MULTILATERAL INVESTMENT FUND
EQUITY INVESTMENT PROFILE

I. BASIC PROJECT DATA

Project title:	Central American Renewable Energy and Cleaner Production Facility (CAREC)	
Project number:	RG-M1002	
Country:	Regional (Central America)	
Beneficiaries:	Small and medium enterprises utilizing renewable energy technologies or employing cleaner production measures	
Project team:	Daniel Shepherd (MIF), Team Leader; Susana Garcia-Robles (MIF)	
Facility manager:	E&Co-LAC	
Financing plan:	MIF: Facility III-B:	US$ 5,000,000
	Other Facility investors:	US$15,000,000
	Facility Total:	US$20,000,000
	MIF: Facility III-A:	US$ 500,000
	Other grant contributors:	US$ 500,000
	Grant facility total:	US$1,000,000
Tentative dates:	CRG – March 2004	
	Donors Committee – April 2004	
MIF Classification:	Ecoefficiency Cluster	

II. BACKGROUND AND PROBLEM STATEMENT

A. Cleaner production and financing opportunities

2.1 Faced with this urgent need for improved competitiveness for industry combined with a growing concern for environmental degradation, more and more companies throughout the world have begun adopting cleaner production techniques in their quest to improve their competitiveness through increased ecoefficiency. Financing in cleaner production (CP) has attractive economic benefits due to a reduction of input costs for materials, energy and water and reduced expenditures on waste treatment and disposal. Payback periods can often times be relatively short. Nevertheless, small and medium enterprises have a particularly difficult time financing CP measures for reasons that range from the cost of capital to the absence of appropriate financing mechanisms.

2.2 While some organizations in the region have undertaken efforts to create access to financing for SMEs interested in implementing CP, there still remains a dearth of available financing for this area. More often than not, SMEs interested in financing for CP are unable to secure traditional sources of financing. Access to financing in CP has been hampered by a number of issues: (i) small size of their operations; (ii) small transaction sizes; (iii) short timeframes of the loans (generally financing is needed for one to three years in time); (iv) lack of credit history and collateral; (v) limited experience and lack of familiarity of traditional lenders with providing financing related to CP/environmental management; (vi) perception of these activities as high risk investment; (vii) perception by financial institutions that financing for CP is not lucrative; (viii) lack of managerial capability and entrepreneurial expertise on the part of borrowers in the region; and (ix) lack of interest by lenders in environmental conservation and social sustainability.

B. Opportunities for renewable energy power generation

2.3 The Central American region currently has an installed capacity of 7,400 MW and an annual electric generation of 28,033 GWh. Demand has been growing over the last 10 years at annual rates of more than 7%. Continued growth in demand during the next 10 years will require the installation of at least 5,500 MW. E&Co-LAC projects that at least 50% of such installed capacity should come from renewable energy sources, meaning some 2,750 MW to be installed over the next decade. Thus, at an average cost of US$1,000,000 per installed MW, the region will demand approximately US$2.75 billion over the next decade. Assuming a financial structure of 35% equity and 65% debt, approximately US$1.79 billion in debt along with roughly US$960 million in equity funds will be required. Based on current expansion plans as well as investment trends in the region, it is expected that around 62% of that capacity will likely be fossil fuel based, with the remaining being renewable (mostly hydro and geothermal). This represents a tremendous investment opportunity for clean energy financing vehicles.

