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Regional Office for Central American Programs
Agency for International Development
Guatemala City, Guatemala

FINAL REPORT

EVALUATION OF THE LATIN AMERICAN AGRIBUSINESS DEVELOPMENT CORPORATION DE CENTROAMERICA

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November 22, 1985

Mr Julian Heriot
Regional Economic Advisor
Regional Office of Central
American Programs
Agency for International Development
Guatemala City, Guatemala

Subject: Final Report: Evaluation of the Latin American Agribusiness Development Corporation de Centroamerica Contract OTR-0000-I-00-3506-00, Work Order No. 16

Dear Mr. Heriot:

We are pleased to submit the enclosed final report of the results of the evaluation of the Latin American Agribusiness Development Corporation de Centroamerica. Our conclusions and key recommendations are contained in Chapter I.

As you know, this study could not have been completed without a high order of interest and cooperation on the part of the ROCAP staff. We appreciate very much their time and thoughtfulness. We also wish to acknowledge the high level of cooperation given by LAAD's staff in Coral Gables. Our special thanks go to LAAD-CA's staff without whose cooperation and logistical assistance we would not have been able to understand the issues, conduct interviews throughout the region, and reach our conclusions in a timely manner.

We trust that the results of the evaluation will prove beneficial to both AID and LAAD. We enjoyed this opportunity to assist the Regional Office of Central American Programs and look forward to future opportunities to be of assistance.

Very truly yours,

BOOZ, ALLEN & HAMILTON Inc.

John C. Newman
Vice President

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LIST OF ACRONYMS AND CURRENCY ABBREVIATIONS

English

AID	Agency for International Development
CBI	Caribbean Basin Initiative
ESF	Economic Stabilization Funds, provided by AID as balance of payments support
GOES	Government of El Salvador
GOH	Government of Honduras
IDB	Inter-American Development Bank
LAAD	Latin American Agribusiness Development Corporation, Coral Gables, Florida
LAAD-CA	Latin American Agribusiness Development Corporation de Centroamerica, Guatemala
LIBOR	London Interbank Offered Rate
ROCAP	Regional Office for Central American Programs, AID, Guatemala

Spanish

BCCR	Banco Central de Costa Rica
BCH	Banco Central de Honduras
BCR	Banco Central de la Reserva, El Salvador
BNP	Banco Nacional de Panama

	Currency	Abbreviation
Guatemala	Quetzal	Q
El Salvador	Colon	C
Honduras	Lempira	L
Costa Rica	Colon	C
Panama	Balboa (U.S. dollar)	$

I. INTRODUCTION AND SUMMARY

This evaluation focuses on the lending activities of the Latin American Agribusiness Development Corporation de Centroamerica, S.A. LAAD-CA is a subsidiary of the Latin American Agribusiness Development Corporation, which is based in Coral Gables, Florida. LAAD has three other subsidiaries, two that operate similarly to LAAD-CA in the Caribbean and South America, and the LAAD Marketing Company in Coral Gables.

Since 1970 LAAD has provided loan and investment capital to businesses processing and exporting non-traditional agricultural and aquacultural products. LAAD's initial area of operations was Central America through LAAD-CA.

AID has provided LAAD-CA with three loans totaling $17 million at concessional interest rates of 3 and 4 percent. LAAD and LAAD-CA have been consistently profitable, have paid dividends, and have amortized these loans, the outstanding balance of which was $12.7 million as of September 30, 1985.

An additional loan of $12 million has been discussed with LAAD-CA by the Regional Office for Central American Programs of AID. A condition of the financing may be that LAAD borrows $4 million in counterpart financing, most likely from international commercial lenders, to lend to Central American agribusinesses.

A new AID policy for providing financial assistance to the private sector of LDCs was issued in March 1985 and applies to the proposed loan for LAAD-CA. It states that concessionality, i.e., below-market interest rates, constitutes a grant to the owners of private firms, and is, thus, an inappropriate use of U.S. government funds. Moreover, loans provided at below-market interest by LDC financial institutions force down interest rates, which, in turn, inhibit savings mobilization. A concessional rate of interest is defined by the Bureau for Program and Policy Coordination of AID as an interest rate less than the marginal cost of funds to the U.S. Treasury, i.e., the interest rate of Treasury bills with 5- to 6-year maturities. That rate is presently 9.99 to 10.21 percent.

Exceptions to this policy are allowed, if the activity:

- Involves unusual innovations or developmental risk
- Involves training and technical assistance that will improve competition in the industry
- Involves a transfer of technology to the country

- Will have extraordinary start-up costs associated with introducing a new venture to benefit a target group not previously served.

The Bureau for Program and Policy Coordination issued guidelines on May 16, 1985, for providing financing to intermediate financial institutions. The guidelines state that AID may adjust its lending rate to these institutions to the degree necessary to cover the costs of intermediation or management of a new on-lending program, plus a reasonable profit.

This new policy includes other conditions that apply to loans to a financial institution such as LAAD:

- The on-lending must be consistent with AID's country development strategy (CDSS).

- The sub-borrower must be unable to obtain the proposed loan from commercial sources.

- The on-lending should be at local market interest rates.

AID made its third loan, amounting to $6 million, to LAAD-CA in 1981 through the Agribusiness Employment and Investment Promotion Project. The goals of the Project were to improve the stan- dard of living of the rural poor, stimulate economic and agricultural growth, create employment, and increase rural incomes. These goals were to be met by expanding private agribusiness investments in Central America.

According to the project paper, an important objective was to demonstrate AID support of private sector activities in Central America because working and investment capital credits from traditional sources had been sharply reduced. Co-financing of $2 million from private lenders was required. In addition, sub-borrowers were to have invested at least $6.8 million in their own businesses.

The $8 million was to have been loaned to an estimated 23 agribusinesses, with an average loan of $350,000. It was also estimated that 3,000 jobs would be created with the first round of lending. A part of this evaluation concentrates on the benefits created by the AID loan.

1. THE SCOPE OF WORK CALLED FOR AN OPERATIONAL AND FINANCIAL REVIEW OF LAAD-CA ALONG WITH A STUDY OF THE FINANCIAL MARKETS IN WHICH IT OPERATES

The objective of this evaluation is to assist ROCAP in analyzing LAAD-CA's operations to determine the characteristics

and conditions of an additional loan to that organization. LAAD-CA's operations were examined in terms of:

- Its current and prospective portfolio
- The conditions in Central American and Panamanian financial markets
- A financial review entailing cash flow projections, with particular attention to administrative costs, bad debt reserves, and dividend and retained earnings policy
- A sensitivity analysis with variances in interest rate and the factors studied in the financial review.

The review of LAAD-CA's current and prospective portfolio was to emphasize the development of a profile of its sub-borrowers, financial returns, the extent of repeat borrowing, and the use of funds, e.g., working capital, plant expansion, or new investment loans.

The financial market assessment was to determine the interest rate ceilings for dollar loans to agribusinesses and the sources of financing available to LAAD-CA's sub-borrowers.

2. THE METHODOLOGY INVOLVED NUMEROUS INTERVIEWS WITH LAAD STAFF, SUB-BORROWERS, FINANCIERS, AND GOVERNMENT OFFICIALS, AND AN IN-DEPTH FINANCIAL ANALYSIS

An evaluation team comprising three individuals, an evaluation specialist, an agribusiness specialist, and a finance specialist carried out this assignment in October 1985. They divided the evaluation into four segments:

- Analysis of the current and anticipated portfolios
- Analysis of the market for dollar loans to non-traditional agricultural exporters
- Financial review of LAAD-CA
- Analysis of the LAAD Marketing Company's potential support for the anticipated project.

Data on the impacts created under the most recent loan were collected through interviews with 13 sub-borrowers and a review of loan documents. Nine potential sub-borrowers were interviewed to determine the likelihood that the loans would be made and, if so, their impact. Data on the dollar loan markets were

collected through interviews with commercial and foreign bankers, development finance institution officers, central bankers, and USAID private sector officers. These interviews were conducted in Guatemala, El Salvador, Honduras, Costa Rica, and Panama.

The financial review analyzed LAAD-CA audited statements, LAAD's projections starting with its 1986 budget and other pertinent financial documents and discussions with LAAD-CA officers in Guatemala, LAAD officers in Coral Gables, and shareholders. The analysis of the Marketing Company's operations was based on interviews with LAAD officers in Coral Gables.

A complete list of persons interviewed and a bibliography of documents reviewed are included in Appendices A and B.

3. THE ANALYSIS OF LAAD-CA'S PORTFOLIO SHOWS THAT IT IS AN EFFECTIVE LENDER WHOSE LOANS HAVE CREATED CONSIDERABLE BENEFITS

LAAD-CA project assessments are thorough and rapidly executed, particularly when compared with the application process of local banks.

Loan approvals require little time. A loan under $400,000 may require only one month; a loan over $400,000 requires about three months. Loan monitoring is well done, particularly in the case of problem loans.

Businesses become LAAD-CA sub-borrowers because of its professionalism, knowledge of agribusiness, rapidity in processing loans, reasonable guaranty requirements, and personal interest. In loan collection and rescheduling, LAAD-CA is viewed as firm, but fair.

LAAD-CA's good reputation is well-known in agribusiness and banking circles in Central America. As a result, many clients seek out LAAD-CA. LAAD-CA is lean: it has a staff of only four professionals and a secretary.

The typical LAAD-CA sub-borrower is a strong, capable administrator and entrepreneur. One of LAAD-CA's most important characteristics is its ability to identify and approve loans for sub-borrowers who are solid managers. Only 2 of 13 sub-borrowers sampled are losing money. A few sub-borrowers are U.S. citizens, but the majority are Central Americans.

Of the sub-borrowers interviewed, nine were new loans and four were "repeat" loans. Most repeat loans were for expansion and/or new businesses. Sixty-two percent of the loan proceeds were used for expansion or new businesses; 38 percent was for working capital.

The net worth of sub-borrowers varies from just under $100,000 to over $4 million. Total sales for the sample average $1.7 million, excluding one large firm with average sales of $18 million. Export sales average $1.4 million. Total net export earnings of the sample were $18.7 million. This is substantial, especially considering that three firms of the sample did not export.

Assets per employee averages $11,000, which is deemed sufficiently labor intensive, especially given the level of technology employed by some sub-borrowers.

Employment is a relatively modest impact of the LAAD-CA loans. The firms sampled employed 2,184 employees. Women account for 40 percent of full-time employment. Employment has increased by 275 jobs, or 14.4 percent since LAAD-CA disbursements.

Purchases by sub-borrowers from small farmers and producers had a relatively major impact, amounting to $9.3 million, or 47 percent, of their total raw material costs. This is an average of $783,000 per sub-borrower. Seven sub-borrowers provided advances to small farmers; three provided other types of financial assistance; and seven provided other assistance, such as transportation, inputs, processing services, and equipment repair.

LAAD-CA handles sub-borrower problems well. Again, their professional approach, understanding, and personal interest is critical in dealing with firms' repayment difficulties. Many reschedulings have been successfully arranged with clients, contributing to LAAD-CA's continued success. In one period in 1983-84, 90 percent of the LAAD-CA portfolio had been rescheduled, indicating the high risks involved in making such loans.

LAAD-CA has initiated legal proceedings against sub-borrowers only in rare cases, as defaults have been minimal. LAAD-CA utilizes the services of capable local attorneys to draw up loan and collateral agreements.

Of the nine prospective sub-borrowers interviewed, <u>all</u> would like to become LAAD-CA clients. Like the present sub-borrowers, all have strong management. Loans are requested predominantly for expansion or new businesses, rather than for working capital. Average loan size requested is $650,000, $200,000 more than the loans made to the sample sub-borrower group.

LAAD Marketing is still in its start-up phase, but is beginning to grow and may show a profit in fiscal year 1985-86. While the company does not view itself as a promoter of loan

services, it is generally agreed that it could play a valuable, synergistic role in assisting LAAD-CA clients in finding new markets for export products. There has already been one case where a LAAD-CA client, who was risking delinquency due to inability to sell his exports, was able to find an overseas buyer through contacts made by LAAD Marketing.

Finally, LAAD-CA is a valuable resource of technical and financial information for the USAIDs of the region.

Overall, the evaluation team believes that LAAD-CA has done an excellent job in serving its clients and creating the results called for in the project paper.

4. THE ANALYSIS OF THE MARKET FOR DOLLAR LOANS IN CENTRAL AMERICA SHOWS THAT LAAD-CA IS A UNIQUE LENDER, FINANCING AGRIBUSINESSES THROUGHOUT A HIGH-RISK REGION WHILE CHARGING MARKET OR NEAR-MARKET INTEREST RATES

Analyzing the market for dollar lending in the region, the acute lack of foreign exchange in the region results in a very limited amount of dollar lending. Interest rate levels vary from country-to-country, but the best indicators of dollar rates are:

. El Salvador dollar letter of credit	LIBOR plus 2.5 percent
. Honduras dollar export financing	13.5-14 percent
. Costa Rica dollar loans registered at Central Bank	LIBOR plus 3.0 percent
. Panama commercial loans	LIBOR plus 3.0 percent

The commercial bank interest rate ceiling on local currency loans influence interest rate levels. Each country has set an interest rate ceiling on local currency borrowings:

. Guatemala	12 percent
. El Salvador	14 percent
. Honduras	19 percent
. Costa Rica	25.5 percent, floating
. Panama	LIBOR plus 3 percent

These rates may directly, as the case where the loan must be registered at the central bank, or indirectly affect the interest rates that LAAD-CA charges, but other determinants are important:

. Risks faced by the venture

- Management strengths
- Financial strength and options to borrow
- Rate of devaluation of the local currency
- Desire by LAAD-CA to support an innovative, potentially profitable activity.

LAAD-CA cannot afford to have a portfolio composed entirely of high-risk loans. This posture would bring the demise of LAAD-CA and would work against the interests of AID. It should be pointed out that an inelastic demand for LAAD-CA loans does not exist, despite its fine reputation. Stronger borrowers will seek their loans elsewhere if the interest rate is set arbitrarily high. Financially weaker, and, thus, riskier, firms will accept higher rates, but this could bring the per- verse effect of portfolio losses. LAAD-CA needs a balanced portfolio to be able to loan to some higher-risk firms and continue in business; therefore, it cannot maximize the interest it charges in every case.

LAAD-CA has made some 100 percent working capital loans to sub-borrowers who likely could have gotten these loans, on a short-term basis, from conventional lenders. The effects of such loans are less tangible than loans for fixed assets and, therefore, are less desirable from a developmental viewpoint.

LAAD-CA is charging market or near-market rates on its loans. Its portfolio yield was 12 percent in 1984 and is currently 12.7 percent. LAAD-CA has charged closing fees of one to two percent of numerous loans to raise their yields.

LAAD-CA does not face much competition in Central America:

- As noted above, dollar financing by foreign banks is nearly non-existent.
- Commercial lenders are wary of the type of borrower to which LAAD-CA lends because of agronomic, business, and marketing risks, and concentrate their portfolio on 6- to 12-month, roll-over loans.
- The USAID-financed lending programs are often limited to small- and medium-sized industrialists, and, thus, the loan size is limited. The USAIDs also channel their funds through the commercial banking sector, which is highly inefficient, political, and may require high guarantees or extensive, time-consuming feasibility studies. Alternatively, USAIDs use financieras that generally make smaller loans and that have not been effective in moving their funds.

- IDB- and World Bank-financed development loans tend to be difficult to obtain due to inefficiency of the intermediaries or excessive loan application requirements.

Compared to its competitors, LAAD-CA is a unique lender, financing risky businesses on a regionwide basis. Unlike commercial banks, it has no deposit base to reduce its cost of funds. Its cost to make and monitor loan funds are greater because of its regional, as opposed to a national, coverage. Unlike the typical Central American financial institution, it is a subsidiary of a lending and investment corporation operating in three geographic regions and directed by a high-caliber team of management and financial specialists.

LAAD-CA has executed retention arrangements with the central banks of Guatemala, Honduras and El Salvador that reduce the exchange risk on its loans. These arrangements are a unique innovation, are judged to be well-conceived by regional bankers, and, if emulated, could allow some foreign banks to begin making dollar loans in the region again.

LAAD-CA's activities are generally consistent with the development strategies of the USAIDs, except in one respect. The USAIDs are upgrading the private banking sectors in their respective countries to better serve the private sector as a whole. LAAD-CA is an external lender that does not contribute to the improved functioning of the region's commercial banks. Prior attempts by ROCAP to condition loans to LAAD-CA with co-financing clauses have failed because LAAD-CA's project formulation process and disbursement are considerably faster, and, thus, their operation is largely incompatible with the operations of commercial lenders and the Central American Bank.

