EXECUTIVE SUMMARY

PROJECT DESCRIPTION:

For MFIs in Latin America who are transitioning away from concessionary funding, bank financing could be an attractive and appropriate source of funds with which to continue to grow their loan portfolios and to expand the range of financial services offered to micro entrepreneurs. However, many MFIs are organized as NGOs and are not supervised by bank regulators. They tend to have limited or no access to local commercial bank financing due to their riskier credit profile, weak capital structure or unconventional ownership. In addition, most "mainstream" commercial banks do not yet understand the risks involved in micro finance as a business and therefore are still reluctant to undertake direct credit exposure to MFIs. If commercial banks lend at all to MFIs, it is almost always on a collateralized or guaranteed basis.

While some funds do exist in Latin America to guarantee MFI bank debt, most are either small national funds or those that provide guarantees strictly for their own network affiliates. By contrast, LACIF will be a regional credit enhancement fund designed to support the growth of Latin American MFIs who are currently experiencing difficulties in accessing commercial bank loans. LACIF is intended to expand MFIs' access to a wider (commercial) funding base, particularly during what can often be a lengthy transformation phase. LACIF will help these institutions to overcome this hurdle by extending guarantees, direct loans and other credit enhancement products and by offering re-guarantees to local guarantee funds and second tier lending institutions.

LACIF will target four types of institutions:

- Transforming B-level MFIs, defined as those which are dedicated to financial sustainability but currently have limited or no access to commercial funds/capital markets (direct guarantee or loan product)
- Established affiliates of international NGO networks (re-guarantee product)
- Wholesale Latin American lending institutions (re-guarantee product)
- Established A-level MFIs with strong financial performance which already have some access to bank lines of credit but which require credit enhancement to access local capital markets (credit enhancement or direct loan product)

PROJECT OBJECTIVE:

LACIF's specific objectives will be fivefold:

- To assist financially sound MFIs in obtaining local currency funding which

will allow them to continue to grow their loan portfolios during their transformation process

- To familiarize commercial banks with MFI credit risk and encourage them to increase their direct exposure to MFIs
- To leverage Development Finance Institution investment capital with financing from private SRIs
- To support the growth of existing guarantee funds through re-guarantee partnerships
- To "graduate" MFIs to the point that they no longer require guarantees to access commercial bank funding

FOUNDERS GROUP/ MANAGEMENT COMPANY: The six sponsors of LACIF (Founders Group) are well-regarded micro finance practitioners, and bring their proven operating, financial and investment experience in Latin America to this transaction. The Founders Group consists of SCDF, a Washington, DC-based NGO which provides micro finance advisory services, Banco Solidario, an Ecuadorian (micro finance) commercial bank, FUNDAPRO, a Bolivian NGO wholesale micro finance lender, and FUNDES, MEDA and SIDI, three international NGOs active in providing financial services to small and micro entrepreneurs. The Founders Group has been instrumental in supporting the Fund during its preliminary stages and has been operating under a Founders Agreement since September 1997.

The Founders will comprise and own 100% of the Management Company that will manage LACIF. The Management Company will in turn own approximately 36% of LACIF's common shares as a result of both incentive shares and capitalized pre-operating expenses. The Founders Group will be represented on LACIF's Board of Directors by the Management Company's Director (see annexed *curricula vitae*). The Management Company will have a five year contract with LACIF that will be reviewed annually by the Board of Directors.

FUND STRUCTURE: LACIF will be legally incorporated as a limited liability corporation in Panama, a tax-free jurisdiction, and will be headquartered in San Jose, Costa Rica. The Management Company will be structured as a Delaware limited liability corporation and will be 100% owned by the Founders Group. Organizational charts for both LACIF and the Management Company are annexed.

