

I. Basic Project Data

<u>Title:</u>	Solidus – Mezzanine Fund For Micro Finance Institutions																																									
<u>Country:</u>	Regional																																									
<u>Project Number:</u>	TC0306012																																									
<u>Beneficiaries:</u>	(i) Financial intermediaries and companies providing financial services to the small and micro enterprise sector in Latin America and the Caribbean (LAC), and (ii) the small and micro enterprises in LAC, clients of the financial intermediaries.																																									
<u>Executing Agency:</u>	Cyrano Management, S.A.																																									
<u>Estimated Costs and Financing:</u>	<table><tr><td>MIF</td><td>US \$ 4,000,000</td><td>(20.7%)</td></tr><tr><td>Desjardins*</td><td>US \$ 500,000</td><td>(2.6%)</td></tr><tr><td>Finnfund</td><td>US \$ 2,000,000</td><td>(10.4%)</td></tr><tr><td>Norfund</td><td>US \$ 2,000,000</td><td>(10.4%)</td></tr><tr><td>Novib</td><td>US \$ 500,000</td><td>(2.6%)</td></tr><tr><td>Cordaid*</td><td>US \$ 100,000</td><td>(0.5%)</td></tr><tr><td>Idealista*</td><td>US \$ 100,000</td><td>(0.5%)</td></tr><tr><td>IFC</td><td>US \$ 4,000,000</td><td>(20.7%)</td></tr><tr><td>KfW</td><td>US \$ 2,000,000</td><td>(10.4%)</td></tr><tr><td>BIO</td><td>US \$ 4,000,000</td><td>(20.7%)</td></tr><tr><td>Cyrano Management*</td><td>US \$ 100,000</td><td>(0.5%)</td></tr><tr><td>TOTAL</td><td>US \$ 19,300,000</td><td></td></tr><tr><td colspan="3">* Private investors</td></tr></table>			MIF	US \$ 4,000,000	(20.7%)	Desjardins*	US \$ 500,000	(2.6%)	Finnfund	US \$ 2,000,000	(10.4%)	Norfund	US \$ 2,000,000	(10.4%)	Novib	US \$ 500,000	(2.6%)	Cordaid*	US \$ 100,000	(0.5%)	Idealista*	US \$ 100,000	(0.5%)	IFC	US \$ 4,000,000	(20.7%)	KfW	US \$ 2,000,000	(10.4%)	BIO	US \$ 4,000,000	(20.7%)	Cyrano Management*	US \$ 100,000	(0.5%)	TOTAL	US \$ 19,300,000		* Private investors		
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<u>Date of Project Request:</u>	May, 2003																																									

II. Background and Justification

- 2.1 The microfinance industry has made significant progress over the last decade in Latin America. Even during 2001 when many economies in LAC experienced economic downturn, the 29 Latin American Micro Finance Institutions (MFIs) tracked by Micro Rate (the “MicroRate 29”) expanded their loan portfolios by nearly \$100 million, achieving 23% portfolio growth from the previous year. Furthermore, all but four of the MicroRate 29 were profitable in 2001, indicating that, as an industry, MFIs can maintain profitability despite the recession and banking crises in the region.

- 2.2 MIF has invested in microfinance directly to MFIs and indirectly through specialized investment funds. MIF has been a catalyst and an important investor for funds specialized in MFIs and has invested in four such specialized funds: ProFund, Latin American Challenge Investment Fund (LA-CIF), Accion Inversiones in Microfinance (AIM), and Gateway MIF-Trust. MIF investments have played an important role in promoting the progress of MIF industry in LAC towards commercial sustainability through formalization. MIF's microfinance portfolio has been satisfactory so far without any defaults. MIF exited from earlier investments and realized \$10.7 million from its original investments of \$6.5 million to three MFIs.
- 2.3 Despite the growth of the sector, an IDB study shows that on average only 2.6% of Latin American small and micro enterprises have access to loans from MFIs. Further assistance from MIF/IDB to the sector is necessary to improve the access to credits for small and micro enterprises in the region. Solidus will not only help MFIs reach more clients, but it will also promote further formalization of the MFI industry through its long-term equity and debt investments.
- 2.4 The microfinance industry is changing its shape in LAC. In the early developmental stage of the sector, the industry was dominated by non-governmental organizations (NGOs). Most MFIs started out as NGOs with a social mission. Because of its success, it is now rapidly evolving into a sub sector for the financial service industry. Each year more MFIs are becoming a regulated financial institution and their loan portfolios continue to grow. Some MFIs are more profitable than some world-class financial institutions.
- 2.5 The growth of MFIs in LAC leads to the problem of capitalization. As a sector, MFIs operate with much lower level of leverage than a typical commercial bank. Without further capitalization, many MFIs will find it difficult to extend more loans to small and micro businesses and sustain the growth trend of the portfolio. Many non-regulated microfinance NGOs operate with a debt to equity ratio of 1:1. Regulated MFIs can leverage their capital to some extent; however, due to the low level of collateral values MFIs have, the leverage is limited to on average 4.5 times of the equity among regulated MFIs of the MicroRate 29. Regulated MFIs also need growth capital to expand their activities.
- 2.6 For the majority of MFIs, it is still difficult to attract commercial equity funding due to the perceived high risk for the sector, the small size of the investment, and the lack of exit opportunities. Solidus will help address the need for capitalization of MFIs through investments in long-term equity. Mezzanine financing is considered the most appropriate instrument for the capitalization of MFIs, given the absence of interest in subscribing shares of MFIs by the private sector.
- 2.7 Another trend in the industry is the clear shift away from the subsidized donor funding and towards commercial funding. By the end of 2001, ten of the

