

## **Environmental and Social Strategy (ESS)<sup>1</sup>**

### **Mexico Ventures SME Mezzanine Fund**

#### **I. OVERVIEW**

- 1.1 The objective of the Mexico Ventures SME Mezzanine Fund (the “Fund”, the “Borrower”) is to increase small and medium size Mexican companies’ access to finance, specifically mezzanine products, to fund capital needs. The Fund will operate with two parallel investment strategies. The first strategy is to provide direct mezzanine loans in the target range of US\$1 million to US\$9 million (in Mexican pesos equivalent) to companies that have revenues of up to US\$45 million per annum. The second strategy is a fund of funds program by which the Fund invests through equity participations targeting US\$5 million to US\$9 million in funds with mandates similar to the Fund’s.
- 1.2 The Mexico Ventures SME Mezzanine Fund management structure is a joint venture between Fondo de Fondos and Sun Mountain Capital (together the “Fund Manager”). The two companies have worked together since 2010, when NAFIN released a request for proposal for a Mexico focused fund of funds and direct investment manager. The Fund will be the third Mexico-focused fund managed by the joint venture.<sup>2</sup>

#### **II. STATUS AND COMPLIANCE**

- 2.1 Based on Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703), the Fund is classified as a Financial Intermediary and as such this operation is not categorized according to its potential environmental and social impacts and risks. However, given that the Fund’s target investments will likely include large SMEs and possibly Corporate-sized companies, it is expected that some of the individual transactions (i.e. Fund-financed operations) could fall into Category B operations under the IDB’s environmental and social impact classification system. The Fund will exclude Category A operations. Based on the initial information presented, this fund is preliminarily categorized as medium risk (FI-2).

#### **III. ENVIRONMENTAL AND SOCIAL IMPACTS AND RISKS**

- 3.1 **Environmental, Social, Health and Safety and Labor Impacts and Risks.** The Fund will finance a broad cross section of SMEs directly and indirectly through other funds. While the Fund does not have a particular sector focus, it will exclude loans in certain higher risk sectors<sup>3</sup> and ensure that each individual loan does not exceed US\$10 million

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<sup>1</sup> This ESS will be made available to the public in accordance with the Bank’s policy on information disclosure. The ESS does not represent either the Bank’s approval of the Project or verification of the ESS completeness or accuracy. The Bank, as part of its due-diligence on the feasibility of the Project, will assess the environmental and social aspects. This assessment will be presented in the Project Environmental and Social Management Report that will be prepared by the Bank, and will be made available to public prior to consideration of the Project by the Bank’s Board of Executive Directors.

<sup>2</sup> Previous funds include: Mexico Ventures I Fund and the Mexico Ventures I Annex Fund.

<sup>3</sup> Excluded industries include infrastructure, banking, insurance, gambling, real estate, alcohol, tobacco, and weapons.

in financing. Project finance will not be a product offered by the Fund.<sup>4</sup> Currently, a generic exclusion list is applied, and under an IDB loan the Fund would ensure application of the IDB's List of Excluded Activities for Non-Sovereign-Guaranteed (NSG) operations. As a pipeline of operations has not yet been identified, the potential environmental and social impacts of operations cannot be assessed ex-ante. The specific environmental and social impacts and risks will be those related to or caused by each specific investment. These impacts may be diverse and their significance will depend on the transaction characteristics, such as size, sector, and location. Analysis of these impacts and the potential for E&S risk will be further investigated during due diligence with the aim to identify the potential for triggering particular IDB Environment and Safeguard Policies. Additionally, IDB will analyze the potential E&S risks presented under the fund of fund investments, and determine proposed mitigation measures and screens that can be applied to these investments where leverage to address E&S risk is more limited.