The success of LACIF will hinge on the following fundamental factors:

- diversification of risk
- low loan and guarantee losses
- tight expense control
- sound credit analysis and decision-making

- close and timely monitoring of portfolio
- below-market rate capital structure

As mentioned above, LACIF's financial structure will be a key element in the Fund's success. A below-market cost of funds is necessary in order to provide the guarantees at a reasonable cost to MFI customers and to "jump-start" their relationships with commercial lenders. The Fund's capital structure is expected to consist of several debt and equity instruments, including commercial paper, a short-term multi-currency line from FMO (a Dutch Development Finance Institution), long-term debt, preferred stock and common stock. A list of other potential debt and equity investors and management's best estimates regarding the size and probability of their investments in LACIF is annexed. At closing, the Fund's capital structure is targeted as follows:

INSTRUMENT	TOTAL (USD)	MIF	MC	OTHERS
DEBT				
Multi-Currency Line(FMO)	2,500,000	0	0	2,500,000
5% Subordinated Notes	4,000,000	3,000,000	0	1,000,000
EQUITY				
6% Preferred Stock	1,498,500	599,400	299,700	599,400
Common Stock	1,875	600	675	600
TOTAL CAPITALIZATION	8,000,375	3,600,000	300,375	4,100,000

USAID RE-GUARANTEE ROLE:

The re-guarantee facility from USAID will play a key role in attracting lenders and investors to LACIF. This facility constitutes a critical cushion for the sharing of potential portfolio losses on direct loans and guarantees, providing an extra layer of asset protection for the Fund's equity base and reducing credit and equity risk. USAID will provide LACIF with a USD 3 million five year (renewable) facility under which LACIF may re-guarantee a portion of its direct guarantee and loan portfolio. The USAID facility will be structured with a USD 300 thousand cumulative deductible; any losses up to a maximum of USD 300 thousand must be borne 100% by LACIF. Any subsequent losses up to a USD 6 million maximum would be shared on a 50/50 basis between LACIF and USAID. LACIF will pay 80 basis points p.a. on the utilized amount under the

facility, with a one-time set-up fee of 50 basis points. The MIF will require that LACIF maximize utilization of the USAID re-guarantee facility. The latter was approved by USAID's Credit Committee on July 17, 1998.

PROPOSED MIF FINANCING:

The MIF is proposing a total financing package of USD 4.075 million consisting of USD 115 thousand in Technical Assistance, USD 3.0 million in subordinated debt and USD 600 thousand in Preferred and Common equity Units. The MIF's USD 3.6 million investment represents 45% of the target capital structureat closing. LACIF is currently in the process of raising debt and equity commitments from other Development Finance Institutions. A list of other creditors and investors which are considering investments in LACIF is annexed.

To determine the profitability of this transaction, the project team used management's Base Case projections, and assumed that all debt repayment, dividend payout and share redemption occurred as scheduled. Common shares were expected to be sold at book value. Under this scenario, the weighted average IRR on the debt and equity instruments in which the MIF proposes to invest is 6.81% (see annexed calculation). The MIF views the below-market return as an acceptable trade-off in exchange for being able to assist in "jump-starting" transforming MFIs in accessing commercial sources of funds and building long-term linkages between MFI borrowers and commercial lenders.

PROJECT BENEFITS:

1. Improve transforming MFIs' access to local currency lines of credit, thereby allowing them to continue to expand their financial services to micro entrepreneurs and increasing their interaction with commercial sources of financing.
2. Provide an alternative source of direct local currency lending if local commercial funding is not available.
3. Build local commercial banks' confidence in and understanding of MFIs, with the ultimate goal of increasing the loan to guarantee ratio and "graduating" the MFI from LACIF.
4. Stimulate interest and investment in the micro finance industry from SRIs through the sale of CP to this sizable investing group.

RISKS & ISSUES: *Asset quality and minimization of losses depends upon the ability of LACIF management to monitor/manage credit risk.*

LACIF's credit policies, procedures and methodology have been established and reviewed by LACIF's sponsor group, its Advisory Board members, and some of the most experienced practitioners in the micro finance industry. The monitoring tools proposed by LACIF seem reasonable and prudent, and the MIF's Technical Assistance funds will be used for an Integrated MIS Tracking System which will allow LACIF management to monitor its portfolio on a timely basis. LACIFs asset quality will also be a function of the judgement and decision-making of management and the Credit Committee. While LACIF's staff has not yet been hired, the sponsors are seeking candidates with strong financial/banking backgrounds to ensure thorough credit analysis of prospective borrowers.