The major factors affecting the demand for LAAD-CA loans are:

- Political stability, influenced by both internal and external forces

- Management of the economy, exchange rate stability, and control of inflation

- Credit provided by commercial banks and other financial institutions, either using their own funds or lines of credit provided by USAIDs and other development organizations

- Incentives, including the Caribbean Basin Initiative, to attract export industries or entrepreneurs

- Local entrepreneurial talent

- The need of companies to obtain foreign exchange for machinery, equipment, and raw material purchases in the short-term.

Based on the above, the following 2-year assessments are made of LAAD-CA's country markets:

- Costa Rica will be its best market because it has made economic adjustments, created incentives to stimulate exports, and has remained politically stable, actions that bode well for the near future. Three new drawback plants started operations in the last three months, and additional interested investors substantiate this outlook.

- El Salvador will also be a strong market based on its well-managed economy, strong group of entrepreneurs, high labor productivity, and "new" export orientation and harmony among the BCR, private sector, and USAID/El Salvador. The USAID is emphasizing both non-traditional agricultural exports and drawback industries.

- Guatemala will be an average market because of poor management of the economy, namely the uncertainty that surrounds exchange rates. However, because LAAD-CA is located in Guatemala, and because there is a strong group of export-oriented agribusinesses, LAAD-CA will be able to generate a modest number of loans.

- Honduras will be a very limited market because of internal and external political uncertainty, overvaluation of the currency, and its limited entrepreneurial base.

- Panama will constitute a very poor market because of its political instability, rampant government corruption, onerous labor laws, poor labor productivity, and lack of entrepreneurs.

Based on interviews with prospective sub-borrowers and the past performance of LAAD-CA in making loans in the region, it should be able to disburse $16 million in new funds during the next 3 years.

5. THE FINANCIAL ANALYSIS OF LAAD-CA REVEALS THAT ITS LONG-TERM SURVIVAL IS THREATENED UNLESS IT RECEIVES CONCESSIONAL FINANCING

An in-depth financial analysis was also made of LAAD-CA. LAAD-CA has shown impressive performance over the 9 years

covering 1976 to 1984. Although facing deep fundamental changes in the economic structure of Central America due to social unrest, economic retrenchment, high interest rates, and scarcity of foreign exchange, LAAD-CA continued to show a profit, pay dividends, and build equity. During that period, numerous other competing organizations faltered or went under.

The gross spread between interest income from loans and interest expense to AID and commercial banks during 1976 to 1984 has generally fluctuated between 5 and 8 percent, and the net spread, after deducting operating expenses and reserves, has never exceeded 2 percent. In some years, the net spread was negative.

The average rate on portfolio climbed steadily from 9.3 percent in 1977 to a high of 14.2 percent in 1982. During this time, 5-year loans were placed at rates significantly higher than those in the past, raising the average yield of the portfolio. Even after interest rates began to decline, LAAD-CA continued to enjoy high rates of return due to the effect of the older, higher-yielding loans on the portfolio. As they were actually replaced by lower interest loans, the average yield of the portfolio declined to about 12 percent in 1984-85, where it is expected to stabilize for the next few years. The decline was more gradual that the original increase, which was driven by floating rate loans. At the time, such loans represented a larger percentage of the portfolio than they do today.

The increase in interest rates affected the gross spread as well, since bank financing made up more than one-third of total borrowings in 1980, driving the cost of money to 7.1 percent, compared to 4.7 percent in 1979. The high cost of borrowing did not begin to decline until 1983.

The net spread, already influenced by the higher cost of money, was also significantly affected by the events in Nicaragua in 1978-79, which were accompanied by a general deterioration of the business climate in all of Central America. The decision to place the Nicaraguan loans on non-accrual and begin to reserve against their future loss caused the net spread to drop to zero in 1980. When it was decided to increase the amount reserved yearly from an average of about $300,000 to over $600,000 for 1982 and 1983, the net spread became negative and did not return to a positive figure until 1984.

This period of crisis also prompted a shift of LAAD's policy in the direction of maintaining greater liquidity to protect itself against potential interruptions in its loan income stream and further write-offs in its portfolio. Liquid assets, which in the years before 1980 comprised only a small fraction of

total assets, were increased dramatically during 1980-84 to their present level, where they make up a full 32 percent of total assets and are approaching one-half the value of the loan portfolio.

A significant consequence of this management decision has been the corresponding shift in the composition of gross income. Income from marketable securities and time deposits was insignificant up to 1980. In 1984, it reached $1,019,000, which is nearly 91 percent of net income for the year.

Administrative expenses tended to follow the same trend line as the reserve charges, having been relatively stable at most times. They did not increase during the difficult time in Nicaragua, and salaries and benefits, in fact, declined in absolute dollars between 1980 and 1983.

An analysis of the 1986 budget and the projections for the subsequent four years disclosed a trend characterized by a gradual deterioration of the portfolio yield from its present level of 12.7 percent to about 11 percent by 1990, where it is expected to stabilize. This is an effect of the lower market interest rates currently being negotiated on new loans. As the new rates slowly replace the old, higher rates coming due, the yield on the portfolio will drop over the five-year period from 1986 to 1990.

The cost of money, which is dominated by the current AID financing at 3 and 4 percent, will not be materially affected by the new AID loans of $12 million, if it is assumed to be at a 4 percent rate of interest. The $4 million co-financing package was calculated at 9 percent, which raises the weighted average up to 5.3 percent. However, the effect of the three long-term AID loans will keep the total interest cost somewhat under 5 percent. By 1990, the $17 million dollars of principal on the first three loans will have been paid down to $7,789,000,

The 25 percent co-financing requirement imposed upon prior loans has been a hindrance to LAAD-CA's operations. It raises the average cost of funds and brings in another element of instability into a business that is already characterized by uncertain and erratic cash flows. LAAD-CA loses money on loans made with funds borrowed from commercial banks and must make this up with concessional rate financing from AID. In addition, it forces LAAD-CA to be even more conservative in its liquidity policies, because of the risk that the commercial bank financing may have to be replaced at a higher rate when it comes due, since it is generally made for a shorter period than the long-term AID loans.

Administrative expenses will be stable for the next 4 years and will not grow at the historical rates experienced in the

past. Several people currently on the LAAD payroll will be transferred to the LAAD Marketing Company payroll, which is not allocated to any of the subsidiaries. The building in which LAAD occupies space has been sold and is now leased back under an agreement which will lower cash flow requirements. The computer system will also be transferred to LAAD Marketing, and it is anticipated that the computer services will be offered to other companies, particularly in the area of accounting.

The reserve for losses will be increased by 2 percent of total portfolio. The Nicaraguan portfolio of $1.9 million will be written off at the rate of 1.5 percent of total portfolio per annum, starting in 1985. At this rate, it will be completely written off by 1989. This action will not have an income statement effect, since the deductions from the portfolio are also deducted from the reserve. The net effect on the total reserve balance will be an annual increase of 0.5 percent per annum.

The net spread will stabilize at about 1.5 percent and is unlikely to ever reach much higher. This stable level is based upon the assumption of a 4 percent AID loan. A 6 percent rate would provoke a decline in the spread. An 8 percent rate would cause the spread to go negative in 1987, and a 10 percent rate would cause the spread to become negative in 1986. The long-term survival of LAAD-CA will be threatened with any loan rate in excess of 4 percent.

6. ROCAP SHOULD PROVIDE LAAD-CA WITH ADDITIONAL FINANCING AT CONCESSIONAL RATES AND WITH NO CO-FINANCING REQUIREMENT

ROCAP should proceed to process an additional loan for LAAD-CA without the co-financing requirement. The analysis of the financial structure of LAAD-CA demonstrates that it cannot compete for funds in the open market and continue to provide the unique service it offers to non-traditional agricultural exporters who purchase from small farmers and producers. ROCAP should set the interest rate on this loan at a concessional rate.

LAAD-CA should be encouraged to continue to balance the risks in its portfolio to be able to provide loans to some higher-than-normal risk firms.

Reflows from 100 percent working capital loans should continue under the purview of ROCAP until those funds are used for loans with at least a 50 percent fixed asset component.

LAAD-CA should be encouraged to market loans to medium-sized firms that need assistance in export marketing. LAAD

Marketing Company can assist in a number of break- throughs. A good example of this is Vivero Xochical, near San Salvador.

LAAD-CA should make a good faith effort to develop a working relationship with a commercial or foreign bank in each country, to co-finance non-traditional agricultural exporters. This might be done by allowing the local bank to take the short-term, working capital component, while LAAD-CA takes the term and dollar components of the loan. To encourage the local banks to participate, it may be necessary for LAAD-CA to hold the collateral and guarantee the bank's exposure. LAAD-CA should acquaint these banks with its loan processing techniques. Such co-financing should not condition the recommended loan, unless additional concessionality is contemplated.

LAAD-CA and ROCAP should consider financing drawback industries, particularly in Costa Rica and El Salvador, and to a lesser extent in Honduras. If ROCAP supports this concept, but does not want to detract from LAAD-CA's non-traditional agricultural lending impact, the loan under consideration should be increased.

LAAD-CA should more conservatively prepare its investment analyses to reflect the level of risks that their sub-borrowers face. This is not meant to exclude firms, but to analyze their situation realistically to avoid re-scheduling of loans.

LAAD-CA should maintain a full set of loan documents in its Guatemala City office for all loans in its portfolio.

ROCAP officers backstopping the LAAD-CA project should make arrangements to visit LAAD-CA sub-borrowers, as time allows, to monitor better the impact of these loans.

AID/Washington, and particularly the Bureau for Private Sector, should be informed of the loan interest rate recommendation above. If a financial institution as well-run as LAAD-CA cannot operate without concessional interest, AID's current policy may force many smaller, less-well-run institutions into bankruptcy. The guidelines set by the Bureau for Program and Public Policy regarding financing of intermediate financial institutions are appropriate to LAAD-CA.

LAAD needs to establish a strict cost monitoring program that allows it to track all of the major and more volatile components of operating expenses, especially personnel, travel, and communications, which together make up nearly three-fourths of total operating expenses. A special monthly report should be prepared for management detailing the specific components of

these line items, comparing them to the budget, explaining any significant variances, and delineating corrective measures, as necessary. The report should also include a year-end forecast for these items, updated on a monthly basis.

II. ANALYSIS OF LAAD-CA'S PRESENT AND PROJECTED PORTFOLIOS

This section reviews the LAAD-CA project formulation process, the type of sub-borrowers served, and the uses of loans. The section also analyzes the developmental impacts created. Finally, LAAD-CA's monitoring process and assistance provided, especially to problem loans, are also assessed.

To analyze the present and projected portfolios, the evaluators interviewed 10 of 16 sub-borrowers under the Agribusiness Employment and Investment Project (see Exhibit II-1 for a list of those projects) and three borrowers financed with LAAD-CA funds. The sample was selected on the basis of its representativeness. Some short-term, working capital loans were omitted from the sample because of the difficulties in measuring their impacts. The evaluators also interviewed nine prospective sub-borrowers. These businesses, which had not received a loan from LAAD-CA previously, were suggested by LAAD-CA staff.

1. PROJECT FORMULATION PROCESS REQUIRES LITTLE TIME, IS EFFECTIVE, AND IS ALSO WELL RECEIVED BY SUB-BORROWERS

The sub-borrowers and potential clients who were interviewed all have a high regard for LAAD-CA's project assessment and loan approval process. Pre-loan procedures, documents requested, and meetings conducted were felt to be reasonable by LAAD-CA clients or potential sub-borrowers. Project assessments were viewed as detailed and thorough.

Steps in LAAD-CA's project formulation process are:

- The client contacts LAAD-CA or LAAD-CA identifies the company as an appropriate borrower.
- LAAD-CA makes a decision to "try to lend," which must be ratified by LAAD in Coral Gables, based on projected cash availability.
- LAAD-CA staff travel to the client's plant to prepare the Project Assessment and Investment Proposal with company owners and managers (forms used to analyze the client's finances are included in Appendix D).
- If the loan is less than $400,000, it can be approved by the LAAD president; if larger, it must be approved by LAAD's Investment and Loan Committee at a quarterly meeting.

EXHIBIT II-1
LAAD-CA Sub-Loans Under the Agribusiness
Employment/Investment Promotion Project

Sub-Borrower	Amount	Activity
Guatemala		
CARDINSA	$ 800,000 2/	Cardamom processing and export
Industrias Sesamo	700,000 2/	Sesame processing and export
OPERK 1/	400,000	Spices and fruit production, processing, and export
PROEXPORT	50,000	Sesame processing and export
Honduras		
APROFO 1/	250,000	Production and export of wooden handles
MADECAS 1/	150,000	Production and export of wooden handles
Catacamas 1/	1,000,000	Cattle breeding and fattening
Costa Rica		
KATOJEKE 1/	350,000	Cultivation and export of ginger, macadamia nuts, and endows
American Flower Corporation 1/	400,000	Flower and ornamental plant cultivation
Plantas Tropicales 1/	150,000	Flower and ornamental plant cultivation

EXHIBIT II-1(2)

Sub-Borrower	Amount	Activity
Panama		
Proveedora Internacional de Mariscos 1/	350,000	Shrimp processing
INTERMATRA 1/	300,000	Shrimp processing
Empacadora Avicola 1/	700,000	Poultry production
TOTAL	$5,600,000	

1/ Interviewed by Booz, Allen & Hamilton.

2/ Two loans made to sub-borrower during the 1981-84 project period.

- If the loan is approved, borrowers are informed and arrangements are made to draw up the loan and collateral agreements.

- The loan is disbursed.

- Periodic monitoring begins.

If the loan is less than $400,000, this process can take about 30 days; if larger, the loan processing time averages 3 months. Exhibit II-2 illustrates the process.

LAAD-CA personnel were given high marks for their skill and professionalism. "Their interest and understanding of our business makes them unique lenders" was repeated with frequency. LAAD-CA was also given praise for the speed in processing applications, especially compared with local commercial banks or development finance institutions. Delays of 6 to 8 months for loan rocessing by such lenders (delays of 15 months or more were mentioned) are common throughout the region.

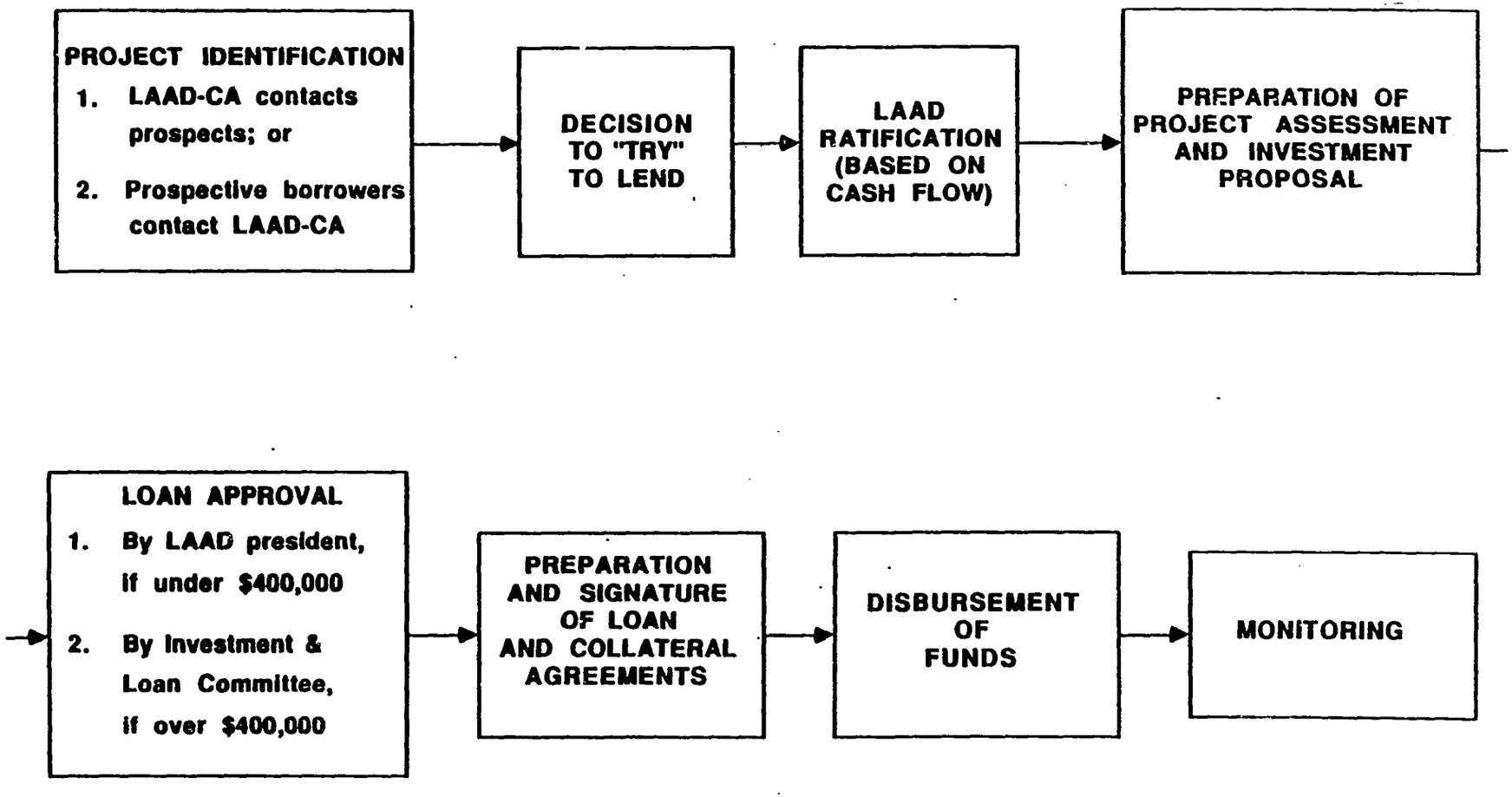
Sub-borrowers also felt that LAAD-CA's collateral requirement of 150 percent of loan value was reasonable; collateral requirements of 200 to 400 percent required by other lenders are common. Most local banks are reluctant to finance new agribusiness projects because they are perceived to be extremely risky. Almost no term loans, even highly secured ones, are available for such ventures.