C. Problem with existing sources of financing

2.4 In spite of the experience that Central America and many local entrepreneurs have in renewable energy projects, cleaner production and energy efficiency, it remains challenging for them to access adequate and appropriate financing for such efforts within the local financial markets. In the case of cleaner production, MIF recently commissioned a study focused on financing for cleaner production, which identified several obstacles including the lack of familiarity of companies with how to deal with financial institutions and present bankable proposals. The same study also identified that financial institutions often lack a technical understanding of this type of financing as an important barrier. Moreover, entrepreneurs are confronted by a distinct mismatch between the needs of the projects and the conventional financial sector products including such issues as terms of loans and collateral requirements. Light manufacturing, hotels, dairy and meatpacking companies are typically the ones most interested in cleaner production financing in the Central American region. Financing for cleaner production often entails additional costs beyond equipment associated with technical expertise to identify the necessary technology, adapt the machinery to the needs of the company and to train employees in its proper use. All of these “service” costs come at high price, which conventional banks have been reluctant to finance as they are erroneously viewed as “pre-investment.” CABEI offers a line of credit for environmental related investments, but these has not been used yet, as it still must be channeled through commercial banks, which confront the problems mentioned above.

2.5 After almost ten years supporting modern energy entrepreneurs in the Central American region, E&Co-LAC has developed a network of entrepreneurs and projects, but its more significant accomplishment has been its acquired knowledge as to the financing gaps that stall the implementation of clean energy projects and in devising approaches that can bridge these gaps. Direct consultations with, and investment in, small and medium-size clean energy projects, have uncovered the fact that an innovative financing mechanism is needed for this sector. More specifically, entrepreneurs demand and require assistance in the form of targeted, proven support services and opportune seed and growth capital, structured in a manner that is appropriate for the particular project, rather than a “one-size fits all” approach. In other words, the terms and details of cleaner production and renewable energy financing vary tremendously across different companies, making it more cumbersome for financial institutions to undertake their analysis because of the heterogeneous nature of the deals, which results in decreased interest, despite the fact that financially they be worthwhile.

2.6 FENERCA (Financiamiento de Empresas de Energía Renovable en América Central) is a program of USAID initiated in April 2000 and being implemented by E&Co in association with the Biomass Users Network of Central America (BUN-CA) that seeks to increase the use of renewable energy in five countries in Central America including Guatemala, El Salvador, Nicaragua, Honduras and

Panama. FENERCA offers assistance in project and business structuring and includes direct investment as loans through E&Co in the initial development steps of selected projects. FENERCA has completed more than 20 training sessions in financial engineering, development of business plans and financing of renewable energy projects. Through these training sessions, more than 170 businessmen, NGOs and government representatives along with 60 financial institutions have benefited. In summary, FENERCA serves as a useful instrument for pipeline development for projects needing additional financing, thus laying the foundation for a financing vehicle to enter the market.

2.7 The establishment of a long-term, clean energy exclusive, mezzanine-type facility for Central American SMEs will be innovative and fill an important, though difficult gap in the marketplace. The combination of investment resources combined with enterprise development assistance services adds value and will strengthen the investee companies, improving the profitability and overall performance of the Facility. MIF's participation is crucial for this financing Facility to become operational and in ensuring that it targets small and medium enterprises. Such an initiative would be innovative for the MIF in that it is seeking to use alternative financing instruments to assist SMEs in the region.

2.8 MIF is supporting several initiatives in Central America to promote the use of cleaner production and environmental management. These include: El Salvador: Promotion of Cleaner Production Processes (ATN-MH-7007-ES), Environmental Management Instruments and Partnership with Industry for Clean Production (ATN/MH-7257-PN & ATN/MH-7258-PN), Costa Rica: Cleaner Production in the Business Sector (ATN/MT-8429-CR & ATN/ME-8430-CR) and Nicaragua: Adopting Cleaner Production Methods to Enhance Competitiveness (ATN/ME-8427-NI) This proposed Facility would complement these other efforts by offering a financial facility to those companies interested in undertaking further cleaner production measures to improve their competitiveness.

III. PROGRAM OBJECTIVE AND DESCRIPTION

A. Objectives

3.1 The general objective of the project is to promote the use of renewable energy technologies for power generation and to improve the use of energy and other inputs for companies' operations in Central America. The purpose of the project is to provide financial support to a mezzanine financing facility that targets renewable energy, energy efficiency and cleaner production related deals in Central America.