MicroRate 29 had no subsidized funding at all, and another nine had an immaterial amount (less than 5 percent). Most profitable MFI under the MicroRate 29 had no concessional funding and another five highly profitable MFIs had very small concessional funding. It is evident that the subsidies from the donor played a role in helping new MFIs get their start, but continued subsidies from the donors worked as a disincentive for MFIs to reduce costs and become efficient, and delayed the transition to regulated MFIs. LA-CIF, the existing fund managed by Cyrano Management, has charged market-based rates for MFIs according to the country and MFI credit risks, and the proposed Solidus Mezzanine Fund will also price investments according to market risk principles.

- 2.8 The Project has incorporated lessons learned from the previous MIF investments in funds for MFIs. MIF has invested \$3 million common equity in Profund in 1994. Profund has been very successful in contributing to the development of MFIs with its equity investments in 11 major MFIs in LAC. A consolidated portfolio of its investee MFIs totals \$351 million, covering 352,000 clients. Profund is in the process of divesting its investments; however, the market for the shares of MFIs are thin. The microfinance industry is still not yet attractive for private sector equity investments due to its perceived high risks and lack of exit opportunities.
- 2.9 MIF's investment in Solidus will be mainly in preferred shares. Solidus, in turn, will provide mezzanine financing to MFIs and will not subscribe common shares of MFIs. A mandatory redemption of Solidus shares will take place upon termination of its investment period. MIF's investment in Solidus, therefore, has a lower exit risk due to the self-liquidating nature of the operation.

III. Project Beneficiaries

- 3.1 Solidus will invest in up to 15 MFIs, which meet the investment criteria. Investee MFIs of Solidus include (a) regulated MFIs, which need growth capital for further expansion of its loan portfolio, and (b) unregulated MFIs, which require additional capital for transition to regulated MFIs.
- 3.2 The clients of MFIs are small and micro enterprises with less than 10 employees. The expected average loan size of MFIs to its client will be around \$1,000. These clients usually do not have access to formal credits offered by commercial banks. MFIs will leverage the capital invested by Solidus to reach more clients. The Project will also contribute to the growth of the economy in the region through expansion and improvements on the small and micro enterprise sector, which is the major sector for many economies in LAC.

IV. Project Objectives, Components, and Activities

A. Objectives

- 4.1 Solidus has been established with the main objective of providing long-term mezzanine financing and loans to help capitalization of MFIs in LAC. Another important objective of Solidus is to attract investors who are willing to provide long-term investment in MFIs, in particular from the private sector. In doing so, Solidus is proposed to offer 6% annual dividend to its preferred shareholders. By helping the capitalization of MFIs, Solidus will help assist the transition of MFIs toward formal financial institutions or larger financial institutions.
- 4.2 As Solidus will make its mezzanine financing based on commercial principles, it will help improve the efficiency of the MFI industry. Since Solidus will concentrate on making long-term investments, it will not compete with LA-CIF whose main financial product is a short-term loan.

B. Components

- 4.3 Solidus will offer investors equity units at a price of \$1,000 per unit. Each equity unit will consist of (i) one common share with par value of \$1.00, and (ii) nine hundred ninety nine cumulative redeemable preferred shares with a par value of \$1.00. An annual preferred dividend of 6% will be paid to Solidus preferred shares. Mandatory redemption will occur for both common and preferred shares upon termination of an investment period.
- 4.4 MIF will invest up to \$4 million with a purchase of up to 4,000 equity units of Solidus. If fully invested, MIF will have \$4,000 worth of common shares and \$3,996,000 worth of preferred shares of Solidus. Private investors of Solidus include Desjardins (Canada), Cordaid (the Netherlands), and Idealista (Spain). Other investors include MIF's co-investors for LA-CIF such as Finnfund and Norfund. Solidus will be participated by new investors such as KfW, BIO, and IFC.