More than half of the respondents made the initial contact with LAAD-CA about their loans. They had heard of LAAD-CA from its previous clients, commercial bankers, or even central bankers. This "word-of-mouth" advertising of LAAD-CA seems fairly widespread in the agribusiness, banking, and political circles throughout the region. LAAD-CA's good reputation has spread far beyond the clients in its portfolio.

Most sub-borrowers praise LAAD-CA for its loan monitoring. In this regard, supervisory visits by LAAD-CA personnel vary as to client, status of loan, and type of project. A new client, not current and involved in a new, non-traditional project, may be visited several times per month, as was, for example, APROFO. A repeat sub-borrower such as American Flower Corporation, with a good past record and current with the present loan, may hear from LAAD-CA only two or three times per year. Annual audited financial statements and biannual statements are required from all clients. Quarterly reports and monthly export sales figures are required from most.

If a client has problems, LAAD-CA visits more frequently and investigations are more detailed. The staff's personal interest

EXHIBIT II-2
LAAD-CA'S PROJECT FORMULATION PROCESS



has made the greatest impression on their clients. "They work with us" was a common remark describing their client relations. Numerous loan reschedulings have been arranged.

While loan monitoring is considered to be of exceptional quality and effectiveness, assistance in implementation or management training is rare and is not considered part of LAAD-CA's mandate. In fact, LAAD-CA does not have sufficient personnel for such services.

LAAD-CA is referred to as a "pioneer" in financing non-traditional export projects. Several sub-borrowers stated that it is miraculous that LAAD-CA has continued to operate in the region, despite the intense political and economic turmoil of the last 6 years. LAAD-CA is viewed as performing a critically needed service, i.e., providing term financing for new projects. It is also considered free of the political pressures that reduce the effectiveness of many commercial banks and some development finance institutions.

2. THE TYPICAL LAAD-CA SUB-BORROWER IS A CAPABLE ENTREPRENEUR

The evaluation team concluded that LAAD-CA identifies and selects strong sub-borrowers well. The typical sub-borrower is an entrepreneur who has at least a B.S. degree or more, plus special training and practical experience. Two or more management-level people with college degrees in a medium-sized firm is common. Seven owners or managers have degrees from U.S. universities in agriculture, engineering, or business administration. Some have "grown up" in the industry in which they are working.

Some sub-borrowers are more astute in management, marketing, or the technical aspects of projects than others, but all seemed to be strong entrepreneurs. Most are not averse to the risks and challenges in undertaking new or non-traditional agribusinesses. However, most are disturbed with the inadequacy of term financing for their ventures. The sub-borrowers may have other business interests and often are civic leaders. All appeared to have the drive and determination to produce more and do so efficiently. Some exceptions to these observations are discussed below.

Sub-borrower managers and administrators, although high-caliber, multi-talented professionals abreast of numerous details, are not hesitant to delegate, and most are better-than-average communicators. They know their markets, and are current on prices, demand for their products, and their competition. New technology is reviewed for applicability to their businesses.

Surprisingly, good labor relations are a common denominator among these business people. Some had performance-based compensation, on-the-job training, and profit participation plans; one was able to use non-supervised labor (no foreman) as a result of an employee training and motivation program.

LAAD-CA's sub-borrowers represent a mix of small-, medium-, and large-sized projects with diverse product lines, processes, technologies, and efficiencies. Most were, by Central American standards, large businesses, as eight companies controlled more than $1 million each in assets. Average annual sales, excluding the gigantic Empacadora Avicola, were $1.7 million. Most, 90 percent, export; 75 percent of those export to the U.S. Quality, cost, market conditions, and their competition concern them. Expansion, cost reduction, new markets, and more credit are also major concerns.

LAAD-CA considers strong management to be an important loan requirement. Some managers know their business from years of experience in their own or other similar companies. Others are "outsiders" brought in for their specific management skills.

LAAD-CA's selection of sub-borrowers is considered outstanding by the evaluation team. The outcome of this selection process is substantiated by the success of most of the sub-borrowers, past and present, and LAAD-CA's limited number of foreclosures during its 15 years in Central America. Although it is not LAAD-CA's job to train good managers, they have made it their job to select good managers.

(1) Sample Sub-borrowers Are Large Firms With Assets Averaging $1.9 Million, But This May Not Be Typical

Although average assets of the 13 sample sub-borrowers is $1.9 million, this is probably not typical of LAAD-CA's total portfolio. Catacamas and Empacadora Avicola, with assets of $4.5 million and $5.2 million respectively, account for over 40 percent of the total assets of the sample firms.

As displayed in Exhibit II-3, assets vary from a low of $175,000 to over $5 million, with five of the 13 firms having assets of less than one million dollars.

(2) Some Sub-borrowers Are U.S. Citizens, But The Majority Are Central Americans

Of the 22 actual and potential sub-borrowers, only four are U.S. citizens. Three others are second-generation Europeans who were citizens of Guatemala or El Salvador. Most LAAD-CA sub-borrowers and managers are Central Americans.

EXHIBIT II-3
Assets Per Full-Time Equivalent Employee
(Expressed in thousands)

SUB-BORROWER	LAAD-CA LOAN	TOTAL ASSETS	TOTAL FULL-TIME EQUIVALENT EMPLOYEES	ASSETS PER EMPLOYEE
1. OPERK	$ 400	$ 1,800	554	$ 3,249
2. SEPA	400	3,100	183	16,940
3. MARINA DEL PACIFICO	400	927	128	7,242
4. APROFO	250	1,000	60	16,667
5. MADECAS	150	175	21	8,333
6. CATACAMAS	1,000	4,500	172	26,163
7. KATOJEKE	350	800 1/	168	4,761
8. AMERICAN FLOWER CORP.	400	1,300	302	4,305
9. AGRIBIOTECHNOLOGIA	200	322	11	29,273
10. PLANTAS TROPICALES	180	2,435	104	23,413
11. EMPACADORA AVICOLA	700	5,160	285	18,105
12. INTERMATRA	500	400 1/	76	5,263
13. PROVEEDORA INTL.	350	2,600	120	21,667
TOTAL	$5,280	$24,519	2,184	$11,227 (averag

1/ Estimate pending audit.

(3) Although Entrepreneurial Skills Are Strong, LAAD-CA's Sub-borrowers Utilize Outside Technical Assistance

Outside specialists and scientists in plant breeding, seed technology, veterinary medicine, and food technology, for example, have been brought in (usually from U.S.) by most company managers. These specialists have been employed to train mid-level management and technical personnel, as well as for specific problem solving and application of preventive maintenance.

LAAD-CA does not assist the firms with technical assistance, however, the sub-borrowers and USAIDs find that LAAD-CA can provide them with reliable information on markets, financing, and recent economic trends. LAAD-CA should not be expected to provide more technical assistance; although the LAAD Marketing Company will be able to provide useful marketing information for some sub-borrowers (see Section 9 below).

3. ONLY 2 OF 13 SUB-BORROWERS ARE CURRENTLY UNPROFITABLE

Eleven of the thirteen firms are profitable, a good performance for any lending institution working in a similar high-risk environment. (5 out of 12 sample firms were unprofitable in the 1977 LAAD-CA evaluation; two of eight firms sampled in 1983 were losing money.)

As Exhibit II-4 indicates, two Panamanian sub-borrowers presently report losses. INTERMATRA, which also reported losses in the last evaluation of LAAD-CA, has improved only slightly since 1983. INTERMATRA's accumulated losses since 1981 approach $2 million.

Proveedora International de Mariscos has slipped since 1983; however, their new general manager, with the backing of the board president and stockholders, seems to be moving the company in the right direction. This case is discussed in greater detail below.

Catacamas is profitable, but not by much. Its 1 percent profit on sales, however, is an improvement over the negative 3 percent registered in the 1983 evaluation.

4. NINE FIRMS WERE NEW BORROWERS AND FOUR WERE "REPEAT LOANS"

ROCAP expressed concern that LAAD-CA was becoming increasingly conservative, directing many of its loans to repeat customers. Nine sub-borrowers received new loans and four are

EXHIBIT II-4
Financial Rates Of Return To The Sub-borrower
(Expressed in thousands)

SUB-BORROWER	TOTAL SALES	NET PROFITS	NET WORTH	PROFIT TO SALES %	PROFIT TO NET WORTH %
1. OPERK	$ 2,030	$ 305	$ 1,500	15	20
2. SEPA	4,200	300	2,000	7	15
3. MARINA DEL PACIFICO	800	50	1,240	6	4
4. APROFO 1/	1,800	225	750	13	30
5. MADECAS	----	----	----	---	---
6. CATACAMAS	4,850	29	4,200	1	1
7. KATOJEKE	222	30	86	14	35
8. AMERICAN FLOWER CORP.	2,500	250	800	10	31
9. AGRIBIOTECNOLOGIA	500	100	400	20	25
10. PLANTAS TROPICALES	800	300	3,000	38	10
11. EMPACADORA AVICOLA	18,000	850	2,000	5	43
12. INTERMATRA	1,500	(100)	250	(7)	(40)
13. PROVEEDORA INTL.	1,100	(300)	2,000	(27)	(15)
TOTAL	$38,302	$2,039	$18,226	5.3	11.2

1/ APROFO and MADECAS are considered as two separate firms, but their financial data are combined.

repeat borrowers. Included in the "repeat loan" category are KATOJEKE, American Flower Corporation, Catacamas, and Empacadora Avicola. KATOJEKE, Catacamas, and Empacadora Avicola are considered repeat loans because LAAD-CA previously made loans to other divisions of their companies. Although not included in the sample, CARDINSA and Industrias Sesamo in Guatemala are also repeat borrowers.

Repeat loans may not always be a result of increasing conservatism on the part of LAAD-CA. To the contrary, it may be a good business practice that results in profound developmental effects. For example, American Flower has received four loans from LAAD-CA. When LAAD-CA made its first loan to American Flower, its lack of solid collateral would have kept it from receiving term financing from conventional sources. LAAD-CA accepted the sunshades and irrigation system that the company installed on its flower farm as collateral.

Twelve years later, American Flower is a well-run, solvent firm with orders that may cause it to double, and perhaps triple, its output. It has recently obtained term financing from local commercial banks. One of the evaluators has first-hand knowledge of the export sector in Costa Rica, and it is known that, since American Flower initiated its operations in 1970, 35 to 40 new flower and tropical plant growers have been started around San Jose. American Flower is the recognized "padrino" of these businesses, as many of their owners are former employees of American Flower.

The evaluators would not recommend additional financing to American Flower, because it can now obtain its term financing locally. However, the evaluators would recommend additional financing if American Flower expands to Panama, where such development needs a "padrino."

Another good example of supporting entrepreneurs who are creating desirable effects is LAAD-CA's loan to Catacamas. Catacamas, a beef processing plant, is a subsidiary of Grupo Ganadero Industrial of Costa Rica, to which LAAD-CA has made seven loans. The head of Grupo Ganadero is a high-caliber entrepreneur whose businesses have created positive effects for the rural poor in Costa Rica and Honduras. Identifying and targeting this entrepreneur with repeat loans has helped LAAD-CA to meet the goals set by AID.

5. MOST OF THE LOAN PROCEEDS WERE USED FOR EXPANSION OR NEW BUSINESSES

Investment declined sharply in Central America during 1981-84. Nevertheless, 62 percent of the LAAD-CA loan proceeds provided to the sample sub-borrowers was used for expansion or

new businesses. Only 38 percent was used for working capital. Eight used 60 to 100 percent of the loan proceeds for expansion or a new business. Five used 50 percent or more of their loan proceeds for working capital. One received a 100 percent working capital loan, but LAAD-CA made this loan because it involved large purchases of raw sesame from small farmers. The evaluators disagree with the concept of making 100 percent working capital loans because the developmental impacts of such loans are likely to be minimal.

6. LAAD-CA'S LOANS CREATE BENEFITS IN TERMS OF EMPLOYMENT, EXCHANGE EARNINGS, AND SMALL PRODUCER PURCHASES

By virtue of the activities financed by LAAD-CA loans, a series of benefits are created. Attribution of such benefits to the investors, LAAD-CA, or other lenders is difficult. Time frames do not coincide and causality is sometimes difficult to establish. As noted in Exhibit II-3, LAAD-CA financing amounted to approximately 22 percent of the total assets owned by the sub-borrowers. The evaluators believe, nevertheless, that the LAAD-CA loans in many cases have been pivotal, because they are made for longer terms, have been used mostly for expansion or new businesses, and provided needed foreign exchange.

(1) Sub-Loan Analysis Reveals Increasing Employment Creation And An Average Of Over $11,000 In Assets Per Employee

The 13 sub-borrowers studied have total assets of $24.5 million and 2,184 full-time equivalent employees. Exhibit II-3 reflects $11,227 as the average assets per employee. This average is felt to be quite satisfactory, given the level of technology that must be employed to produce high-quality output, competitive in world markets. Four firms do have assets per employee ratios in excess of $20,000. The evaluators expect that, given an examination of LAAD-CA's total portfolio, the average assets per employee, might be even lower. This figure is less than the $13,880 average recorded in the 1977 evaluation of LAAD-CA, especially when inflationary effects are considered.

The sample firms hire more employees than the firm studied in previous evaluations: the present figure is 168 compared to 102 per company in 1977, and 91 per company in 1973.

According to Central American standards, these are large employers; however, relative to other development impacts created, employment had less effect. Although payroll

estimates were not called for under the scope of work, an approximate total payroll for the 2,184 employees, based on the 1983 payroll estimate, is $7.0 million. In strict dollar terms, this is less than either net export earnings or raw material purchases, as noted below.

Employment increased as a result of the LAAD-CA sub-loans by 275, an increase of 14 percent. This is substantially under the 3,000 new jobs estimated in the project paper. This may be attributed to projections by the project designers that LAAD-CA would be lending to more start-up, rather than existing, businesses. One firm, noted previously as having financial difficulties, has had a notable decrease in employment since the 1983 evaluation. At the time of the previous evaluation, INTERMATRA had over 250 employees, but now reports only 76 employees.

Actual full-time employment figures, broken down by sex, total 1,312 male employees (60 percent) and 873 females (40 percent). Exhibit II-5 provides a break-down on categories and sexes of employees. The evaluators consider that the 40 percent female figure is a positive benefit created by LAAD-CA loans.