B. Description of the Mezzanine Financing Facility

3.2 Central American Renewable Energy and Cleaner Production Facility ("the Facility") will seek to identify 25-30 small and medium-sized enterprises (SMEs), with annual revenues of up to US$5 million and less than 100 employees in the Central American region with strong management teams that can benefit from the capital and financial expertise to be provided by the Facility. This Facility will focus on SMEs that employ renewable energy technologies for on-grid power generation and technology to further efficiency in industrial and commercial processes. More specifically, the Facility will engage in mezzanine financing, a specialized form of investing which seeks to achieve mid- and long-term capital appreciation through debt and quasi-equity instruments in private sector companies.

3.3 Eligible sectors include renewable energy grid-connected SMEs utilizing technologies such as hydro, biomass, wind, geothermal and alternative cogeneration schemes. The initial pipeline includes 28 possible hydro deals, three wind and three biomass. The Facility can also invest in SMEs employing energy efficiency and cleaner production improvements. As stated above, the Facility will

principally be a debt instrument; though can also utilize other quasi-equity instruments to allow for upside potential on certain deals.

C. Description of grant facility

3.4 The Facility will also administer a grant support program that will, where needed, be used to provide technical assistance to eligible companies, which operate within the Facility's criteria. This grant facility will operate on a matching grant basis with resources from the benefiting enterprise or from third-party sources. It should be noted that these grant resources are not restricted to particular firms for which the Facility will necessarily provide debt financing. Rather, these resources will be used to improve the likelihood of the company finding financing in general, but without an obligation on their part to seek capital from the Facility per se, nor on the Facility's part to provide financing, where possible, these grants will be structured to recover amounts disbursed as well as the direct costs of providing technical assistance and intermediary services, with the goal of being repaid if and when the projects receive financing. In addition, resources from this grant facility will be used to undertake periodic evaluations of the Facility.

C. Financing Guidelines

3.5 Facility transactions will comply with the following basic criteria:

(i) The Facility will invest mainly through mezzanine-type financing instruments, with pre-agreed repayment schedules, where applicable.
(ii) The Facility will seek to invest in projects structured as contract-based cash flows such as energy performance contracts (EPCs) and power purchase agreements (PPA).
(iii) Investees' compliance with national environmental and labor laws, regulations and standards consistent with the general objectives of the MIF's environmental and social guidelines.
(iv) Be structured under appropriate market pricing schemes, related to the scope of the Facility.

IV. COST, FINANCING AND EXECUTION TIME

4.1 MIF will be committed to up to the lesser of US$5 million in capital or no more than 50% of the Facility's aggregate capital commitments, assuming a minimum of at least US$10 million total. The Facility is expected to have a total capitalization of US$20 million. As the anchor investor, the MIF will have a key role in structuring the Facility in accordance with Bank environmental and sustainable development objectives, and its investment will offer other donors confidence in the Facility's implementation. Even though the MIF will have a large stake in the Facility, its exposure to any one project will be much less, considering that the Facility will always invest jointly with Sponsor and local complementary financing. The Facility will be an efficient way to channel MIF resources to an innovative and growing target market, while also raising co-investment capital from other private and public investors.

4.2 MIF will commit US$500,000 to the grant facility, which will be structured on a matching grant basis (see paragraph 3.4).

4.3 The Facility is expected to have a ten-year life, with the possibility of two one-year extensions. The investment period will be four years from the date of the first close. Based on initial estimates, the Facility is expected to have a return to investors of between 11% and 13%.

