operating costs between 2011 and the end of 2016 on a "run off" basis. The team estimated that an IRR of 10.9 per cent before donor funds are included and 6.7 per cent after donor contributions would be needed to achieve break even.

To put this in perspective, the IRR on the EBRD's Q1 2012 portfolio of unrealised equity investments stood at 6 per cent (gross after funding costs but before operating costs) or 7.7 per cent on exits achieved in that quarter. With some caveats, the challenge for LEF to break even is within plausible bounds and the conclusion can be drawn that donor funds are fulfilling the purpose intended of covering incremental costs of LEF.

The main caveat is around equity exits. The EBRD has found exits from small projects particularly difficult in the past and in the thin markets of the Western Balkans, exits are likely to be challenging for LEF too. The LEF equity portfolio is still relatively unseasoned and there are no significant prospects for exits in process at this time.

The financial scenario also indicated that the LEF approach is not readily scalable. The intensive approach leads to fixed costs similar to that of larger projects but recovered on a much lower front-end fee or margin income. The monitoring intensity also limits the portfolio to projects that can be managed effectively by Operation Leaders (OLs). Therefore, more projects on the LEF model, at the historic average transaction size, will require roughly pro rata more staff resources and most probably additional donor support.

[14] Mandatory cost sharing for donor funds was introduced in 2011, ranging from 20-50 per cent.
[15] Constructed from the Bank's management accounting data.

7. Environmental impact

Environmental performance is satisfactory and the level of environmental change is *Some*.

LEF is categorised as C in the Board document and does not require environmental due diligence at the facility level. At the outset, projects were expected to meet local environmental standards as a minimum. By the third replenishment in December 2010, operations were expected to meet EU standards.[16] Prior to this, the approach of the Environment and Social Department (ESD) was to push for EU environmental standards in projects where jurisdictions were on a path to convergence with EU requirements.

The environmental process has been standardised for delegated authority facilities under the Small Business Investment Committee (SBIC). Initial screening is questionnaire-based and all LEF operations are reviewed by ESD. The majority are categorised as B, meaning additional environmental review or due diligence is required, which almost always leads to an environmental action plan. This is consistent with observations for the field sample.

ESD comments on all projects presented to the SBIC, including an explicit rating using A/B/C categorisation under the Bank's policy. Communication of explicit rating and adoption of the Bank's categorisation clears up potential ambiguities observed in other delegated authority facilities that existed prior to the establishment of SBIC where projects would only be rated if they were deemed "higher risk", the definition of which was unclear.[17] A small number of projects were identified as higher risk at approval. In three examples ESD were fully involved in due diligence, developing action plans and reviewing environmental reporting.

8. Key findings and recommendations

The evaluation identified the following key findings:

8.1 LEF is an effective instrument for developing smaller projects. Intensity of management is key to containing difficult situations but is resource consuming. Support for the framework from donors and/or the EBRD may be needed for some years before equity investments can be realised.

LEF is an effective and flexible instrument for devecredit

loping smaller projects while maintaining EBRD standards of project preparation. The intensive monitoring process has been a particularly valuable initiative in raising and responding to issues early. The management approach has helped contain losses from a high risk group of projects. Donor funds have fully played their part in facilitating the project pipeline – financial viability of the framework to the Bank

[16] Expressed in the Board document as "target borrowers/investee companies will be required to comply with the Bank's Performance Requirements", meaning the Bank's 2008 Environmental and Social Policy requiring EU or equivalent standards.

[17] Clarification of terminology for delegated authority facilities was a recommendation of the Evaluation Special Study - Direct Lending Facility (DLF) and Medium Sized Co-financing Facility (MCFF) CS/AU/10-20.

would be questionable without this support and it is questionable whether the approach can be extended without adding pro-rata to resources and support.

There are some good examples of value creation in small equity investments in the LEF portfolio but the Bank's experience has been that exits from small investments in difficult environments are particularly challenging. It may be some years before there are LEF equity investments completing the cycle to successful exit. During this time continuing Bank support for the facility will be required.