- 3.2 **Management of Environmental and Social Aspects.** As with other funds financed by the IDB, Fund Manager staff will have primary responsibility for screening, assessing and managing the environmental and social aspects in a manner that is consistent with the IDB's environmental and social policies, specifically by implementing an appropriate Environmental and Social Management System ("ESMS"). The ESMS for this Fund will require application of the national and local legislation and in some cases IDB Safeguard Policies and Guidelines where higher risk operations are identified. The ESMS will include key elements such as: screening of sub-loans against exclusion criteria, impact categorization of proposed sub-loans according to guidelines agreed with IDB, undertaking of due diligence and monitoring procedures commensurate with the levels of impacts (including with the use of independent external consultants in exceptional cases), the structuring and contracting of sub-loans so that they meet environmental and social requirements, the monitoring of the environmental and social performance of sub-loans and where necessary application of corrective actions, and reporting to IDB on the performance of the ESMS and of the sub-loans. As with other IDB funds, the IDB will monitor the implementation of the ESMS closely. The ESMS will additionally have procedures for indirect fund of fund investments that will also ensure environmental and social analysis is undertaken prior to investing in any fund.
- 3.3 As a general rule for the Fund, the Fund will present the first three operations for review by IDB with the aim to evaluate the effectiveness of the ESMS. Category B operations presenting high risk factors may also undergo in-depth review, possibly by an independent expert and in some cases in conjunction with the IDB. Likewise, monitoring and reporting arrangements will reflect the levels of risk involved in each sub-loan. The IDB will respond to the first three operations in a timely fashion. Each investment will be carefully assessed during the environmental and social review process, which will be conducted by the Fund Manager and/or the Due Diligence consultant for each proposed

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<sup>4</sup> In the event, the Fund does grow to consider the inclusion of larger operations in excess of US\$10 million or to include project finance, the IDB and Fund manager will revisit and revise the application of the ESMS. In such an event, Category A operations would remain excluded, and sub-loans of this size would require IDB review and application of international good practice standards (e.g. IDB Environmental Policies and Guidelines, or IFC Performance Standards).

operation. The ESMS must be fully implemented before the Fund formally considers any transaction.

#### **IV. STRATEGY FOR ENVIRONMENTAL AND SOCIAL DUE DILIGENCE**

- 4.1 The environmental and social due diligence (“ESDD”) for the Fund will focus on agreeing on the key elements of the ESMS with the Fund Manager, the particular approach with regard to fund of fund investments, as well as the fundamental operational aspects of the ESMS in relation to higher risk Category B sub-loans. This will include details on early communication to IDB on the possibility of financing a potential high risk loan to enable the IDB to identify: (i) the need for complementary analysis, and (ii) measures to ensure the legal and technical availability of measures and mechanisms to monitor the implementation of mitigation strategies and to address any non-compliance with IDB policies or unmitigated environmental and social impacts or risks during the execution of relevant Fund investments.
- 4.2 As part of the Fund ESDD, the IDB will (a) identify any particularly sensitive impacts or risks that may be posed by companies expected to be financed by the Fund, including reputation risks; (b) review existing policies and standards established by the Fund Manager and to be applied under this Fund; (c) detail the components of the ESMS at the direct company investments level as well as fund of fund investment level to ensure compliance with IDB Safeguard Policies and Guidelines and assess the resources that may be required to implement the ESMS; (d) work with the Fund to develop eligibility criteria and engagement options for funds, taking into account the composition of their respective portfolios (sector, size, location, etc.) and their investment rules and E&S criteria or processes. (e) determine the contractual and monitoring arrangements between the Fund and the IDB to ensure proper functioning of the ESMS and performance and sustainability of the sub-loans and fund of fund investments the Fund finances; and (f) determine the measures and mechanisms to address any non-compliances with IDB policies or unmitigated environmental and social impacts or risks during the execution of Fund-approved transactions.
- 4.3 The IDB and the Fund Manager will agree on an ESMS for the Fund and any ESG requirement necessary to be applied by the Fund, based on the findings of the ESDD. The results of the due diligence will be presented in an Environmental and Social Management Report (“ESMR”). This will include a description of the key aspects of the ESMS and related contractual requirements, and the identification of the activities and its timeframe that will need to be conducted as part of the initial phase of implementation of the Fund’s management mechanisms, including the ESMS.