(2) <u>Export Earnings Are Strong And Significant In a Foreign Exchange-Short Region</u>

Total export sales were reported at $20.3 million. Net export earnings of $18.7 million are impressive, especially in light of the fact that three sub-borrowers are not exporters. One company, Empacadora Avicola, has negative export earnings, importing some $0.5 million in inputs, with no export sales. See Exhibit II-6, for a tabulation of export earnings.

LAAD-CA's projections for this period were $31.2 million in net export-earnings, over-estimated by almost $12 million. There have been some unforeseen reasons for the shortfall from the estimates. For example, Proveedora International de Mariscos, located at David, Panama, had 1984 export sales of $2.3 million. LAAD-CA's monitoring and visits, until 6 months ago, noted increasing catches of shrimp. However, management had not been overhauling its fleet of 14 old shrimp boats. Until then, management had been more concerned with showing ever-increasing catches than in a prudent vessel repair program. Once the problem was discovered, a new, well-qualified general manager was brought in to reduce losses and refurbish the fleet. Subsequently, the number of boats at sea has been cut by half, and catches have correspondingly reduced. LAAD-CA is now abreast of the situation, and export sales projections have been scaled down.

EXHIBIT II-5
Sub-borrower Employment

SUB-BORROWER	Administration		Sales		Full-Time Equivalent Production		Total		Total Both Sexes	Employment Impact1/	Date of Disbursement
	M	F	M	F	M	F	M	F			
1. OPERK	9	5	1	-	267	272	277	277	554	94	4/84
2. SEPA	16	3	-	-	44	120	60	123	183	65	9/84
3. MARINA DEL PACIFICO	3	2	1	-	37	85	41	87	128	26	9/85
4. APROFO	3	1	-	-	56	-	59	1	60	0	12/83
5. MADECAS	1	-	-	-	20	-	21	0	21	21	3/84
6. CATACAMAS	20	2	1	-	149	-	170	2	172	(40)	3/84 to
7. KATOJEKE	10	3	-	-	103	52	113	55	168	87	4/84
8. AMERICAN FLOWER	23	-	4	-	155	120	182	120	302	73	9/83
9. AGRIBIOTECNOLOGIA	2	-	-	-	1	8	3	8	11 2/	11	2/85
10. PLANTAS TROPICALES	2	3	-	-	9	90	11	93	104	18	11/84
11. EMPACADORA AVICOLA	23	3	130	-	129	-	282	3	285 3/	44	10/83
12. INTERMATRA	5	6	-	-	9	56	14	62	76 4/	(174)	4/82 & 9/84
13. PROVEEDORA INTERNACIONAL DE MARISCOS	2	4	-	-	77	37	79	41	120	50	5/83
TOTALS	119	32	137	0	1056	840	1312	872	2184	275	
PERCENTAGE	51%	21%	6%		48%	38%	60%	40%	100%		

1/ Employment increases or decreases since loan disbursement.
2/ A new business.
3/ Labor on farms (some 200 plus) not included.
4/ Reduced from over 250 employees in 1983-84.

EXHIBIT II-6
Net Export Earnings
(Expressed in thousands)

SUB-BORROWER	ACTUAL EXPORTS FOR LATEST FISCAL YEAR	IMPORTED INPUTS FOR SAME PERIOD	NET EXPORT EARNINGS	LAAD-CA PROJECTIONS FOR SAME PERIOD 1/	DIFFERENCE
1. OPERK	$ 2,030	$ 140	$ 1,890	$ 1,860	$ 30
2. SEPA	4,200	---	4,200	4,794	(594
3. MARINA DEL PACIFICO	800	61	738	1,579	(840
4. APROFO	1,800	25	1,775	5,640	(3,865
5. MADECAS	---	---	---	---	---
6. CATACAMAS	4,850	229	4,621	8,257	(3,636
7. KATOJEKE	222	---	222	626	(404
8. AMERICAN FLOWER CORP.	2,500	360	2,140	1,478	662
9/10. AGRIBIOTECHNOLOGIA/ PLANTAS TROPICALES	1,300	130	1,170	1,303	(133)
11. EMPACADORA AVICOLA	---2/	500	(500)	---	---
12. INTERMATRA	1,500	60	1,440	2,500	(1,060)
13. PROVEEDORA INT. MARISCOS	1,100	85	1,016	3,150	(2,135)
TOTAL	$20,302	$1,590	$18,712	$31,188	($11,976)

1/ Net of imported inputs.
2/ Local sales of $18 million.

Despite firms whose output has declined or is destined towards domestic markets, export earnings, especially in a region suffering from foreign exchange scarcity, are a significant benefit of LAAD-CA's loans.

(3) Sub-Borrower Purchases From Small Farmer And Producers Are Considerable

Ten companies reported $9 million worth of purchases from small farmers and producers, an average of $940,000 for each sub-borrower that has outside purchases of raw materials. Three sub-borrowers do not purchase raw materials.

Of the $20 million of raw material costs, 47 percent was purchased from small farmers and producers and 49 percent is company produced. See Exhibit II-7 for a summary of raw material purchases. These purchases of locally produced raw materials represent a very large amount of indirect employment at the farm level, however, it would take a considerable amount of additional analysis at a micro-level to quantify its magnitude. We can only speculate that LAAD-CA projects result in farming marginal lands by family members and local labor. The 1977 evaluation of LAAD-CA, which included a sociological study at the farm level, found that aggressive small farmers who marketed their crops to LAAD-CA sub-borrowers rented their neighbors' idle land and hired them to cultivate it.

There are some indirect raw material purchases not registered in these figures. For example, a subsidiary of Empacadora Avicola alone purchases corn worth $1.2 million from over 500 small farmers.

Some sub-borrowers provided services of additional benefit to the small farmers and producers. Seven provided cash advances to small farmers and three provided other types of financial assistance. Seven firms provided other assistance, such as transportation, inputs, processing services, and equipment repair.

7. LAAD-CA WORKS EFFECTIVELY TO RESOLVE SUB-BORROWER FINANCIAL PROBLEMS

Problem loans are not uncommon, yet LAAD-CA personnel are capable of assisting with solutions. Four problem loans were observed during our evaluation.

MADECAS and its affiliate, APROFO, are manufacturers and exporters of high quality wood dowels, principally used as broom handles. Their plants and field operations utilize

EXHIBIT II-7
Purchases From Small Farmers Or Producers

SUB-BORROWER	TOTAL RAW MATERIAL COST	SMALL FARMER OR PRODUCER PURCHASES	PERCENT	COMPANY PRODUCTION	PERCENT
1. OPERK	$ 1,300,000	$ 975,000	75	$ 325,000	25
2. SEPA	3,827,000	3,827,000	100	----	0
3. MARINA DEL PACIFICO	350,000	245,000	70	105,000	30
4/5. APROFO/MADECAS	1,100,000	880,000	80	220,000	20
6. CATACAMAS	2,750,000	1,925,000 1/	70	55,000	2 2/
7. KATOJEKE	125,000	6,250	5	188,750	95
8. AMERICAN FLOWER CORP.	1,600,000	48,000	3	1,552,000	97
9/10. AGRIBIOTECNOLOGIA/ PLANTAS TROPICALES	562,000	----	0	562,100	100
11. EMPACADORA AVICOLA	5,400,000	810,000	15	4,590,000	85
12. INTERMATRA	1,400,000	140,000	10	1,260,000	90
13. PROVEEDORA INTL.	1,352,000	540,000	40	811,200	60
TOTALS	$19,766,000	$9,397,050	47	$9,599,050	49

1/ Small cattlemen classed as owning less than ten head.
2/ Balance of 28% purchased from medium/large cattlemen.

low-technology. Demand in the U.S. is strong and prices for the products are increasing. The companies buy their raw material, scrap wood that otherwise would be wasted, from small- to medium-sized sawmillers.

Their problem is unusual. The owner/general manager is in jail, accused of being an accomplice to the murder of an officer in the Honduran military. The owner's two sons now manage both companies. Fortunately for LAAD-CA, the sons are proving to be good managers. Lenders are rescheduling their loans and creditors are deferring collection on outstanding bills. LAAD-CA's local lawyer has been actively monitoring the situation and feels that they will succeed. A quick recovery on the part of management, together with LAAD-CA's understanding, but firm posture regarding these two problem loans, was critical to the survival of the businesses and collection of the loans. The sons recently became current with the LAAD-CA loan.

KATOJEKE has a problem common to start-up businesses--strong, technical know-how, but weak management. Both principals are strong specialists in agronomics, post-harvest technology, and marketing of perishable produce. However, neither is a strong administrator. Their loan is delinquent, as they are 3 months behind on their loan payments. Negotiations are underway, and rescheduling will most likely result. KATOJEKE has a strong potential and its major problem could be solved quickly. LAAD-CA understands this weakness and has made suggestions to strengthen its management.

INTERMATRA is a medium-technology company with considerable financial backing, run by inexperienced management and technical staff. Management has changed its operational policy too often over the past 3 years. Priorities were changed every few months regarding the type of shrimp to catch, areas and depths fished, equipment used, markets, etc. The results were reduced catches, increased operational costs, and increased losses.

Management now seems to have settled on its operational policy and priorities. Projected losses of $100,000 for 1985 are less than those experienced in 1984. INTERMATRA is presently current on its interest payments, but it owes some $20,000 in principal. Although LAAD-CA has adequate personal guaranties and collateral, this is a problem loan to which LAAD-CA could have paid more attention. It was the only case found where LAAD-CA might have become more involved in resolving a sub-borrower's financial problems.

Proveedora Internacional de Mariscos was described above as having made management changes, suggested by LAAD-CA, that are

resulting in a positive turnaround. Losses have been reduced from $600,000 in 1984 (including 1983 non-recurring losses) to an estimated $300,000 for 1985.

The firm's new general manager, who has been working closely with the LAAD-CA vice president since joining the firm, is exceptionally well-qualified. The principal product is frozen shrimp. Most are caught by the firm's own boats, but an increasing share is purchased from small, independent shrimpers.

Cost reductions; improved boat repair, overhauls, and maintenance; better labor relations; and general operational efficiencies were evident. This general manager, with only 6 months on the job, commented that he had never heard of more assistance and personal interest in a borrower than that given by LAAD-CA. Proveedora is classified as delinquent, and negotiations for loan rescheduling are underway.

8. PROSPECTIVE SUB-BORROWERS ARE REQUESTING LARGER TERM LOANS FOR EXPANSION AND NEW BUSINESSES

The evaluation of nine prospective sub-borrowers was carried out in Guatemala, El Salvador, Honduras, Costa Rica, and Panama.

The average loan size requested is over $675,000, up from $406,000 for the sub-borrowers analyzed above. Most of these loan requests, if approved, will be disbursed over the next 2 to 3 years. Most requests are for term financing of 3 to 5 years. Seventy percent of the financing will be for expansion and new businesses. All will be new loans--none have previously been LAAD-CA clients. All but one will export; most will export 60 to 100 percent of their production. See Exhibits II-8 and II-9 for a list of these prospective sub-borrowers and the proposed uses of the sub-loans.

All of these nine potential sub-borrowers had strong management. Most contacted LAAD-CA and are looking forward to becoming a LAAD-CA client. Labor relations seemed strong. Applied technology, including advanced agronomic practices, was used. For example, Vivero Xochical in El Salvador produces the highest quality floraculture in the country. Another good example is Granjas Marinas San Bernardo in Honduras, a large shrimp farm whose vast cultivation areas are ready for harvest.

These businesses range from small-sized, in start-up phases, to large firms, with present export sales exceeding $3 million. LAAD-CA's loans would assist these firms to nearly double sales and to double exports. Direct employment increases of 344 new employees would result from LAAD-CA's financing. See Exhibit II-10 for estimates of impacts created by LAAD-CA's sub-loans.

EXHIBIT II-8
LAAD-CA Prospective Sub-borrowers

PROSPECTIVE SUB-BORROWER	BUSINESS
Guatemala	
CAMSA	furniture - clock boxes for export
El Salvador	
VIVERO XOCHICAL	ornamental plants for export
DELICIA (APE)	honey, beeswax, and candies for export
MATADEROS DE EL SALVADOR	frozen beef exports
SARAM (part of MOORE group)	mixed feeds, ag. chemicals
Honduras	
GRANJAS MARINAS SAN BERNARDO	shrimp farming for export
Costa Rica	
CASTILLO RIO	orange concentrate, local and export sales
NARANJALES DEL NORTE	passion fruit and orange juice
Panama	
HACIENDA LA MUNA	swine production

EXHIBIT II-9
Future Portfolios
Prospective Loan Size And Uses

PROSPECTIVE SUB-BORROWER	SIZE LOAN REQUESTED	TERM REQUESTED	PURPOSE OF REQUESTED LOAN: WORKING CAPITAL	EXPANSION	NEW BUSINESS
CAMSA	$1,000,000	3 years	40%	60%	0%
VIVERO XOCHICAL	350,000	3 years	30%	70%	new nursery is major portion
DELICIA (APE)	400,000	3-5 years	0%	0%	100%
MATADEROS DE EL SALVADOR	500,000	N/A	60%	40%	0%
SARAM (Moore Group)	1,200,000	5 years +	35%	65%	0%
GRANJAS MARINAS SAN BERNARDO	500,000 1,600,000 1/	N/A	50%	50%	a new business
CASTILLO RIO	200,000	3 installments 3 yr grace + 4 yrs	25%	40%	35%
NARANJALES DEL NORTE	200,000	4-5 years	30%	35%	35%
HACIENDA LA MUNA	150,000	4 yrs + 1 grace	0%	100%	new business started 1983
TOTAL	$6,100,000				
AVERAGE	$ 677,777		30%	51%	19%

1/ 1st phase: Lempiras 1.0 million 1985-86 = US$500,000
2nd phase: Lempiras 3.2 million 1986-87 = US$1,600,000

EXHIBIT II-16
LAAD-CA Prospective Sub-borrowers
Potential Loan Impact
(Dollar figures expressed in thousands)

PROSPECTIVE SUB-BORROWER	PRODUCT LINE	SALES PRESENT	SALES PROJECTED	EXPORTS PRESENT	EXPORTS PROJECTED	EMPLOYMENT PRESENT	EMPLOYMENT PROJECTED INCREASES
CAMSA	mahogany clock boxes-furniture	$ 450	$ 950	$ 180	$ 475	198	22
VIVERO XOCHICAL	ornmtl. plants	75	160	---2/	96	18	35
DELICIA (APE)	honey, beeswax, candies	2,000	2,500	2,000	2,500	31	12
MATADEROS DE EL SALVADOR (ADOC)	frozen beef	4,200	5,100	3,150	4,845	120	40
SARAM	mixed feeds, ag. chemicals	400	550	60	330	350	50
GRANJAS MARINAS SAN BERNADO	shrimp farming, frozen shrimp	----	3,500	---2/	3,500	82	122
CASTILLO RIO	frozen orange concentrate	----	500	---	3 yrs. no exports	10	10 per year
NARANJALES DEL NORTE	passion fruit, orange juice	280	500	---2/	150	52	50 or mor
HACIENDA LA MUNA	swine prod.	----	217 1/	---	---	16	3
TOTALS		$7,405	$13,977	$5,390	$11,896	877	344+

1/ 1985-86
2/ New export enterprise.

Two of these businesses would have to be financed with LAAD-CA's own resources, since USAID prohibits the use of its funds in citrus projects.

9. THE LAAD MARKETING COMPANY COULD PROVIDE CONSIDERABLE SYNERGY BY USING ITS CONTACTS AND EXPERTISE TO HELP LAAD-CA SUB-BORROWERS FIND NEW MARKETS

The role of the LAAD Marketing Company is to promote sales in the United States of agricultural and fisheries products from Latin America and the Caribbean. It provides a particularly useful service for smaller exporters, who normally would be at the mercy of brokerage firms. The company focuses on non-traditional exports, such as fresh fish, asparagus, and snow peas, but also handles manufactured goods that use agricultural or forestry inputs, like rubber gloves and plywood.

The company has only been in operation since 1984, and has required some time to organize itself and make the necessary contacts among both suppliers and buyers. Although presently operating at a loss, the company expects to become profitable in 1986.

The LAAD Marketing Company has formed a series of small marketing companies to sell products exported by suppliers in the areas where LAAD operates. LAAD Marketing provides the seed capital for the new venture, and then charges a monthly fee for consulting services provided to the organization. In addition, LAAD Marketing is entitled to a share of the profits of the new venture, according to the percentage of the stock that it holds. At present, legal and regulatory restrictions limit LAAD Marketing's share to 25 percent of an individual marketing company. However, the growth and development of the LAAD Marketing Company may provide LAAD with new opportunities for equity investments in companies engaging in production and export of agricultural goods.