The MIF's primary source of repayment is the liquidation of the Fund. The secondary source of repayment is the proceeds from the issuance of SRI CP or commercial debt. Full repayment of debt and equity investments could be jeopardized by LACIF's ability 1) to receive full value at liquidation for its loan and guarantee portfolio, and 2) to raise SRI and/or commercial funds.

LACIF's Board of Directors can decide at any time to liquidate the Fund. Assuming liquidation occurs under normal circumstances (and not a default situation), the probability of full repayment is good. The principal sponsor, SCDF, has experience in attracting SRI capital to below-market investments (USD 10.6 million for DEVCAP, an SRI mutual fund), and is likely to be able to raise sufficient capital to redeem the MIF's debt and equity investments.

LACIF's target market consists of B-level MFIs which have a higher credit/default risk, therefore the business risk of the portfolio will be higher than average. While LACIF will demand collateral from the MFI as security for a loan or guarantee, the work-out costs and recovery value of such collateral are difficult to determine.

Diversification of credit and country risk, prudent credit decision-making and diligent portfolio monitoring will be the keys to handling this risk. Furthermore, losses on direct loans and guarantees above the USD 300 thousand cumulative deductible will be covered on a 50/50 basis by the USAID re-guarantee. Finally, all loan and guarantee agreements will include a cross default clause and LACIF will always demand that its borrowers establish back-up reserves and post collateral.

LACIF sponsors have a low (cash) equity stake in the Fund.

To date, the Founders Group has made considerable pre-operating cash outlays related to the structuring and creation of LACIF; approximately USD 300 thousand of these expenditures are expected to be capitalized as the Founders' contribution to LACIF. While the Founders Group is comprised of leading micro finance organizations, most are NGOs and are not able to invest additional resources in LACIF at this time.

Lower than expected demand for LACIF products or a faster than expected "graduation" to unsecured borrowing would reduce LACIF's profitability considerably.

This Fund is conceived as being as a temporary solution to what is hopefully a temporary problem; therefore, LACIF is designed to have a limited life. Indeed, lower demand for guarantees could be considered a measure of the industry's success, in that this would mean MFIs were able to borrow from commercial sources on the basis of their own creditworthiness, with no need for external credit enhancement. Unfortunately, the market demand researched by LACIF's sponsors and corroborated by other industry practitioners and the project team indicates that most B-level MFIs are still not able to tap commercial lenders directly. If lower than projected demand were to be experienced, LACIF's Board of Directors could at any time decide to wind down the Fund, which could be expected to take 12-24 months.

The leverage achieved on LACIF collateral funds depends upon local commercial banks' willingness to assume direct, unsecured MFI risk and LACIF's ability to replace the more costly SBLC bank guarantee structure in later years with commercial re-insurance.

It is not possible to <u>force</u> a commercial bank to assume direct MFI risk; the bank must receive an appropriate risk premium and must become comfortable with the MFI's credit risk over time. This assumes the MFI's financial performance is sufficiently healthy and fits the local bank's creditworthiness criteria and that the MFI is willing/able to pay market rates for its credit risk.

If LACIF is unable to replace the SBLC bank guarantee structure with less costly commercial re-insurance, the portfolio's growth will be considerably limited and profitability reduced since the leverage expected with commercial re-insurance is higher than that expected from the bank SBLC structure.

The returns the MIF will receive on its investment in LACIF are below-market.

LACIF's below-market cost of funds is critical to providing the guarantee structure at a reasonable cost to the MFI borrower. The MIF views the below-market returns as an acceptable trade-off in exchange for being able to assist in "jump-starting" transforming MFIs in accessing commercial sources of funds and building long-term linkages between MFI borrowers and commercial lenders.

LACIF's ability to maintain a lean operating cost structure and to improve the operating expense/ average portfolio ratio is fundamental to the profitability of the Fund.

LACIF's projected operating costs appear reasonable, and the proposed staff size appears appropriate in relation to industry benchmarks. Productivity improvements will hinge upon 1) increasing the number of clients/employee, the number of renewals and average transaction size, 2) keeping workouts and losses to a minimum, 3) using commercial re-insurance to replace bank guarantees in the Fund's later years.