8.2 LEF is at a critical juncture and there are some major challenges ahead

LEF is not a mass market facility and the initial pipeline of projects in the Western Balkans has been successfully developed. Further rapid growth of the portfolio is unlikely as there are limited numbers of supportable projects rather than limited availability of EBRD funds under LEF. At the same time donor funding, valuable for project facilitation, is nearing depletion.

The challenges ahead include how to integrate the SME Platform[18] concept in a way that builds on the experience of LEF to date. LEF by design has not addressed capacity building or market development issues in equity investment but the issue remains. Mobilising direct equity investment in SMEs remains a challenge even in developed markets but there should be some expectation among stakeholders that, having supported the development of a group of projects, the experience can somehow be leveraged to generate market development impacts. The slow uptake of equity in the Western Balkans under LEF highlights that the equity gap is not likely to be addressed by supply of finance alone. It is likely that fresh approaches will be required to address the business environment of the Western Balkans. The way this experience is applied in the Western Balkans may be very different to that of the later countries added to the LEF operation (Bulgaria, Romania and Turkey) where the approach has not yet been differentiated.

The evaluation makes the following recommendations:

8.3 Target higher level objectives that contribute to market development

LEF has been replenished three times. On each occasion, transition impact objectives have been restated as residing at the level of the individual framework projects and no higher level or systemic transition objectives were set for the overall framework. The challenge remains as to how to leverage the development of a portfolio of projects into sustainable private sector investment mechanisms.

Finalisation of the new collaborative SME and venture financing mechanism for the Western Balkans (the SME Platform) and expansion of LEF to new countries of operations presents the opportunity to identify how EBRD engagements in smaller projects can be structured to impact on higher level or systemic transition challenges such as access to finance, the enabling environment for venture financing and fostering the establishment of venture funds (sustainable capacity building).

[18] See BDS11 299 Western Balkans SME Platform (the Platform). The Platform co-mingles investment funds and donor support from multilateral and bilateral development partners in a Luxembourg listed vehicle. The LEF team will act as Investment Adviser for a component of the Platform.

8.4 Potential overlaps between EBRD activities and international partners should be identified and management arrangements clarified to ensure cooperation and complementarity between initiatives

The 2008 Action Plan for Western Balkans, Serbia and Croatia provides a good outline of the EBRD's activities in the region. There have been many developments since then and international coordination is a rising concern as the potential for overlaps and competition between international agencies is a very real possibility. The opportunity should be taken to update and clarify the strategic context in the Western Balkans, the areas the EBRD will address and the coordination arrangements to manage both internal and external overlaps.

8.5 Articulate the objectives and approach to countries added to LEF since 2010

The geographic expansion of LEF to Turkey, Bulgaria and Romania occurred under very different circumstances and took LEF to countries facing very different issues to those of the Western Balkans but a differentiated approach has not been developed. The strategic objectives of LEF in these later countries should be revisited and any refinement of the approach presented to the Board, possibly in conjunction with revisiting the 2008 Action Plan for Western Balkans, Serbia and Croatia.

Annex 1: Operation performance rating

Performance indicator	Rating
Overall transition impact (analysis in Annex 3)	●●●●●○ Good
Environmental performance of the project and sponsor	●●●●○○ Satisfactory
Extent of environmental change	✱✱✳✳ Some
Additionality	■■■■ Fully verified
Company financial performance	●●●○○○ Marginal / ●●●●○○ Satisfactory
Fulfilment of project objectives	●●●●●○ Good
Bank handling	●●●●●○ Good
Overall performance	♦♦♦◊ Successful

General	Extent of Environmental Change
●●●●●● Excellent ●●●●●○ Good ●●●●○○ Satisfactory ●●●○○○ Marginal ●●○○○○ Unsatisfactory ●○○○○○ Highly Unsatisfactory	✱✱✱✱ Outstanding ✱✱✱✳ Substantial ✱✱✳✳ Some ✱✳✳✳ None/Negative
Overall performance	**Additionality**
♦♦♦♦ Highly Successful ♦♦♦◊ Successful ♦♦◊◊ Partly Successful ♦◊◊◊ Unsuccessful	■■■■ Fully verified ■■■□ Largely verified ■■□□ Partly verified ■□□□ Not verified