LAAD Marketing is not an active promoter of new loans among the suppliers contacted while carrying out its marketing activities. However, it can play a very valuable role in assisting LAAD-CA sub-borrowers who are having difficulties finding outlets abroad for their products. There was recently a case where a LAAD-CA client, risking delinquency due to an inability to sell his products overseas, was able to find a buyer in Europe through contacts made by LAAD Marketing.

III. MARKET ANALYSIS OF DOLLAR LOANS FOR NON-TRADITIONAL EXPORTS

This section analyzes several important issues:

- The determinants affecting demand for LAAD-CA loans
- Country-by-country economic conditions
- Interest rates, terms, conditions, and practices of competitive lenders.

Important issues for ROCAP discussed in this chapter are:

- The unique arrangements that LAAD-CA has developed to continue lending in a high-risk, economicallyvolatile environment, especially in light of the difficulties other AID-financed lending programs have had fomenting exports in the region
- Given interest rate ceilings imposed in several countries and other related factors, determination as to whether LAAD-CA is charging its sub-borrowers market interest rates.

This section concludes with an estimate of sub-loan disbursements based on the economic conditions in the sub-market countries, the average loan size requested by prospective borrowers (as noted in Chapter II), and the number of loan operations and average loan size made by LAAD-CA during the past 5 years.

Three fundamental points should help clarify the issues discussed in this section:

- Under unstable conditions, borrowers are likely to prefer loans in their own currency in order to avoid exchange risks, i.e., losses resulting from having to pay back dollar loans with a greater amount of local currency because of local currency devaluation.
- If the loan is denominated in local currency, and the currency devalues, the borrowers reap the benefit of re-paying their loans with "cheaper" units of currency.
- Under such conditions, the interest rates borne by local currency and dollar loans will tend to differ, sometimes widely.

1. THE MARKET FOR LAAD-CA LOANS IS AFFECTED BY ECONOMIC CONDITIONS, POLITICAL STABILITY, AND DEVELOPMENT CREDIT PROVIDED BY AID AND OTHER LENDERS

LAAD-CA operates in five distinct sub-markets subject to constantly changing conditions. The major factors affecting the demand for LAAD-CA loans within each sub-market are:

- Political stability, influenced by both internal and external forces
- Management of the economy, exchange rate stability and control of inflation
- The availability of credit provided by commercial banks and development finance institutions, either using their own funds or lines of credit provided by AID and other development organizations; the efficiency of these lenders; and the interest rates, terms, and conditions applied to these loans
- LAAD-CA's ability to deliver needed financing, bearing market interest rates, and requiring reasonable guaranties, within a short period of time
- Incentives, including the Caribbean Basin Initiative, to attract export industries or entrepreneurs, or to promote domestic investment
- Local entrepreneurial talent
- Labor productivity, wages, benefits, and union activity
- The need of companies to obtain foreign exchange for machinery, equipment, and raw material purchases in the short-term.

The five countries share some common conditions:

- Each is affected by the political instability caused by the Sandinista take-over in Nicaragua, especially in terms of reduced investment.
- Each has received lower prices for its major traditional commodities (coffee, bananas, sugar, and cotton) due to reduced world demand.
- Each has less credit available due to a reduction of exposure by international lenders.

LAAD-CA has continued to operate under these adverse and dynamic conditions. These adversities, in some cases, have

created new opportunities for LAAD-CA and its borrowers. Those who invest may face less competition.

Below, the conditions in each country are examined to determine its quality as a market for LAAD-CA loans, along with an analysis of the prevailing interest rates, terms, and collateral requirements. The evaluation team defined LAAD-CA's market and estimated levels of lending during the next 3 years.

2. GUATEMALA'S EXCHANGE CONTROL SYSTEM IS UNSTABLE AND PRESENTS A HIGH RISK TO EXPORTERS AND BORROWERS OF DOLLAR LOANS, AND ECONOMIC AND POLITICAL INSTABILITY WILL REDUCE INVESTMENT

Guatemala's foreign exchange reserves are very low because prices on its major commodities dropped, multinational banks have reduced their exposure, and political uncertainty has resulted in considerable capital flight. Monetary expansion has created inflation of 40 to 50 percent, resulting in the devaluation of the quetzal in the parallel market from Q1=$1 to approximately Q3.75=$1. Pressure for further devaluation continues.

The Bank of Guatemala, the central bank, has been weakened by staff replacements; reportedly, few experienced staff remain. Its ability to manage competently the economy is questionable. The newly-appointed central bank president has delayed servicing of the external debt, causing considerable consternation in the private sector. Guatemala has no stand-by agreement with the IMF and has received no recent World Bank financing. USAID/Guatemala's development assistance and ESF funds have been limited to $35 million annually, conditioned primarily for highland area development.

Currently, the Bank of Guatemala will exchange 50 percent of hard currency earnings of non-traditional exporters at Q1=$1 and 50 percent at the parallel rate, an arrangement that essentially taxes these exporters. This may change to a 100 percent exchange at the parallel rate, an arrangement greatly benefiting non-traditional exporters. Thus, non-traditional exporters dealing in non-perishable items are holding, rather than exporting, inventories in hopes of a policy change.

Traditional exporters are "taxed" more harshly than non-traditional exporters because their hard currency sales proceeds are exchanged by the Bank of Guatemala at the official rate, Q1=$1. The result is a great deal of smuggling. Reportedly so much coffee is smuggled to Mexico that Guatemala will not have enough to meet its quota this year.

Considerable uncertainty surrounds the presidential elections, scheduled for November 1985, with the inauguration to take place in January. There appears to be no strong candidate, and few believe that the new president will be able to negotiate a stand-by agreement, even a provisional one, with the IMF that will infuse any new foreign exchange into the economy prior to June or July of 1986. The USAID wants to see evidence of increased democracy, less military intervention, and greater human rights before making more aid available. Most anticipate a very difficult economic situation for the next 12 to 24 months.

For the most part, borrowers will not take loans in dollars because the risk of further devaluations is high. A large, sudden devaluation could cause the bankruptcy of firms with dollar obligations. Many bankers feel that the only possibility for lending dollars in this climate is short-term, well-secured loans for export activities that generate hard currency earnings.

(1) <u>The Commercial Bank Interest Rate Ceilings Strongly Limit Commercial Lending Rates, But Financiera Rates Exceed The Ceiling By Four Points</u>

The Government of Guatemala has established an interest rate ceiling of 12 percent on commercial bank lending. Many commercial banks pay 9 percent on passbook savings, although some pay as low as 5 percent, depending on the security and service provided. Commercial bank liquidity is low and bankers anticipate, therefore, that the interest rate ceiling will have to be raised in the near future to allow greater savings mobilization.

Quetzal loans provided by financieras bear interest of 15 to 18 percent, averaging 16 percent. These rates have increased steadily: the average rate was 14 percent 2 years ago and 15 percent last year. Financieras generally pay 2 percent above commercial bank passbook interest on bonds that generate much of their capital. They are currently paying 11 percent on these bonds. Financieras are receiving a 5.0 to 5.5 percent spread, which is reportedly inadequate if excessive loan monitoring or reporting is required. If the commercial bank ceilings are raised, the interest charged by financieras will also increase.

There is no interest ceiling on dollar loans; however, for the reasons stated above, there is both a limited demand and a limited supply of dollar loans. Some bankers felt that if dollar loans can be made, the rates must have a strong correlation to LIBOR or U.S. prime rate. If the interest

rate exceeds the LIBOR or U.S. prime rate by too much, a limited number of borrowers, those with sufficient deposits in U.S. or offshore banks, will seek loans outside the country. If they do not have such resources, and this will apply to the majority of such borrowers, they may not borrow until interest rates drop. One banker estimated that the interest rate on a dollar loan could go as high as 15 percent; another suggested that, if the loan is subject to exchange risks, it should be set at 11 percent.

Commercial lending rates loans have dropped since 1980, while the rates charged by financieras dropped to 14 percent and rose to 16 percent again. LAAD-CA decreased its interest rates from 13 to 12 percent to coincide with the commercial bank interest celing. The most recent loan at 15 percent was a 1-year loan to a cardamom exporter. According to one respondent, such exporters can pay such a high level of interest because of high margins and underinvoicing. This loan was made under a retention agreement with the Bank of Guatemala, which eliminates the exchange risk for the most part. As will be discussed below, such retention agreements give the Bank of Guatemala an opportunity to approve rates charged by LAAD-CA. Therefore, it is not suprising that LAAD-CA rates have coincided with the commercial lending ceilings.

Two LAAD-CA sub-borrowers were able to receive local bank financing. One company obtained a Q90,000 letter of credit at 12 percent on a signature arrangement; the other received a Q550,000, 1-year, 12 percent, roll-over loan from the Banco de Cafe for sesame exports. One sub-borrower would have preferred a local currency loan to a LAAD-CA loan, because he was uncertain about exchange risks. However, such a loan was not available. The other liked LAAD-CA's dollar financing, because he dealt primarily in exports and the loan could be paid off with little risk.

The evaluators conclude that the interest rate charged by LAAD-CA has been at or above commercial lending ceilings, especially during the last 3 years. Its most recent loan bears a rate appropriate for current conditions, especially since the retention agreement reduces the exchange risk. Given the strong demand for quetzal credit to maintain working capital levels and low liquidity in the banking system, interest rates will most likely move upward during the next 2 years.

(2) Commercial Lending Terms Tend To Be Short And Collateral Requirements High Because Of Traditional Banking Practices And Current Economic Conditions

Commercial banks reportedly have 90 percent of their portfolios in 1-year, roll-over loans that are made to industrialists and commercial interests posing little risk of default. Letters of credit require a cash deposit of up to 200 percent of the credit limit as collateral.

Foreign banks have sharply reduced their exposure and are making very few loans, generally only to those clients in work-out status. They also provide short-term, stand-by letters of credit backed by dollar deposits in a multinational bank.

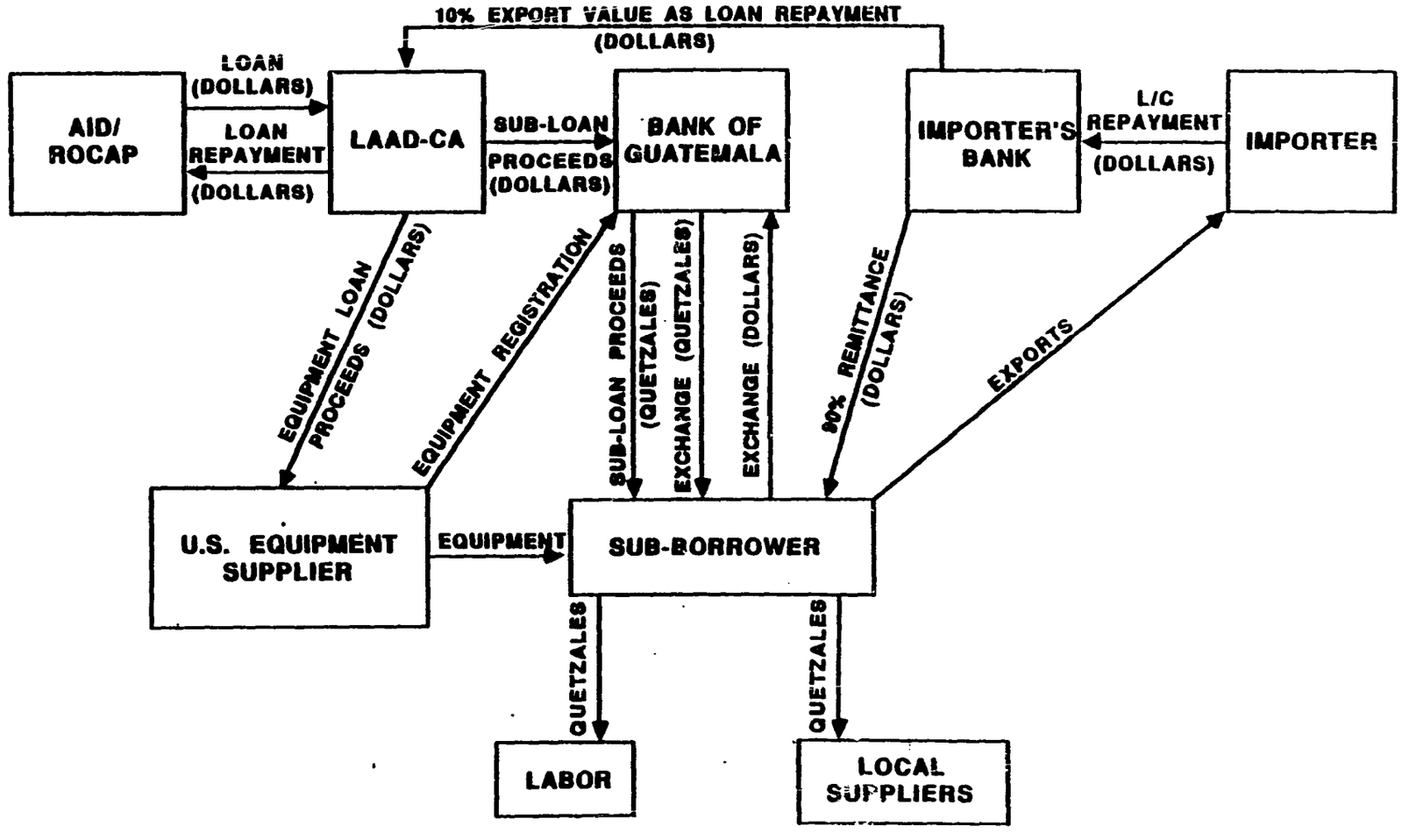
Financieras can make quetzal loans to agriculture and industry for terms of 3 to 15 years; however, they are presently lending for 3-year terms only. Collateral is based on property or fiduciary guaranties, but in every case equity pledged must exceed the value of the loan. Few will lend on plant and equipment because there may be no re-sale value for such assets if the company fails. In all cases, the lender must have confidence in the cash flow projections of the operation and the high reputation of the borrower.

LAAD-CA has generally secured its loans with 150 percent collateral or, in rare cases, fiduciary guaranties based on previous good experience with the borrower. Given lending practices in Guatemala, LAAD's requirement of 150 percent collateral is not excessive, and the fiduciary guaranties are very liberal. In the case of a strong entrepreneur without collateral, LAAD-CA has at times required less collateral.

(3) LAAD-CA Has Developed Retention And Repayment Agreements With The Bank of Guatemala Enabling It To Continue Making Dollar Loans

Because of the devaluation of the quetzal, and with further devaluations possible, most borrowers do not want to bear the exchange risk involved in a dollar loan. LAAD-CA, at the time of its 1983 evaluation, was pioneering agreements with the Bank of Guatemala that allowed it to continue making dollar loans. The process (See Exhibit III-1) is based on the Bank of Guatemala's need to bring foreign exchange into the financial system. All loans and equipment purchased with direct dollar loans are registered at the Bank of Guatemala at face value. The Bank of Guatemala provides quetzales at the current official rate

EXHIBIT III-1
LAAD-CA'S RETENTION AND REPAYMENT AGREEMENTS WITH THE BANK OF GUATEMALA



of Q1=US$1 to the LAAD-CA sub-borrower who uses these funds to conduct his business. Except for loans for importing equipment, the sub-borrower is, in essence, borrowing quetzales and repaying the loan in dollars. The result is a "quasi-dollar" loan that is exposed to less exchange risk than a dollar loan.

Once the sub-borrower's exports are received by the purchaser (denoted as importer in the exhibit), the purchaser's bank remits 90 percent of the invoiced export value to the exporter and 10 percent directly to LAAD-CA. The exporter exchanges these remittances at the Bank of Guatemala for quetzales at rates based upon whether the product shipped was a traditional (coffee, cotton, sugar, or cardamom) or a non-traditional export. Traditional export dollar proceeds are exchanged at the official exchange rate, i.e., Q1=US$1. Non-traditional exporters can exchange export proceeds at 50 percent at the official rate and 50 percent at the parallel rate.

Although these agreements eliminate most of the exchange risk, some risks still exist. The exchange rate policy in Guatemala may be changed at any time, affecting whether the sub-borrower can feasibly export or not. If the exchange arrangement becomes more burdensome, the exporter can counter, to some extent, with greater under-invoicing. The most important risk, however, resides in the dependability of the export market where the dollars for loan repayments are generated.

