INVESTMENT FUND FOR SMALL BUSINESSES IN THE ENVIRONMENTAL SECTOR

(TC-97-07-37-6)

EXECUTIVE SUMMARY

EXECUTING AGENCY:	North American Environmental Fund (NAEF)	
FINANCING:	Modality:	Capital
	IDB/MIF (parallel fund):	US$4,000,000
	Counterpart:	
	NAFIN:	US$2,000,000
	OECF:	US$2,000,000

ENVIRONMENTAL CLASSIFICATION: The CESI approved the operation at its meeting on October 10, 1997.

OBJECTIVES: The purpose of the project is to support the development of small Mexican firms, particularly new businesses, in the environmental sector. The specific objective is to expand the financial capacity of the Risk Capital Fund of the North American Environmental Fund (NAEF) established in 1993 to finance companies in the environmental market. The IDB/MIF will seek to have greater emphasis placed on investment in small and/or new companies. The project's contribution resides in the fact that fresh resources received by the Fund in the form of IDB/MIF financing and local counterpart funding will be fully invested in small companies meeting the investment criteria indicated herein, based on the principles of profitable investment.

DESCRIPTION: The project provides for the investment of IDB/MIF resources through an administration fund (hereinafter called the "Fund") established in a financial institution of recognized standing. The NAEF will be responsible for administering this fund. Investments made by the NAEF using IDB/MIF resources must be accompanied by an additional investment from the NAEF to be contributed for these purposes by the OECF and NAFIN (hereinafter called the "Counterpart Resources") in an amount equivalent to at least the amount of the IDB/MIF investment. The Fund's operational management, investment decisions and the follow-up on these decisions will be the responsibility of Ventana Global, Administrator of the NAEF Capital Fund, taking advantage of its organizational and operational configuration and experience to date, in accordance with the guidelines

established in the investment policy (paragraphs 2.9 to 2.13). The fund will have a term of eight years, as does NAEF.

The average investment made by the Fund, using NAEF resources, will be US$1 million, with the maximum amount of an investment not exceeding US$1.5 million. Investments in existing companies will be restricted to companies with sales of less than US$3 million.

In addition to showing economic potential and future profitability, the investment projects selected must meet the following criteria: (i) have received a Uniform Environmental License; (ii) carry out productive activities having a positive environmental impact; (iii) include in their design ways of mitigating or reducing negative effects; and (iv) be enterprises with whose main line of business is in the area of solid waste treatment, particularly hazardous wastes, water treatment, pollution control, soil recovery, recycling, and renewable energy.

The Administrator will sit on the Board of Directors of the companies in which the Fund invests and will negotiate a firm agreement with these companies regarding the business plan, the exit mechanism, and a clause reflecting the mandatory nature of the environmental monitoring and worker safety, before carrying out the investment (paragraph 2.12). The Fund will try to divest itself through a public offering, although depending on the situation it may propose other mechanisms such as a sale to strategic buyers, the enforcement of contractual safeguards, options to buy or sell, etc. The Administrator must determine whether it is feasible for Fund shares to be traded on the medium-sized business market.

The Administrator will make every effort to divest itself of an investment by its eighth year, and to reimburse the IDB/MIF in cash from the proceeds of the sale of the investment.

The payment structure for fund administration is in line with market standards. The Administrator will receive a fixed annual fee equivalent to 2.5% of the Fund's total committed capital to cover administrative expenses, payable on a semiannual basis in advance and will also receive as a success fee a share of the earnings as an incentive for good management. To this end, the Administrator will receive a 20% share of the capital gains if at distribution a market evaluation of the portfolio should show that the value of the Fund exceeds its

initial value after replenishment of any losses. The remaining 80% shall be distributed between the IDB/MIF and NAEF in proportion to their share in the investment.

ROLE OF MIF: Through its participation, the IDB/MIF will play a major role in: (i) raising a total of US$8 billion dollars in capital for private investment in areas of technological risk and small companies, in which entrepreneurs are still reluctant to invest on their own; and (ii) environmental protection and assessment. The IDB/MIF requirements are even more stringent than those established by the NAEF, a factor that will convert NAEF into a model for environmental project management in Mexico.

RISKS: The main risks identified with this operation are:

a. Devaluation. The Fund will invest in local currency and in the event of devaluation, the value of an investment could decline. However, as noted in the past, this risk is minimized by the fact that the Fund invests for the long term.

b. Divestment. The investments will be made in small companies with little liquidity that will need to grow in order to reach a size that is suitable for trading on the stock exchange, or even in the secondary market. Before an investment is made, a strategy and a business plan will be worked out with the principal partner, with an eye to eventually launching a public offering and alternative exit mechanisms will be established.

c. New small projects. Investment risks in new projects are higher than investments in established companies. These risks will be minimized by the Fund Administrator's direct participation in the companies, and by careful analysis of the business plan and careful monitoring of its performance. When the Fund participates in an entirely new project, it will do so only with an experienced investor or partner, with proven technology and sufficient funds to meet contingencies.

d. Sector. The Fund will concentrate on investments within a single sector; this could minimize some benefits associated with portfolio diversification by sector. However, it is felt that there is sufficient diversification within the sector to minimize this risk. The risks

associated with environmental sector compliance with governmental environmental regulations is minimal, considering how far along Mexico is in this area and the sector's increasing importance. Consequently, no changes are anticipated in the commitment of the government and the industrial sector.

SPECIAL CONDITIONS: The following conditions must be met prior to the first disbursement:

a. Demonstrate that OECF and NAFIN are committed to disbursing the counterpart funds to NAEF;

b. Have reached agreement with IDB/MIF on a procedure for submitting periodic reports;

c. Have designated the Fund's external public auditors.

d. Have obtained a legal opinion regarding the validity and enforceability of the Management Contract, and all permits or authorizations obtained to operate in accordance with the objectives set forth in the Contract.

e. Have proposed and agreed on environmental criteria with IDB/MIF.

f. Have opened a bank account in which disbursements will be deposited.