Annex 2: *Ex post* transition impact analysis

TI checklist		Short-term verified impact	Long-term TI potential	Risk to potential TI
	Step I: change by the project at corporate level			
3	Private ownership	●●●●●○	●●●●●○	✱✱✱✳
5	Skill transfers	n/a	n/a	n/a
6	Demonstration effects	n/a	n/a	n/a
7	New standards for business conduct	●●●●●○	●●●●●○	✱✱✱✳
	Step II: transition impact at the level of the industry and the economy as a whole			
1	Competition	●●●●●○	●●●●●○	✱✱✱✳
2	Market expansion	●●●○○○	●●●○○○	✱✱✱✳
3	Private ownership	n/a	n/a	n/a
4	Frameworks for markets	n/a	n/a	n/a
5	Skills transfers	n/a	n/a	n/a
6	Demonstration effects	n/a	n/a	n/a
7	New standards for business conduct	n/a	n/a	n/a
	Summary of verified, potential and risk ratings	●●●●●○	●●●●●○	✱✱✱✳
	Overall TI rating	●●●●●○		

General	Extent of Environmental Change
●●●●●● Excellent	✱✱✱✱ Outstanding
●●●●●○ Good	✱✱✱✳ Substantial
●●●●○○ Satisfactory	✱✱✳✳ Some
●●●○○○ Marginal	✱✳✳✳ None/Negative
●●○○○○ Unsatisfactory	
●○○○○○ Highly Unsatisfactory	
Overall performance	**Additionality**
♦♦♦♦ Highly Successful	■■■■ Fully verified
♦♦♦◊ Successful	■■■□ Largely verified
♦♦◊◊ Partly Successful	■■□□ Partly verified
♦◊◊◊ Unsuccessful	■□□□ Not verified

Annex 3: Evaluation approach

This document presents an Operation Evaluation utilising, for the most part, the regular assessment criteria and rating scales for project evaluations. Certain aspects of the approach have been tailored for the multiple countries and operations under the framework approach.

The main elements of the evaluation approach are:

- review of a full history of core project documents and supporting material, including credit, project and transition monitoring reports, Western Balkans strategic papers
- interviews with key stakeholders in the EBRD and the Italian authorities
- selection of four focus countries and a sample of projects for desk and field review
- review of project documentation for the project sample against facility objectives with mini evaluation assessments of sample projects (see table below for sample analysis)
- field interviews with stakeholders in the focus countries such as local banks, the European Commission and other agencies with interest in SME development.

The data cut-off for sample selection was the team portfolio report at February 2011. At the cut-off LEF project commitments stood at €161.1 million (including IISF first loss co-financing of €16.2 million). No projects had been disbursed in Romania, Bulgaria or Turkey (although two projects in Turkey had been signed), and only one equity project had been disbursed in Croatia in 2010, which was too early for evaluation at the time of writing.

The focus countries and project sample were selected to satisfy the following criteria:

- a concentration of seasoned, evaluation ready projects
- a mix of higher and lower transition territories, suitable for coverage in a two week field programme
- presence of debt and equity projects and projects with or without IISF support
- a mix of commercially successful and more difficult projects [19]
- a project selection likely to yield insights and lessons.

The project sample yielded 13 projects, which is too small to be statistically representative but is considered by LEF management as broadly typical of LEF interventions.

[19] Note: projects of greatest relationship sensitivity due to ongoing negotiations with the Bank or financial failure were not included in the sample. It is recognised that this presents a positive bias.

Table: Summary analysis of field sample

	Field sample as a percentage by value				Field sample as a percentage by number of operations		
Country	Equity €	Debt €	All €		Equity #	Debt #	All #
Albania	33%	67%	50%		40%	67%	50%
FYR Macedonia	9%	67%	37%		33%	100%	60%
Kosovo	48%	31%	38%		50%	43%	45%
Montenegro		91%	91%			100%	100%
Sample analysis for all LEF countries	18%	31%	26%		28%	42%	36%

Source: LEF team data

	Field sample by value				Field sample by number of operations		
€ millions	Equity €	Debt €	€		Equity #	Debt #	All #
Sample	11.08	30.95	42.1		5	10	15
All LEF	62.6	98.5	161.1		18	24	42

Annex 4: Analysis of field sample results

This table presents a summary assessment for the 13 in-depth projects reviewed, including a field visit. The assessments comprised a desk review of key project records, a site walk around and approximately a half day of meetings with key stakeholders, usually owners or senior management.