(4) Demand For LAAD-CA's Loans In Guatemala Will Be Limited By The Lack Of Political And Economic Stability During The Next 2 Years

Investment is likely to remain at low levels during the next 2 years, and this will affect LAAD-CA's ability to make term development loans. LAAD-CA has made some short-term, working capital loans to Guatemalan sub-borrowers with AID funds in the past few years. The evaluators believe that, despite economic conditions, LAAD-CA should make such loans a very low priority, especially if the prospective borrower is sufficiently strong to obtain working capital financing from commercial lenders. The country is not totally bereft of prospects for financing development projects, as the OPERK loan and SEPA, a recent loan prospect, demonstrate. LAAD-CA should continue to seek such borrowers out. If LAAD-CA must lend short-term working capital to such firms as CARDINSA and Industrias Sesamo to maintain the yield on its portfolio, especially if the loans meet the non-traditional agricultural export and small farmer impact criteria, such loans are an

acceptable option. However, the reflows from those funds should continue under the purview of ROCAP until those funds are used for term financing. Until LAAD-CA makes loans that contain a portion of, say, 50 percent fixed-capital financing, use of the repayments should continue to be approved by ROCAP.

3. EL SALVADOR'S ECONOMIC SYSTEM IS WELL-MANAGED BY THE CENTRAL RESERVE BANK, BUT IT CONTINUES TO SUFFER A FOREIGN EXCHANGE SHORTAGE AND ITS NATIONALIZED BANKING SYSTEM LACKS DEVELOPMENT LENDING CAPABILITY

Due to its internal political strife, the reduction in prices for its traditional commodities and reduction in output due to agrarian and export reforms, the economy deteriorated from 1979 to 1983. In 1983, the economy began to recover in real terms, but the foreign exchange shortage caused by these factors continues to be severe. While the official exchange rate remains pegged at C2.5=US$1, the parallel rate has floated to C4.85=US$1. The black market rate recently peaked at C10=US$1.

Foreign exchange is allocated by the Central Reserve Bank among users on the basis of pre-determined priorities. In order of descending priority, these are foodstuffs, medicines, fuels, agricultural inputs, replacement parts for transportation, and replacement parts for export industries. Importers of these priority goods may buy foreign exchange from the BCR at the official rate of C2.5=US$1. Other importers must buy dollars at the parallel rate, and often experience delays of 1 year before foreign exchange is disbursed.

Despite these problems, the economy has been well managed by the Central Reserve Bank, which has kept a tight rein on monetary expansion. Inflation has been contained to the following levels:

Year	Inflation Rate
1979	14.8
1980	18.6
1981	11.6
1982	13.4
1983	12.1
1984	11.7
1985 (through June only)	16.0

The current BCR strategy is to maintain interest on savings at relatively high levels while using "soft" lines of credit to finance exports. Liquidity in the banking system is currently high, but liquidity is cyclical in El Salvador. During the

harvests of the major crops: coffee, sugar, and cotton, liquidity is reduced. The harvest season extends from November to March.

Many interviewees feel that the economy's recovery is strengthening and investment will accelerate in the near future, despite a recent small increase in capital flight. One negative event has been the announcement of the closing of the Texas Instruments plant. Nevertheless, the evaluators were favorably impressed with number and quality of LAAD-CA loan prospects.

The most important phenomenom noted with regard to future economic growth was the positive change in government-private sector relations. Following the agrarian, banking, and export reforms, the private sector, the majority of which comprised the group controlling the old socio-economic order, was viewed skeptically by the government. That view has not totally disappeared; nevertheless, the reforms have had a positive effect. Although the wealthy were forced from the lands and the banks by the reforms, not all left the country, and those who remained have sought to maintain their standard of living. Some have pursued non-traditional exports as the means to do that, an activity that coincides with the current growth strategy of the government, the Central Bank, and AID. The BCR portrayed the "development team" as the BCR; the private sector; FUSADES, a private sector research organization; and AID.

Many bankers and businesspeople gave USAID/El Salvador high marks for providing strong balance of payment support during this critical period. Recently, new colon discount lines amounting to $326 million were provided for the private sector financing by the USAID ($100 million) and the BCR ($226 million). The major question regarding this financing is whether the nationalized banking system will move the new lines or not. To raise the efficiency in loan processing, the USAID is developing uniform credit applications based on proven models and is financing the training of more than 100 loan officers at Citibank facilities in Puerto Rico. It is also promoting the formation of a private financiera to lend to non-traditional exporters.

An additional positive sign is the establishment of a $75 million facility by the U.S. Ex-Im Bank, which has attracted some U.S. banks to provide letters of credit for trade financing.

The USAID's 1-year goal is to create 5,000 new jobs and $20 million in additional net exports. USAID is emphasizing non-traditional agricultural and marine exports as well as drawback

industries. For the latter, the focus is upon U.S. garment manufacturers that are seeking to move their overseas operations into the CBI area.

(1) The Commercial Lending Ceiling Is 14 Percent But Some New Credit Lines Bear Even Lower Rates

The commercial banks are presently allowed to charge up to 14 percent on their own funds. Passbook savings and certificates of deposit pay from 7 to 13 percent.

The colon credit lines available for agribusiness and industry through the BCR and the commercial banks are as follows:

Source	Use	Interest Rate
USAID and BCR	Capital, machinery, and technical studies	14%
	New export industry construction	10%
IDB and BCR	Industrial reactivation, working capital, machinery, construction	14-15%
USAID and BCR	Exports outside of CACM	10%
	Exports to CACM	11%
Economic Development Fund	Establishment of agroindustries	10%
BCR	Re-financing for rehabilitation of industries	10%

Because of the extreme foreign exchange shortage and subsequent difficulties in repatriating several loans, LAAD-CA has made only one loan in El Salvador in the last 5 years. On that loan, which was made recently, it charged 13 percent with a 2 percent closing fee. That technically makes the rate higher than the commercial lending ceiling, although the ceiling does not apply to such loans.

The sub-borrower was not able to obtain term financing from any source other than LAAD-CA. It was able to borrow working capital funds from the Banco Capitalizador on a 1-year, roll-over basis at 14 percent.

(2) Commercial Banks Require Collateral Of 125 Percent On Their Own Funds, But Loans Through The New Lines Will Require Collateral Of Only 10 To 15 Percent

The commercial banks require collateral valued at 125 percent of the loan if they lend their own funds. The banks also require that the application be accompanied by a highly detailed feasibility and market study. These studies appear to be the bottleneck in the process of making term loans. Some prospective or actual LAAD-CA borrowers reported that such studies require, not only the approval of the commercial bank, but also the approval of the BCR. This process, described as a "ping-pong game," can require more than 1 year before final approval. As the new lines require minimal levels of collateral, the feasibility studies will serve in lieu of collateral and will be scrutinized even more than in the past. Prospective borrowers anticipate considerable delay.

The new LAAD-CA sub-borrower, Marina del Pacifico, lost over 1 year trying to obtain a loan from the Banco de Fomento Agropecuario to purchase shrimping boats. Even after preparing an in-depth feasibility study, the company was turned down. Fortunately, the USAID private sector office was cognizant of LAAD-CA's program and put the two organizations together. LAAD-CA reviewed the feasibility study and made the loan.

(3) LAAD-CA Has Recently Negotiated A Retention Arrangement With The Central Bank That Paves The Way For Future Loans

The BCR, USAID/El Salvador and LAAD-CA are pleased with the recent retention agreement negotiated between the BCR and LAAD-CA in connection with the Marina del Pacifico loan. Under the agreement, which is similar to the one negotiated with the Bank of Guatemala, 20 percent of export proceeds are sent directly to LAAD in the U.S. through a retention agreement. The remaining 80 percent of the proceeds will be sold by Marina del Pacifico to its bank at the parallel rate. The USAID sees a strong future role for LAAD-CA because of the bottlenecks in the banking system. The BCR favors the LAAD-CA retention arrangement because the country is in dire need of foreign exchange, and such lending can generate considerable foreign exchange. Furthermore, LAAD-CA can be useful in that its fast disbursements to firms needing dollars to buy machinery avoids the problem of price changes by suppliers and delays in obtaining foreign exchange from the BCR.

Many bankers see a considerable demand for LAAD-CA loans as they represent a relatively trouble-free source of dollar loans, repayable through retention agreements, in a market where development financing is still limited.

(4) Foreign Banks' Normal Lending Operations Have Been Constrained Since The Banking Reform

There are presently four foreign banks operating: Bank of America, Bank of Santander and Panama, Bank of London, and Citibank. These banks have been strongly constrained in their activities by the GOES since the banking reform. At that time, they were given 1 year to terminate their operations, but all have received extensions to operate during the past 5 years. This is partly due to the GOES' recognition that attracting U.S. and other foreign investors is important and will be difficult if these banks are closed. These banks are not only symbolic of the GOES tolerance for foreign investment, but also the recognition that they, through their extensive systems, can expedite the overseas transactions of a foreign investor.

These banks currently generate most of their earnings through foreign trade financing. Typical financing is a 180-day letter of credit, guaranteed by a deposit in dollars amounting to 25 to 50 percent of the letter of credit limit. Interest charged on these loans is LIBOR plus up to 2.5 percent, a limit imposed by the BCR. Local banks also participate in such trade financing through correspondents.

There are also "intermittent" lenders, such as Citizens and Southern Bank, Bank of Boston, and Bank of West Palm Beach, which move in and out of the market seeking letter of credit business. For the most part, this short-term trade credit does not compete with LAAD-CA term lending, nor, as noted above, does LIBOR plus 2.5 percent ceiling apply to LAAD-CA financing.

(5) Two Salvadoran Financieras Established By AID Either Became A Commercial Bank Or Went Bankrupt

Two financieras were formed under AID auspices in the mid-1960s. After concessional financing was withdrawn, one converted into a commercial bank and was nationalized at the time of the reform; the other went bankrupt. This is consistent with the findings of this report concerning LAAD-CA's operations and the need for concessional financing.

(6) LAAD-CA Will Enjoy A Strong Market In El Salvador During The Next 2 Years

The Private Sector Office of El Salvador and the BCR support the idea that LAAD-CA make as many loans to non-traditional exporters as possible, as soon as possible. The USAID and BCR will continue to encourage and train the nationalized bankers to make development loans. However, they are not fully confident that these bankers will lend to businesses such as those financed by LAAD-CA. USAID and BCR officials are confident that LAAD-CA, with its proven record, should be a part of their program. The BCR sees the foreign exchange brought in through LAAD-CA loans as needed, and they appreciate the competition with the local banks that LAAD-CA creates.

4. HONDURAS HAS A STAGNANT ECONOMY CREATED BY INTERNAL AND EXTERNAL POLITICAL UNCERTAINTY AND OVER-VALUATION OF THE LEMPIRA

As in Guatemala and Costa Rica, elections will be held shortly, and there is great uncertainty regarding future government policies. Futhermore, the presence of the counter-revolutionary Nicaraguan forces in Honduras creates additional uncertainty. The result is little domestic or foreign investment. The USAID reported only four significant new investments since the start of the CBI, 18 months ago. Honduras' major commodities, bananas, coffee, lumber, meat, sugar, and cotton, have suffered from a drop in world demand and exports are down. Adherence to a L2=$1 official exchange rate has made Honduran exports more expensive compared to competitor countries. The trade balance has been negative for the last 4 years.

Resistance to devaluation stems from the perceived political consequences of increasing prices of imported consumer goods. The government views exporters as the group gaining the most from a devaluation. Since exporters are few in number, and consumers are numerous, the government has held on to the official L2=$1 rate. Indeed, inflation has been contained, according to government estimates, at a low 6 percent. Unofficial estimates put inflation at 15 to 20 percent. There are pressures to devalue. The unofficial parallel rate oscillates between L2.60 and 2.80=US$1.

Because of the lack of exports, there is an acute foreign exchange shortage. Like the central bank in El Salvador, the Central Bank of Honduras allocates foreign exchange according to set priorities:

- Foodstuffs and medicines

- Fuels, lubricants, and farm inputs
- Industrial inputs
- Non-luxury consumption goods
- Luxury consumption goods.

Individual banks may have enough foreign exchange at a given time for modest international transactions totaling $40 thousand to $50 thousand. If the transaction is larger, foreign exchange disbursements from the BCH may require up to 1 year.

In light of the foreign exchange shortage, export development is desirable, but exports face many obstacles. Because of the foreign exchange shortage, the BCH requires that 100 percent of hard currency remittances be turned over to the banking system. The banks retain 70 percent of the foreign exchange and pass 30 percent to the BCH. If exporters require foreign exchange to purchase imported raw materials or replacement parts, they must make a request to the BCH and wait up to 1 year for foreign exchange to become available.

These restrictions on foreign exchange stem from the government's perception that exporters create capital flight. The exporters request dollars to finance imported raw materials, under-invoice their exports and, by previous arrangement, have their dollars deposited in a bank account in the United States. Exports are generally believed to be under-invoiced by up to 25 percent. Under-invoicing is a common practice of exporters throughout the region. Apparently some exporters have a worse reputation than others. Shrimp exporters, for example, are believed to practice flagrant under-invoicing and illegally sell their export proceeds on the black market.

Additional problems for exporters are caused by the national budget deficit. There is a need to expand the tax base, but efforts to do so have proven futile; thus, taxes fall heavily on imports and exports. As a result, contraband to other Central American countries is increasing. Because there is pressure to increase exports, the GOH has reduced selected export taxes. For example, taxes on banana exports have been reduced as a function of volume.

As noted above, exporters face pricing problems due to the official exchange rate of L2=US$1, which overvalues exports. Traditional exporters are trying to regain competitiveness and maintain sales levels, but, given their prices and reduced sales, many are unprofitable. Devaluation appears to be the

easy solution, but it is more complicated than that. Besides the political factor, Honduras also faces a critical lack of entrepreneurs.

A country long-dominated by the Standard Fruit Company and the United Brands Company, the majority of its industries are small- or medium-sized, and most do not have export capability. Those who become industrialists want to recoup their investment in the short-term. Because Honduras' capacity to export is primarily limited to traditional products, a devaluation may not improve the economy, and could set off an uncontrollable downturn, creating further internal political instability.

Many believe that if AID-provided Economic Stabilization Funds had not been granted, the recession in Honduras would be much worse.

(1) <u>There Is A Commercial Interest Rate Ceiling Of 19 Percent, But Development Financing Is Available At 13.5 to 17 Percent</u>

The Central Bank has set an official interest ceiling of 19 percent on commercial loans. Interest rates on industrial financing are currently 15 percent. The average interest charged on discount funds from the Central Bank averages 15 to 17 percent. Passbooks savings rates are 7 percent, and certificates of deposit range from 10 to 14 percent, depending on amounts and period of time. Savings are reportedly low.

The government finances its deficit, in part, through the sale of tax-free bonds that bear 10 percent interest. With the tax-free feature, these bonds yield 23 percent for upper-income brackets. These bonds "crowd out" some investment.

The government recently raised the banks' reserve requirements, reducing liquidity to control inflation and leaving fewer funds available for lending.

Some development financing has been made available by the USAID and other donors that bears interest rates below the interest ceiling:

Source	Use	Interest Rate
BCH	Industrial Working Capital	15%
World Bank	National Fund of Industrial Development	17%

IDB	Industrial Reactivation Program	17%
USAID	Small and medium-sized agribusiness	Negotiable
USAID	Dollar fund for imported inputs for non-traditional exports	13.5-14%
USAID	Non-traditional export term financing (Fund A)	Under 14%
	Guaranteed Term Financing (Fund B)	3% spread to lender

Other than the USAID dollar fund for imported inputs that will be made available in November 1985, no dollar loans are available due to the foreign exchange shortage described above. Bankers indicated that an appropriate interest rate for LAAD-CA loan under present conditions, even with a retention agreement with the BCH, is 14 percent. Thus, it does not appear that LAAD-CA is charging below-market interest. An important factor in Honduras is the level of demand for such loans. As indicated above, the level of new investments is low, and that could force interest rates on LAAD-CA loans downward.

The funds provided by the World Bank for the agricultural sector and agroindustries (industrial development fund) are reportedly moving slowly and have gone to a limited group of producers. Nevertheless, an additional World Bank loan of $40 million to $60 million is proposed.