C. Investment Strategy

- 4.5 Solidus will provide mezzanine financing, such as income loan participations, convertible preferred securities, and convertible subordinated debt loans, to MFIs in LAC. Solidus's investment strategy for mezzanine financing can be summarized as follows:
 - a) Solidus will seek investment opportunities in MFIs, which have maximized their senior debt funding, but continue to seek additional sources of growth capital.

- b) Solidus will evaluate the MFIs' cash flow generation and their ability to withstand performance downturns without adversely affecting their capacity to make payments on sub-debt investments.
 - c) Solidus will structure the sub-debt investment to have an "equity component". The "equity component" will be structured either as convertible preferred, income loans participation or quasi-equity investments. If a convertible structure is employed, the conversion ratio would likely be a contingent upon the pre-determined level of book value per equity share.
 - d) The typical Solidus mezzanine financing will have a term of 5-6 years (renewable) and has a fixed interest rate of between 8% and 15%. Interest rates will be determined as a function of country risk, MFI credit risk, local interest rates, international interest rates, maturity, and investment structure.
- 4.6 Solidus will also provide long-term debt to MFIs, which have good portfolio quality and management but with a low level of net income generation. These MFIs are not suitable for mezzanine financing. The terms and conditions for the long-term loans of Solidus are similar to its quasi-equity investments without any equity component.

V. Project Cost, Financing and Execution Time

A. Capital Commitments

- 5.1 A total authorized share capital of Solidus is \$22.3 million. The initial financial closure will require a total commitment of at least \$6 million. The initial commitment of MIF will be \$1.5 million, 25% of the first financial closing. It is currently estimated that a total proposed \$4 million investment by MIF would represent 20.7% of expected \$19.3 million total capitalization. Cyrano Management is proposing to provide \$100,000 investment in the fund.

B. Investment Period

- 5.2 The investment period is proposed to be 10 years. Proceeds from investments and interest income will be reinvested after paying all the expenses as well as the proposed preferred dividend of 6%.

C. Management Fee and Incentive Bonus

- 5.3 Management Fee: Up to 3.0% per annum of the aggregate capital commitments. In addition to the management fee, the Fund will also reimburse the Fund

Manager direct expenses of Solidus, which needs to be approved by the Board and General Assembly.

- 5.4 Incentive Bonus: It is proposed that Fund Manager will be rewarded in accordance with the financial performance of Solidus. A cash (US dollars) bonus will be paid based on the following formula: (a) the Fund generates positive net income; (b) 6% annual preferred dividend has been paid; and (c) fund manager receives between 20 – 25% of excess over the accumulated net profits.
- 5.5 The terms and conditions of management fees and the incentive bonus are subject to further negotiation with the Cyrano Management.

VI. Executing Agency

- 6.1 Cyrano Management, a Panamanian registered investment firm, has headquarters in Lima, Peru. Cyrano is a specialized company in managing debt funds that on-lend to MFIs in LAC. Cyrano currently manages LA-CIF, a debt fund with \$13.5 million portfolio at December 31, 2002, which is expected to increase to \$22 million at December 2003. MIF was the leading investor in LA-CIF in 1998.
- 6.2 LA-CIF has raised \$9.3 million new funding for the last two fiscal years. In 2002, net income nearly doubled to \$0.45 million, and the share capital increased by 71%, which resulted in a return on equity of 22%. Its portfolio is made up of promissory notes (60.5%) and term deposits (39.5%) issued by MFIs. The average maturity of the loan portfolio is 399 days. All the credit operations are structured with a call option that can be executed by LA-CIF in case a MFI goes beyond the risk limit. So far, LA-CIF has not experienced any defaults or arrears on the interest or principal payments from its borrowers. LA-CIF's portfolio is diversified among six countries: Bolivia, Dominican Republic, Ecuador, El Salvador, Nicaragua, and Peru.
- 6.3 Since initiating its management contract with LA-CIF in December 2000, Cyrano has acquired market knowledge in relation to MFI credit investments in LAC. Through its management of LA-CIF, Cyrano has originated and administered over 18 credit investments. The strong portfolio performance of LA-CIF suggests that Cyrano has developed its expertise in relation to sourcing and structuring successful MFI credit investments.
- 6.4 Encouraged by the success of LA-CIF, additional investors joined in LA-CIF, paying a 10% premium. LA-CIF also attracted commercial investors and lenders. LA-CIF currently has 20 different investors and lenders. In 2002, Desjardins, a Canadian commercial bank, made an additional investment of \$250,000 in LA-CIF. IFC is also expected to invest in LA-CIF. LA-CIF is expected to receive \$4.5 million equivalent senior loans from Banco de Crédito in Peru.