The assessments are not of equivalent depth to Operation Evaluations and in some cases operations are still at a relatively early stage for regular *ex post* evaluation. Ratings reflect a simplified "view in the round" against a limited selection of key performance criteria.

Table: Indicative evaluation rating of field sample

Project	Key evaluation criteria					Overall performance at this stage
	Achievement of objectives	Transition impact	Environmental and social impact	Project financial performance	Bank handling	
A	+	+	+	+/-	+	*Partly successful*
B	+/-	+/-	+/-	+/-	+/-	*Partly successful*
C	+	+	+/-	+/-	+	*Partly successful*
D	+	+	+	+	+	*Successful*
E	+	+	+	+	+	*Highly successful*
F	+	+	+	+	+	*Successful*
G	+	+	+/-	+	+	*Successful*
H	+	+	+	+/-	+	*Successful*
I	+	+	+	+	+	*Successful*
J	+	+	+/-	+	+	*Successful*
K	+/-	+	+/-	+	+	*Partly successful*
L	+	+	+/-	+	+	*Successful*
M	+	+	+/-	+	+	*Successful*

Overall Performance Rating: *Highly successful, Successful, Partly successful, Unsuccessful*

+ performance higher than satisfactory at this stage. +/- performance satisfactory, or uncertain at this stage. - performance less than satisfactory at this stage

Annex 5: LEF transition indicators presented in Board documents

Table: LEF transition indicators presented in Board documents

Indicator	Benchmark examples
Competition and market expansion	- *Improvements in product quality, reduction of prices/margins* - *Improvements of supplier contracts (length, payment terms)* - *Stricter environmental and quality requirements on suppliers*
Restructuring (demonstration effect)	- *Specific operational, managerial and financial restructuring changes* - *Introduction of a new, replicable product/technology* - *Improvements in efficiency/productivity indicators*
Setting standards for corporate governance	- *Implementation of key covenants, policies and procedures (e.g. financial, environmental, legal) focusing on introduction of IFRS and MIS; ; elimination of off-shore structures and trading arrangements* - *Agreement on Environmental Action Plan and implementation*

Source: BDS06-011 (Ad1).

Annex 6: Overview of LEF TC activities

Since the establishment of LEF in February 2006, a Technical Cooperation (TC) component was envisaged and funded by Italy (tied funds). A total of €6 million has been pledged by Italy to support LEF TC operations through three TC COM approvals (in 2006, 2007 and 2009).

TC funds were planned to cover the following costs:

- special employees based in the field or in Headquarters (Italian and local staff)
- travel costs for special employees
- advisory services such as legal, technical, financial due diligences, technical assistance and others.

Up to December 2010 the entire TC LEF envelope was committed and partly disbursed as follows: [20]

Table: TC LEF commitments and disbursements

TC LEF	Call-offs & standalone	%	Committed €	%	Disbursed €
Local Staff	17	15.45%	**977,461**	16.16%	552,349
Italian Staff	10	9.09%	**2,562,883**	42.37%	1,640,454
Miscellanea/travel	2	1.82%	405,000	6.70%	172,455
Due Diligences	79	71.82%	**2,092,565**	34.59%	1,272,253
Others	2	1.82%	11,360	0.19%	2,500
TOTAL	110	100.00%	**6,049,269**	100.00%	3,640,012

Thanks to the Special Employees deployed in the country of LEF operations and the advisory services provided by external consultants the Bank mobilised a pipeline of 103 SMEs and 12 PFIs (some already Bank's clients) with whom the possibility of an investment was assessed. In 35 cases the deal was approved by the LEF Investment Committee. Twenty-five cases were in active pipeline in December 2010 and 55 possible operations were cancelled.

Out of a total of €2.09 million of TC funds for external advisory services implemented through 79 TC operations, 69.53 per cent (that is, €1.46 million) were used for successful deals, 7.97 per cent (that is, €0.17 million) for investments in active pipeline, 22.50 per cent (that is, €0.47 million) for investment operations which were eventually cancelled.