Respondents had differing opinions on the Industrial Reactivation Fund loaned by the IDB. One opinion was that it was well used, having turned over twice. The other view was that it was moving very slowly, mainly because of a very complicated loan application. The evaluators were able to confirm the use of a loan application that required a knowledge of theoretical economics, knowledge most likely not held by Honduran bankers. This led to the conclusion that it must be difficult to get a loan through the IDB line of credit.

USAID/Honduras has recently provided $8 million to a newly formed financiera, Financiera Industrial y Agropecuaria, that is lending to small industries. Its term loans (up to 9 years on fixed assets) are made available at 18 to 24 percent to the user. It made 13 small loans in 1985.

(2) The Banking System Is Inefficient And Requires High Guaranties

There are currently 15 commercial banks. These banks were reported to rely heavily on "name-lending." For those who do not have a "name," collateral requirements reach 300 percent of the loan value. The banks generally will not accept plant and equipment as collateral, but prefer urban, residential real estate (usually in the best Tegucigalpa neighborhoods). Commercial lenders are especially conservative in start-up situations, requiring even higher levels of collateral. Few banks take cash flow into consideration when making a loan; however, both Bank of America and Citibank are relying more on cash flow analyses.

Letter of credit financing must be guaranteed by a 100 percent deposit in local currency. Bank of America requires a 100 percent deposit in dollars in a U.S. bank in order to extend a letter of credit for a foreign transaction. The U.S. Ex-Im Bank and AID have established a guaranty facility of $25 million to keep trade moving. U.S. banks confirm the letter of credit offered by the local bank, insuring that dollars are deposited in the U.S.

(3) Retention And Repayment Agreements Similar To The Guatemalan And Salvadoran Arrangements Have Been Negotiated

LAAD-CA has negotiated agreements with the Central Bank similar to the agreement negotiated in Guatemala. This has enabled it to finance six new Honduran projects. Bankers who reviewed the concept with the evaluators felt that the LAAD-CA scheme avoids the exchange risk adequately and is workable in Honduras.

(4) The Market For LAAD-CA Loans In Honduras Will Be Limited Because Of Economic Conditions And Limited Entrepreneurial Capability

Not many new investments have taken place in Honduras. The adherence to the L2:US$1 exchange rate and the lack of support for exporters by the government negatively affect the promotion of new investments. The recent investment by Griffin and Brand in citrus production, and the Sea Farm Shrimp cultivation project are significant but unusual investments, given the present economic climate.

Some 200 products have been identified by the USAID that could be exported to the U.S., taking advantage of the CBI. FIDE, the Foundation for Industrial Development Research, is focusing its efforts on drawback operations for apparel manufacturers, and wood product manufacturing.

It has developed pre-feasibility studies for 12 investment possibilities, but implementation will depend heavily on entrepreneurial initiative, a capability in short supply. Additional drawback operations will be difficult to promote until new free zone facilities are completed. The free zone at Puerto Cortez is fully utilized by garment manufacturers and transshippers. To address this shortage of space, the GOH is investigating the establishment of a new free zone in a different location.

5. COSTA RICA HAS DEVALUED ITS CURRENCY, HAS CREATED INCENTIVES TO STIMULATE EXPORTS, AND HAS RELATIVELY STRONG POLITICAL STABILITY, MAKING IT A GOOD MARKET FOR LAAD-CA LOANS

In 1981-82 Costa Rica sharply devalued its currency, thereafter undergoing adjustments that are paying dividends in economic stability today. One impact of the devaluation was the surplus in its trade balance with other Central American countries that currently owe it $300 million. GNP growth has been positive; in 1984, it was estimated at 6 percent. There has been a downturn in the economy in 1985, however, due to foreign exchange shortages, austerity measures imposed by the IMF, and the reduction in trade in Central America.

Total exports to non-Central American buyers have not increased markedly. Additional blows to exports were the withdrawal of major foreign-owned banana operations last year and hurricane destruction of banana plantations, jointly resulting in a drop in banana exports of 20 percent. Coffee production was at an all-time high in 1984-85, but is predicted to fall in the 1985-86 season by 15 percent. Sugar cane production is down, but cacao, cattle, and beef exports have increased. Industrial performance is mixed; total growth in that sector during 1985 is expected to be 1 percent.

Non-traditional exports are expected to increase because of incentives provided to exporters. In 1984, non-traditional exporters were exonerated of all income taxes for 12 years. Exporters also are provided with a tax rebate (CATS) amounting to 15 percent of the export value. Other benefits are available through CINDE, a private sector development organization that promotes investment and trains managers and employees of firms engaged in export operations. Three new draw-back industries were attracted to Costa Rica in the last three months: Hathaway Shirts, Farrah Jeans, and Lee Jeans.

A stand-by agreement has been reached with the IMF and conditions have been met so far. While there are foreign exchange shortages, USAID ESF support has made the problem less severe than in Guatemala, Honduras, and El Salvador--foreign

exchange can be purchased with only a 1- to 2-month wait. The devaluation and credit restrictions are specified by the IMF. In 1984 inflation reached 17.3 percent, but in 1985 it is projected to drop slightly to 15.5 percent.

A disincentive to greater output is a highly progressive income tax rate. Incomes over the equivalent of $20,000 are taxed at 50 percent.

(1) Interest Rates Limits Are Adjusted Periodically By The Central Bank, But The Public Sector Banking System Is Inefficient And Political

Under the IMF stand-by agreement, Costa Rica is to maintain positive interest rates. The Central Bank achieves positive rates by setting a basic passive rate (prime rate) that exceeds the inflation rate.

Currently the basic passive rate is 20 percent. Loans to preferred customers are provided at 23 percent and the current interest rate ceiling is 25.5 percent. Passbook savings currently bear 18 percent interest, which was recently decreased from 22 percent because of sufficient liquidity.

The banking system comprises four state-owned commercial banks, 13 private commercial banks, six private savings and loans, and numerous other specialized state-owned financial institutions. Only the state-owned commercial banks can receive deposits, accounting for about 97 percent of total deposits and 93 percent of loans. Private commercial banks are compelled to capture savings through 3-month certificates of deposit on which they are currently paying 23 percent interest.

The state-owned banks are very inefficient. Their administrative expenses average 40 percent, causing decapitalization, and they make political loans with frequency. Although the private banks are operating at a considerable disadvantage by not being able to take deposits, they are growing in importance. They increased their market share of total banking activity from 1 percent in 1980 to 6 percent in 1985.

Presently there are no dollar lines of credit available through the commercial banks because of the shortage of foreign exchange. LAAD-CA borrowers stated that there was not enough term financing available; if available, loans bore variable interest rates that they did not find as attractive as LAAD-CA's fixed rates. One borrower stated that local banks were extremely slow and "almost impossible

to deal with." LAAD-CA's ability to quickly investigate, approve, and disburse a loan were impressive to borrowers when compared to the time required by local banks. Large projects proposed for financing must have a feasibility study that, once prepared, requires 3 to 4 months for approval.

Two of LAAD-CA's borrowers have been able to receive local currency financing from three local banks:

Lender	Amount	Purpose	Interest
Banco National de Costa Rica	C2.8 Million	agriculture	18%
Bank of America	C4.0 Million	floriculture	23.5%
Banca Corporativa	C13.0 Million	floriculture	23.5%

There is, at present, no formal ceiling on dollar loans; however, unless a dollar loan is made at LIBOR plus 3 percent and is registered at the BCCR, the company cannot obtain foreign exchange through the BCCR. These conditions essentially restrict dollar loans to LIBOR plus 3 percent.

LAAD-CA's most recent loan, which bears 14 percent interest, was able to avoid this limitation by arranging an alternative to ensure the availability of off-shore dollars to service the loan. The evaluators consider this an exceptional case--most sub-borrowers will not have off-shore resources and will not be able to pay very high, up-front closing fees. Most loans in Cost Rica will be limited to LIBOR plus 3 percent with up-front closing fees of no more than 2 percent.

(2) Most Commercial Bank Financing Has Terms Of 6 To 12 Months, And Grace Periods Are Not Generally Available For Start-Ups

According to local bankers, medium-term financing, for the most part, does not exist. Most loans are short-term, and are rolled over every 6 months, making them "permanent working capital." Most loans to small enterprises are available through the state-owned commercial banks. Small enterprises can borrow on 5- to 8-year terms, as long as they have no more than $30,000 in assets and 20 employees.

The USAID has made "soft" lines available through the private banks that have up to 7-year terms.

Of the three loans noted above that were obtained by LAAD-CA sub-borrowers, the term from the state-owned bank was 1 year; the Bank of America and Banca Corporativa loans were for 3 and 5 years, respectively. These latter two loans were provided to American Flower, the case discussed in Chapter II. Generally, sub-borrowers were offered loans with 1-year terms by the banks. Sub-borrowers also noted the extreme difficulty of arranging a grace period for start-up operations.

(3) Cash Flow Financing Is Not Done And Large Guaranties Are Required

All except very small projects must accompany their loan applications with a feasibility study. Despite cash flow projections in the feasibility study, these studies are insufficient if the borrower does not have sufficient guaranties. Unlike bankers in some of the other countries reviewed, Costa Rican bankers will consider plant and equipment that, if not considered sufficient, must be accompanied by liens on property owned by the borrower.

For the small enterprise loans provided through the state-owned commercial banks, machinery purchased with the loan proceeds can serve as 75 percent of the required collateral, real estate can serve at 80 percent, and vehicles can serve as 60 percent.

Of the three loans obtained from local banks by LAAD-CA sub-borrowers, the 1-year loan required collateral of crops to be raised and cattle, making it essentially production credit. The C4.0 million (equal to $80,000) provided to American Flower was a signature loan; and the other loan was backed by a mortgage on land. LAAD-CA sub-borrowers felt that the terms offered and the grace periods available through LAAD-CA, were better than any financing available locally.

(4) USAID/Costa Rica Is Supporting Several Lending Activities To Expand Exports And Maintain Private Sector Solvency

The USAID has provided $90 million worth of local currency generations from balance of payment support in "soft" lines. These lines have been channeled through private and state-owned banks to strengthen the capital base and restructure debts of local companies that suffered problems brought on by the devaluation of 1981-82.

The most innovative project, the Private Investment Corporation, the first venture capital company in Central America, was established in 1984 by four private banks plus

some independent investors. The USAID provided a $20 million loan for on-lending and a $1 million grant for technical assistance. PIC can provide dollar loans to borrowers. Five million dollars from local currency generation has also been provided. Presently, PIC focuses on drawback industries and anticipates $10 million in disbursements by the end of 1985. At the time of the evaluators' visit, a $6 million manufacturing opportunity was under consideration. Despite these bright prospects, the USAID is concerned with the slow action by PIC and its high borrower equity requirements.

The USAID is also providing $10 million in medium- and long-term credit for new exports through COFISA, the Costa Rican Industrial Financing Corporation. Dollar export financing of $10 million has been made available through BANEX; however, this activity reportedly has had only limited success.

(5) LAAD-CA's Market In Costa Rica Will Continue To Be Substantial

Political stability, both internally and externally, appears strong even as Costa Rica approaches elections in February 1986. If this stability, coupled with continued prudent management of the economy by the Central Bank, continues, the evaluation team projects a strong role for LAAD-CA in Costa Rica during the next 2 years. Besides the non-traditional agricultural exporters that are prospective borrowers, LAAD-CA should consider financing drawback industries that are moving to Costa Rica to take advantage of the CBI, tax incentives, relatively cheap and productive labor, and the best investment climate in Central America.

6. PANAMA'S ECONOMY IS STIFLED BY POLITICAL INSTABILITY AND CORRUPTION, ONEROUS LABOR LAWS AND LOW PRODUCTIVITY, AND A LACK OF ENTREPRENEURS

In September 1985, the Panamanian political system and relations with the U.S. were jolted by a coup that set the stage for the fifth presidency in 6 years. President Ardito-Barletta had attempted some basic reforms, including labor law amendments, that were blocked by the military, the political opposition, and the labor unions. The U.S. government has expressed its displeasure with the coup. Businesspeople are waiting for the government to clarify its policies before investing. The advantages of good transportation connections and a dollar-based economy mean little under these circumstances, and the country has experienced 3 years of zero GDP growth.

According to bankers interviewed, policies that affect agribusiness development, namely agricultural pricing, are set whimsically by the Institute of Agricultural Marketing (IMA). These exogenous price adjustments adversely affect farm production, while providing the opportunity for IMA to engage in questionable export and import practices.

Corruption in government, the interviewees added, sets the tone for abuse throughout the system. Funds for infrastructural development reportedly dissipate before projects are completed.

According to bankers, businessmen are also suspect. Extraordinarily tight controls must be imposed to ensure that loan proceeds are used for the stated purposes. In addition, many businessmen have limited managerial and technical capability. Market and feasibility analyses for loans are rarely well done. The government does little to support the private sector or export activities.

The foreign banks that lend locally are suspending or cutting back their operations. For example, Bank of America is suspending its agricultural loan operations because they are considered too risky. Chase Manhattan is reducing its lending portfolio because of a lack of profitability. It is currently very difficult to obtain an agribusiness or agricultural loan in Panama.

High benefits for labor, the difficulty in firing a worker, the power of the labor unions, and low productivity keep many investors from starting up in Panama.

As a result of this combination of factors, the country is currently in a strong recession with high unemployment (15 to 20 percent).

(1) <u>Because Panama Has A Dollar-Based Economy, Loan Interest Rates Are Based On LIBOR</u>

Term loans for agribusinesses, if available, are made at LIBOR plus 3 percent. Most personal and business transactions bear a 1 percent government commission; however, agribusiness loans do not. As of October 1985, the interest on such loans is just over 11 percent.

Agricultural loans are subsidized, based on Law 20, passed July 19, 1980. The current interest ceiling on these loans is 10.25 percent. The subsidy is generated by the 1 percent charged on business and personal loans.

The local financial institutions are restricted by an interest rate ceiling of LIBOR plus 3 percent. To compensate for this limit, LAAD-CA also charges sub-borrowers a 2 percent up-front fee at the time of closing.

LAAD-CA's interest rates are in line with local commercial lending rates--its most recent loan was made at 13.5 percent.

One LAAD-CA sub-borrower has also been able to borrow from local banks as shown below:

Loan Source	Type	Interest
Banco del Istmo	6-month roll-over	13.5%
Banco Nacional de Panama	6-month roll-over	14.5%

The IDB has an industrial credit line channeled through the Banco Nacional de Panama. This line, for loans from $15,000 to $1.4 million, bears 14 percent interest on both fixed assets and working capital loans, plus 1 percent upon loan execution. The IDB has also placed a line with the BNP for shrimp production that also bears 14 percent plus 1 percent upon loan closing.

USAID has recently unveiled a $17 million line to be loaned by commercial banks at a rate negotiated with the borrower to provide a spread sufficient to cover "small loan" administration. The line is new and the prevailing interest rate has not been established, but will likely be 13.5 to 14.0 percent.

(2) Term Loans Are Almost Unavailable Although Collateral Required Is Only 100 Percent Of Loan Value

Other than the IDB and USAID lines, term loans are almost non-existent today. This lack of financing is ironic as Panama is the fourth largest banking center in the world; most banks are dedicated to offshore operations. As noted above, the two loans gotten locally by LAAD-CA sub-borrowers are 6-month, roll-over loans.

Collateral in Panama is generally provided through equity invested and appraised at 100 percent of the loan value. Grace periods are extremely difficult to arrange for start-up operations.

While the IDB industrial credit line provides for terms of 4 to 10 years on the fixed asset portion of the loan and 1 to 3 years on working capital loans, it has had great difficulty in moving this line. After 3 years, only 20 percent of its $25 million fund is committed.

The primary obstacle to moving the IDB funds is its conduit, the Banco National de Panama, which also acts as the central bank and a commercial lender. The BNP gives the line little priority, uses time-consuming bureaucratic procedures and applies extremely conservative banking standards.

The new USAID line will result in loans with 5-year terms and 1-year grace periods; however, these loans will be limited to $75,000, restricting the loans to small-sized companies.

(3) Retention Arrangements Are Not Required In Panama Because It Is A Dollar-Based Economy

Because there are no foreign exchange risks or problems connected with dollar loan amortizaton, as is the case in other Central American economies, no retention agreements have been negotiated by LAAD-CA.