V. EXECUTING AGENCY AND FACILITY STRUCTURE

5.1 The Facility will be managed by an affiliate of E&Co-LAC ("Facility Manager"). The Facility Manager will study, analyze projects it considers adequate, control and supervise the investment portfolio and divest at the appropriate time. The Facility Manager's experience dealing with financing in the energy sector will offer the Facility's investors its independence and quality

assurance, as well as its knowledge of new products, technology and/or services; identifying companies and innovative activities; and its relationship with entities in each of the countries provides assurances in terms of dealflow. The Facility Manager will also be responsible for managing the grant facility, which will include, providing mentoring support to SMEs in receipt of start-up and growth capital with securing additional investment in partnership with other FIs that may fall outside the scope of this Facility. The Facility Manager will be paid an annual fee based on a budget to be approved annually by the investors but not to exceed 2.5% annually.

5.2 The Facility will have an Investment Committee and a Board of Directors. MIF will have a representative on both the Investment Committee and the Board of Directors. The Investment Committee will function through a two-stage decision-making process. It will give its initial approval on a particular deal in an early stage in the investment cycle, thus permitting the Facility Manager to proceed with a more in-depth due diligence process, culminating in the development of a detailed investment memorandum that would be submitted to the Investment Committee for final approval.

5.3 The MIF hired E&Co-LAC as fund manager of one of its first environmental funds, the E&Co-LAC Fund, approved in 1996 by the MIF's Donors Committee, and from which the MIF will exit in September 2004. From 1996 to 1999 the MIF was not satisfied with the fund manager's performance. In 1999 the MIF requested several changes in the way the fund was being managed, and as a consequence, a new fund manager was hired by E&Co to run the fund. Since then, the fund has drastically improved, and a recent independent evaluation performed in January 2003 highlighted the difference between the deals done prior 1999 and after 1999. The MIF had set an expected IRR of 3% and at this point it looks that those expectations will be met and perhaps surpassed. One lesson drawn from this fund is that the use of equity in these projects is too risky, while debt or quasi-equity instruments are more manageable.

VI. ENVIRONMENTAL AND SOCIAL IMPACTS AND PROPOSED ACTIONS

6.1 Given the nature of the proposed Facility, negative environmental impacts are not expected. It is the expectation that this Facility will be focused on investments that will result in environmental benefits, through the use of cleaner technologies, which in and of themselves should result in beneficial or at least negligible adverse environmental impact. Moreover, SMEs assisted by the Facility will modern and clean energy services, increasing the energy supply with renewable technologies or assisting other companies to improve their use of materials and energy efficiency. By contributing to the implementation of approximately 120 MW of clean energy, the Facility would contribute to job creation, the development of economic activity and the offset of approximately 5.5 million tons of greenhouse gas emissions over the next decade.

6.2 The Facility Manager will be expected to conduct the operations and investments of the Facility in accordance to the MIF Environmental and Social Guidelines. Moreover, as part of fulfilling the requirements of these guidelines, the Facility Manager will be expected to participate in a MIF/IDB-approved training course on environmental and social review for financial intermediaries, and elaborate a manual for the Facility, for every officer of the Facility to be acquainted with when performing the due diligence in potential investee companies.

VII. MAJOR ISSUES

7.1 The following aspects warrant further consideration during the design and preparation of this proposed project:

(i) the institutional capacity of E&Co to function as Facility Manager. Related to this issue, MIF would seek a strong key man clause for the current fund manager to be the main officer for this Facility;

(ii) coordination or possible strategic alliances with other in-country organizations that can assist with pipeline development (e.g. Association of Renewable Energy Producers, CP Centers, industry associations, etc.);

(iii) assessment of existing pipeline of projects in Central America developed through the USAID-sponsored FENERCA program ;

(iv) assessment of the proposed longevity of the Facility to make certain that it is realistic based on the nature of the expected investments;

(v) assessment and negotiation of the Facility management fee to ensure that it is a correct reflection of the workload associated with such a Facility;

(vi) the establishment of sector and country limitations in terms of the overall Facility portfolio.

VIII. ACTION PLAN

8.1 If the project is determined eligible by the POC, the project team would continue forward with the full institutional and financial due diligence of the proposed Facility, which is expected to take at least four months followed by submission to the MIF Donor Committee for approval.