Table: TC linked to operations complete, in pipeline or cancelled

TC linked to OP	Call-offs	Committed	Disbursed	Average
complete	54	1,455,052	904,224	26,945
pipeline	8	166,740	20,613	20,843
cancelled	17	470,773	347,416	27,693
TOTAL	79	**2,092,565**	**1,272,253**	25,160

[20] Please note in 2011 some TC funds were de-committed (see LEF Team's figures) and two stand-alone TC operations were funded by WEBF (Western Balkans Fund).

The advisory services provided through the abovementioned 79 TC operations can be divided into the following categories:

Chart 1: TC advisory service type

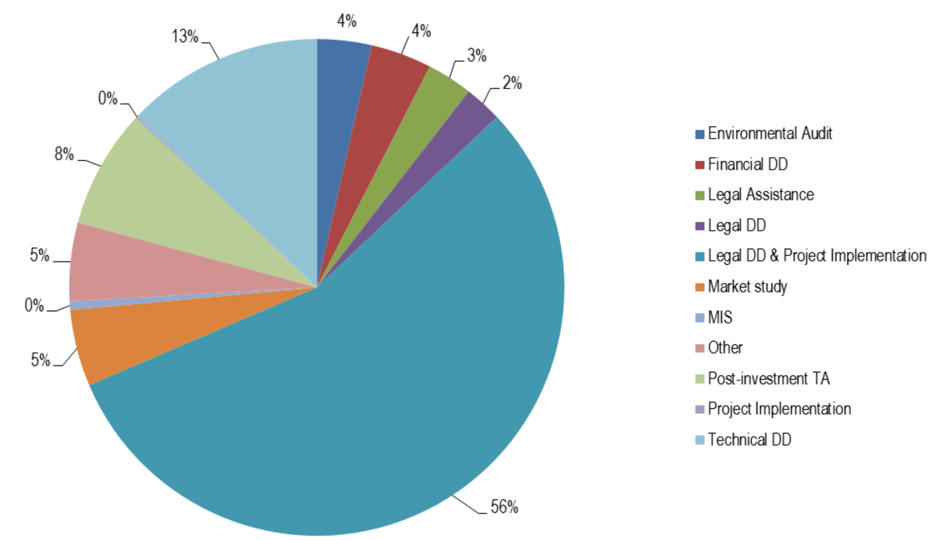
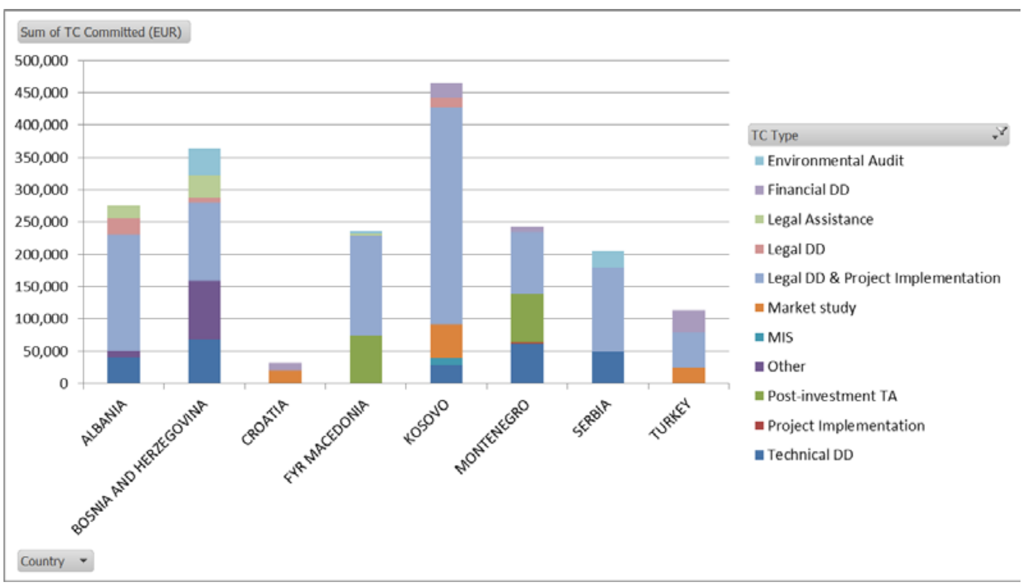