- 6.5 In addition to LA-CIF and Solidus, Cyrano will manage the Global Microfinance Facility (“GMF”), which will provide credit enhancement products, such as letters of credit, letters of guarantee, and direct funded loans, at commercial terms to MFIs through local commercial banks. The main purpose of GMF is to create a fund similar to LA-CIF for the global basis. GMF intends to provide credit enhancement to both regulated and unregulated MFIs. GMF will target a total capitalization of \$30 million. Since Cyrano Management will administer 3 funds, senior managers responsible for each of three funds will be hired.
- 6.6 Cyrano would delegate day-to-day management of Solidus to the qualified staff which would be responsible for: (a) identifying and appraising potential investments; (b) negotiating and structuring investments; (c) monitoring and supervising investments and the operation of Solidus; and (d) managing the flow of funds.

VII. Expected Project Results

- 7.1 The proposed fund will provide mezzanine financing and long-term loans to MFIs according to market principles. The fund is expected to invest in up to 15 MFIs, and they will, in turn, provide a total of approximately 214,300 new loans to small and micro enterprises by the end of year 5. If it is successful, Solidus will be a model mezzanine-financing fund for MFIs not only in LAC but also in other regions of the world. LA-CIF has been able to raise additional funding from commercial sources, and Solidus is expected to source more commercial funding as it has features conducive to private investments.
- 7.2 Assuming that the proposed fund raises its authorized capital of \$22.3 million in the year 2, the Project’s expected results are summarized in the following table:

Item (US\$ '000)	Year 1	Year 2	Year3	Year 4	Year 5
Interest Income from Long-term Loan	1,008	1,922	1,536	1,290	1,356
Income from Quasi-equity Investments	25	552	1,129	1,476	1,466
Non Interest Expenses	(503)	(839)	(736)	(752)	(768)
Net Income	532	1636	1932	2018	2058
Preferred Dividends	(532)	(1424)	(1338)	(1338)	(1338)
Net Income to Common Shareholders	0	212	594	680	720
Total Investments	10,100	22,350	22,800	23,250	23,800
Preferred Equity	10,290	22,278	22,278	22,278	22,278
Common Equity	10	212	594	680	720
Number of investee MFIs of Solidus (#)	3	10	14	13	13
Number of new loans provided by MFIs (#)	10,100	36,350	48,800	59,250	59,800
NAV	1.05	1.07	1.09	1.12	1.14
ROE (%)	5.17	7.27	8.38	8.56	8.53

VIII. Environmental and Social Impact and Proposed Measures

- 8.1 As a financial intermediary, Solidus will not carry out activities which directly impact on environment. The administrator of the Fund, Cyrano Management, will manage the Fund in accordance with IDB/MIF environmental and social guidelines for MIF operations with financial intermediaries (www.iadb.org/mif/website/static/en/inver8.asp). These guidelines include: (a) the MIF environmental and social requirements; (b) environmental procedures and restrictions for financial intermediaries; and (c) the financial intermediaries' list of execution from projects.

IX. Major Issues

- 9.1 **Management Structure and Capacity:** Since Cryano is expected to administer 3 funds, it needs to set up a proper management structure to sourcing deals as well as to oversee three separate funds. The fund management company needs to be adequately staffed to manage three funds. The composition and the role of investment committee, the allocation of potential transactions among three funds, and other management structure issues need to be negotiated during due diligence.
- 9.2 **Conflict of Interest:** The proper mechanism, such as Conflict of Interest Committee, needs to be put in place to avoid any potential conflict of interest. A clause to deal with potential conflict of interest will have to be negotiated and inserted in the appropriate legal documents.
- 9.3 **Market Demand:** During due diligence, the Project Team will contact the potential investee companies of Solidus to verify the existence of market demand for mezzanine financing.
- 9.4 **Diversification:** Some of the investee MFIs of Solidus will be clients of LA-CIF. An overall credit exposure to any single MFI by both Solidus and LA-CIF should be limited in order to ensure diversification of investments. The Project Team will ensure to include appropriate provisions to address this issue in the relevant agreement.
- 9.5 **Negotiation with Cyrano Management:** Detailed terms and conditions of MIF's investment will be negotiated during due diligence in coordination with other potential investors. In addition, compensations for the fund management company, including management fee and incentive bonus, will be negotiated further with Cyrano during due diligence.

X. Estimated Project Preparation and Analysis Time

- 10.1 The timetable for decision-making is estimated as follows:
- MIF Programming Committee: July 2003;
 - Presentation to IIC Expanded Operations Committee and CESI: September 2003; and
 - Donors Committee: November 2003.

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Approved by: Sandra Darville

Date: 07/10/03