Chart 2: Geographic distribution



Annex 7: Financial scenario and impact of donor funds

It was always envisaged in Board documents that LEF would be able to make a positive return on capital for the Bank. There was no one unified approach to the financial scenarios presented in successive Board documents and IRR estimates have ranged from 7 per cent to 17.3 per cent. In common with other frameworks and follow-on operations, replenishments of LEF have not included a retrospective look at financial scenarios presented in the previous Board document.

In support of this evaluation the LEF team modelled a financial scenario to incorporate:

– a profit and loss statement for LEF from inception to December 2010

– a forward-looking scenario to estimate the implicit internal rate of return required for LEF to break even on all costs to the Bank.

As of December 2010, LEF was running a negative contribution to the Bank of €13.96 million (see Table below). It must be emphasised that this creates an unfairly negative impression for the following reasons:

– The debt portfolio has a significant upfront loading of project costs whereas revenues accrue over the loan life or, in the case of equity, over an uncertain future pattern. The years to 2010 were intensive for upfront pipeline and project development costs.

– The Bank’s provisioning policies are conservative. The figures include nearly €4 million of general provisions (determined as a function of the risk ratings and loan life) and fair value adjustments for embedded derivatives in hybrid debt products. In practice, credit performance has been holding up and is superior to local market comparators where impaired loans are around 20-25 per cent of bank portfolios. One specific provision was created in 2010 for €0.7 million and there have been no new specific provisions since. The Bank’s credit department remain cautious in view of the long average loan life and high average risk rating but the portfolio so far has withstood market challenges and the team anticipates that part of the provisions will eventually be released.

Equity valuation is more challenging. Equity gains and losses fluctuate with fair market values (reflected in unrealised losses of €3.69 million at December 2010) but this includes one investment showing a significant gain of approximately €6 million. Some of the unrealised losses have also been reduced in the latest six-monthly valuation exercise which is not reflected in the December 2010 starting point.

Table: LEF P&L 2005-10

	€m
Debt income	4.18
Equity income	0.15
Operating costs	(6.58)
Unallocated costs	(1.05)
Debt: general provisions and fair value adjustments	(6.97)
Equity: impairments and net unrealised gains (losses)	(3.69)
LEF net P&L contribution 2005-10	(13.96)
Donor funded reimbursement of costs	4.94
Net of TC	(9.02)

Source: EBRD Management Accounting Data

The financial scenario prepared by the team (Table 12) indicates an IRR of 10.9 per cent would be required on the portfolio between 2011 and 2016 to break even net of all costs and before TC contributions.

Table 12: IRR scenario for break-even, six year horizon to 2016

	IRR
Overall portfolio IRR	*10.9%*
Equity only IRR	*9.3%*
Overall portfolio IRR with donor funds	*6.7%*

Source: LEF Team

The required IRR for break-even falls to 6.7 per cent when donor contributions are applied to the profit and loss. To put this in perspective, the IRR on the Bank's Q1 2012 portfolio of unrealised equity investments stood at 6.0 per cent and 7.7 per cent achieved on Q1 2012 exits (before costs). The challenge facing LEF therefore seems within plausible bounds to be met and the conclusion can be drawn that donor funds are fulfilling the purpose intended of covering incremental costs of LEF.

Assumptions for LEF team financial scenario

Debt:

- portfolio at December 2010 frozen and managed until maturity
- net interest income calculated at average margin of 400 basis points (bps)
- portfolio running costs assumed at 0.75 per cent of operating assets
- portfolio impairment assumed at 1 per cent a year on the outstanding exposure.

Equity:

- current portfolio is frozen and managed until maturity
- exits from equity investments scheduled as follows :

  2013 – 15 per cent;

  2014 – 25 per cent;

  2015 – 35 per cent;

  2016 – 25 per cent;

- equity portfolio running costs and equity cost of funds assumed at €0.394 million a year.