(4) There Are Some Competitive Sources Of Financing, But They Are Unproven Or Inefficient

The BNP's inefficient handling of the IDB line is discussed above. Other efforts to provide development financing have been made in the past. One such organization was Desarrollo Industrial, S.A., a private credit institution founded in 1964 by a group of prominent Panamanians with funds from AID and the U.S. Export-Import Bank. DISA has failed to become a significant source of industrial credit for the private sector, primarily because large portions of its credit were extended to its major shareholders. GOP interest rate restrictions encouraged placing assets in c.d.'s and short-term commerical paper.

Another organization, the National Finance Corporation, known as COFINA, was a government-owned industrial development bank. COFINA suffered from excessive management turnover, inadequate loan supervision and political loans. Net profit dropped sharply from $1.9 million in 1980 until COFINA went bankrupt in 1983.

The USAID has withdrawn its funds from the BNP and the Ministry of Commerce and Industry, and has launched a $17 million loan program to be channeled through the commercial banking sector. The limitation to the loan program is that

it is directed to small- and medium-sized industries, with a loan limit of $75,000. Another constraint will be the funding channel: the USAID private sector office wants to "reform" the private commercial banks. It hopes to do this by channeling the entire loan program through them while providing them with collateral guaranties of 35 percent of loan value. The assumption is that banks will require less-than-normal collateral and process the loans faster. The bankers have already complained about these collateral requirements. On the other hand, the small industrialists have complained that the interest rates are too high. If the program gets off the ground, there will still be a gap in the financial market comprising those businesses requiring loans over $75,000.

(5) LAAD-CA Can Play An Important Role, But The Market Will Be Limited Due To Political And Economic Conditions

LAAD-CA may be able to make several loans in Panama during the next 2 years. From a supply point of view, there is a gap in the development financing offered. Whether there will be much demand under uncertain political and economic conditions is questionable. Until some amendments are made in the labor laws that will promote new domestic and foreign investment, demand for development loans will be limited.

7. LAAD-CA CONSISTENTLY CHARGES MARKET OR NEAR-MARKET INTEREST RATES FOR ITS LOANS, AND THEY WILL BE DEMANDED BECAUSE OF SPEEDY LOAN PROCESSING AND REASONABLE GUARANTIES

In the sections above, numerous sources of credit were discussed. These are summarized in Exhibit III-2. Regarding LAAD-CA's lending practices, the evaluators conclude the following:

- LAAD-CA loans have equaled or exceeded commercial ceilings in Guatemala and Panama.

- The only recent loan in El Salvador was one point under the lending ceiling, but included a closing fee of 2 percent.

- Loans in Honduras have been made at slightly below the average commercial bank rate on local currency loans of 16 to 17 percent, but are in line with other development finance lines, for example, USAID's dollar line at 13.5 to 14 percent. Local bankers feel that LAAD-CA loans should currently be made at approximately 14 percent, the rate applied to LAAD-CA's most recent loan in that country.

EXHIBIT III-2
Summary Of Central America And Panama Loan Market Data

	Interest Rate Ceiling	Interest Rates On Agribusiness/ Industrial Loans	Terms	Collateral
Guatamala				
Commercial bank quetzal loans	12%		1 yr. roll-over	200%
Financieras quetzal loans		16%	3 yrs.	100 + %
IDB industrial reactivation quetzal loans		15%	1 yr.	3/
LAAD-CA 1/-retention		15%	1 yr.	
El Salvador				
Commercial bank colon loans	14%		1 yrs. roll-over	125%
IDB industrial reactivation colon loans		14-15%	1-4 yrs.	10-15%
USAID development lines colon loans		10-14%	1-8 yrs.	150%
Dollar letters of credit	Libor+2.5%			100%
LAAD-CA 1/-retention		13%+2% closing	3 yrs.	100%
Honduras				
Commercial bank lempira loans	19% 2/		1 yr. roll-over	300%
IDB and World Bank development lines-lempira		17%	1 yr. and 15 yrs.	65-80%
USAID development lines-lempira loans		13.5-15%		
USAID dollar export financing		13.5-14%	Short term	Negotiable
LAAD-CA 1/-retention		14%		150%
Cost Rica				
Commercial bank colon loans	25.5%		6-12 mo. roll-over	100%
Dollar loans registered at central bank	Libor+3%			
BCCR small industry lines colon loans		18%	2-8 yrs.	60-80%
USAID lines colon loans		23.5%	7 yrs.	150-200%
LAAD-CA 1/		14%+2% closing 4/		150%
Panama				
Commercial bank dollar loans	Libor+3%		6 mo. roll-over	100%
Agricultural dollar loans		10.25%	Crop cycle	Crop
USAID small industry dollar loans		Negotiable		50%
IDB industrial credit-dollar loans		14% + 1% closing	4-10 yrs.	
LAAD-CA 1/		13.5%+2% closing	5 yrs.	150%

1/ Most recent loan.
2/ Current average commercial loan rate is 16 to 17 percent.
3/ Guaranteed by the Bank of Guatemala.
4/ Differential between commercial and dollar rates is approximately 14 percent, based on currency devaluation.

- Rates in Costa Rica are understandably below the commercial ceiling for local currency loans, but above the LIBOR plus 3 percent limitation imposed on loans registered at the Central bank.

The conclusion is that, given interest rate ceilings, LAAD-CA is charging market or near-market interest rates on all of its loans. In some cases where it has been limited by ceilings, it has charged closing fees of 1 or 2 percent to increase its yield on an individual loan. In the 1970s, LAAD-CA was required by AID to maintain its interest rates at a level below local market rates. Since that restriction no longer exists, there is no reason to believe that LAAD-CA is not charging market or near-market interest rates.

A further conclusion is that LAAD-CA pursues a rational portfolio management strategy in order to survive. Such a strategy has required that LAAD-CA balance its portfolio with both low-risk and high-risk borrowers. Having all high-risk borrowers would imply higher losses on its portfolio, endangering LAAD-CA's viability, and, thus, working against the interests of AID.

LAAD-CA, therefore, must continue to integrate its portfolio with lower-risk sub-borrowers. These firms, however, do not have an inelastic demand for LAAD-CA loans, despite the fine reputation of LAAD-CA in making and monitoring loans. If the rate is too high, such firms may borrow from off-shore sources, or, if no off-shore resources are available, may decide not to borrow. Such borrowers can negotiate a lower rate on their loans than start-up or higher-risk borrowers. LAAD-CA can charge weaker firms market or above-market rates. This, too, has a limitation. If a firm will accept a rate far in excess of prevailing rates, it is an indication of the weakness of the firm. In these cases, LAAD-CA can maximize the interest charged, but the likelihood of collecting on such loans decreases markedly.

ROCAP can determine whether the sub-borrowers are high-risk or low-risk by reviewing and comparing project assessments and investments proposals of the sub-borrowers (the form used by LAAD-CA to assess risks and loan feasibility is included in Appendix D). ROCAP should not put itself in a position of approving or rejecting LAAD-CA sub-loans. Decisions to lend should continue to be at the discretion of LAAD-CA.

In order to reach the higher-risk firms that AID wants to serve, it is necessary for LAAD-CA to continue to balance its portfolio with lower-risk firms, and this will result in some variation in the interest rates charged.

The collateral requirements that LAAD-CA imposes, and the terms allowed, are very competitive with commercial lending sources.

Four factors stand out regarding LAAD-CA's lending program compared to other development finance institutions operating in Central America:

- Even though the development finance institutions have terms and interest rates comparable to LAAD-CA's, their ability to deliver financing in a timely fashion is often impaired.

- LAAD-CA's ability to make loans within a short time period will help it to maintain a strong presence in agribusiness lending.

- LAAD-CA's loans can contain an element of dollar financing that can be used to import machinery, equipment, and raw materials.

- LAAD-CA's loans can be repaid through a retention agreement that allows it to continue making needed dollar loans in a region suffering from foreign exchange shortages.

8. GIVEN PROJECTED ECONOMIC CONDITIONS AND PAST PERFORMANCE, LAAD-CA COULD MAKE LOANS OF ABOUT $16 MILLION OVER 3 YEARS

Based on the country analyses above, the evaluation team estimates the following general level of activity for LAAD-CA during the next 2 years.

- Costa Rica will be the best market for non-traditional agribusiness and drawback industry loans.

- El Salvador will also be a strong market, but its agribusiness potential is somewhat limited. There will be some demand for drawback industry financing.

- Guatemala, although currently undergoing uncertain political and economic conditions, is the market best known by LAAD-CA personnel. In fiscal 1983-84, LAAD-CA made 10 loans in Guatemala. Because of unstable conditions, Guatemala will be an average market for LAAD-CA, despite its knowledge of the business environment.

- Honduras will be a modest market because of limited investment activity, and there will continue to be some demand for investment financing.

- Panama will be the least active loan market.

The evaluators discussed the concept of financing drawback industries on several occasions with the LAAD-CA president. He indicated that he thought the idea a interesting one, although somewhat foreign to the firm's present line of business. The Private Sector Officers of the USAIDs in Costa Rica and El Salvador expressed their desire to have LAAD-CA make such loans. Financing drawback industries would be new to LAAD-CA, but is certainly not beyond their present staff capabilities. Such loans will create less economic impact than agribusiness exports, but much needed employment will be created in the short-term. Such financing will also further diversify LAAD-CA's portfolio.

Exhibit III-3 shows the number of loans and disbursements during the past 5 years. LAAD-CA's loan operations peaked in 1983-84 when it made 25 loans valued at $7.2 million. Given its present staffing, it cannot be anticipated that LAAD-CA will exceed those levels of activity. If staffing is a constraint, LAAD-CA should consider adding an additional loan officer to move lendable funds.

Given the market conditions prevailing in the region, and barring any major destabilizing incident, the evaluators estimate that $16 million can be drawn down by LAAD-CA during a 3-year period. (See Exhibit III-4 for the estimated disbursement.) This projection is based on a larger loan size (as projected in Chapter II, section 8) and an increase in the number of loans made with AID funds, from 10 to 13 annually.

EXHIBIT III-3
LAAD De Centroamerica

Number of Loans and Disbursements by Quarter
1980 to 1985

COSTA RICA

	FY 79-80	FY 80-81	FY 81-82	FY 82-83	FY 83-84
Q1					
Q2	1,000,000 (2)				350,000 (1)
Q3	1,000,000 (1)				780,000 (2)
Q4	2,150,000 (3)			400,000 (1)	400,000 (1)
Total	4,150,000	0	0	400,000	1,530,000

Average Loan Size $552,727

EL SALVADOR

	FY 79-80	FY 80-81	FY 81-82	FY 82-83	FY 83-84
Q1	500,000 (1)				
Q2					
Q3					
Q4					
Total	500,000	0	0	0	0

Average Loan Size $500,000

GUATEMALA

	FY 79-80	FY 80-81	FY 81-82	FY 82-83	FY 83-84
Q1	29,000 (2)	200,000 (1)	200,000 (1)	700,000 (2)	800,000 (3)
Q2	131,000 (1)	20,000 (1)			450,000 (2)
Q3				400,000 (1)	400,000 (1)
Q4				300,000 (1)	1,800,000 (5)
Total	160,000	220,000	200,000	1,400,000	3,450,000

Average Loan Size $258,571

Note: Number in parentheses indicates number of loans disbursed.

EXHIBIT III-3(2)

HONDURAS

	FY 79-80	FY 80-81	FY 81-82	FY 82-83	FY 83-84
Q1			75,000 (1)		450,000 (2)
Q2		95,000 (1)			150,000 (1)
Q3		150,000 (1)		200,000 (1)	700,000 (2)
Q4				600,000 (1)	450,000 (1)
Total	0	240,000	75,000	800,000	1,750,000

Average Loan Size $260,455

PANAMA

	FY 79-80	FY 80-81	FY 81-82	FY 82-83	FY 83-84
Q1					80,000 (1)
Q2			300,000 (1)		
Q3				350,000 (1)	225,000 (1)
Q4				700,000 (1)	200,000 (1)
Total	0	0	300,000	1,050,000	505,000

Average Loan Size $309,167

TOTAL LAAD DE CENTROAMERICA

	FY 79-80	FY 80-81	FY 81-82	FY 82-83	FY 83-84
Q1	529,000	200,000	275,000	700,000	1,330,000
Q2	1,131,000	115,000	300,000	0	950,000
Q3	1,000,000	150,000	0	950,000	2,105,000
Q4	2,150,000	0	0	2,000,000	2,850,000
Total	4,810,000	465,000	575,000	3,650,000	7,235,000
Number of Loan Operations	10	4	3	9	25

NOTE: Number in parentheses indicates number of loans disbursed.

EXHIBIT III-4
Projected Disbursement Of Funds
(Dollar figures expressed in thousands)

Country	Loans Disbursed 1979-84	Loan Operations 1979-84	Average Loan Size	Average No. of Annual Loan Operations	Projected Average[1/] Loan Size	Projected No. of Annual Loan Operations	Projected Disburs of Lo
Costa Rica	$ 6,080	11	$552.7	2.2	$575	4	$2,300
El Salvador	500	1	500.0	.2	600	3	1,800
Guatemala	5,430	21	258.6	4.2	400	2	800
Honduras	2,865	11	260.5	2.2	500	2	1,000
Panama	1,855	6	309.2	1.2	300	1	300
TOTALS	$16,730	51	$328.0	10.0	$518	13	$6,200

Annual Projected Disbursements:

1986[2/]	$ 3,100
1987	6,200
1988	7,000
Total Projected Disbursement	$16,300

1/ Average loan size under consideration from Chapter II: Costa Rica, $200,000; El Salvador, $612,500; Guatemala, $1 million; Honduras, $2.1 million; and Panama, $150,000.

2/ Assumes AID final approval of project by June 30, 1986.

IV. FINANCIAL ANALYSIS OF LAAD-CA

This section analyzes the performance of LAAD-CA over the last 10 years, identifying trends in interest rate spreads and operating expenses. Based on this analysis, a forecast for the next 5 years is presented, detailing problems likely to be encountered and examining LAAD-CA's profitability in the future under a variety of interest rate assumptions.

1. LAAD-CA CONTINUOUSLY EXHIBITED STRONG FINANCIAL PERFORMANCE DURING A PERIOD IN CENTRAL AMERICA CHARACTERIZED BY SOCIAL UNREST, ECONOMIC RETRENCHMENT, HIGH INTEREST RATES, AND SCARCITY OF FOREIGN EXCHANGE

The decade covering 1976 to 1985 was a time of deep change in the social and economic structure of Central America. This period saw the rise to power of the Sandinista government in Nicaragua, land reform and civil war in El Salvador, an unprecedented increase in interest rates in world markets, and the collapse of a structure of fixed exchange rates that had provided stability for the business sector for many years. These factors contributed to the emergence of an era characterized by uncertainty and instability. These events profoundly affected the environment in which LAAD-CA operates, forcing it to develop new strategies and techniques to deal with the increased risk faced by both lender and borrower.

The degree to which LAAD-CA was successful in overcoming the threats to its continued existence is evidenced by the fact that over the 10-year period:

- Annual net income more than tripled.
- Net worth doubled.
- Return on equity never dropped below 7 percent, and averaged over 12 percent during the last 5 years.
- The debt-to-equity ratio declined from 2.7 in 1979 to 1.6 in 1985.
- Annual bad debt write-offs over the last 5 years amounted to less than 1/2 of 1 percent of the average agribusiness portfolio.

The main element responsible for LAAD-CA's survival through turbulent times that saw the demise or disappearance of other competing institutions was its excellent management team,

complemented by a well-organized and efficient financial management group. Timely, accurate accounting data, coupled with insightful forecasts of trends to come, allowed the company to take timely advantage of opportunities, as well as minimize the negative effect of future events.

2. THE AVERAGE RATE OF RETURN ON THE LAAD-CA LOAN PORTFOLIO HAS REFLECTED WORLD MARKET RATES OF INTEREST

The average rate of return on the portfolio rose steadily over the period 1976 to 1982, climbing from 9 percent to a high of over 14 percent. The high rates of return experienced from 1981 to 1983 were the result of a worldwide increase in interest rates that began in 1979. The effect on the return of the total LAAD-CA portfolio was not immediate because lower-yielding loans were not immediately replaced by those bearing higher interest rates. The decline in interest rates that subsequently took place brought rates of return back to about 12 to 13 percent. This is demonstrated in Exhibit IV-1.

The rate of decline was more gradual than the original increase because the LAAD-CA portfolio contained a larger proportion of floating rate loans. These loans presently make up an insignificant percentage of the total portfolio. It is anticipated that the return on the portfolio will stabilize at a level of between 11 and 12 percent, as the last of the long-term, higher-yielding loans are replaced by new loans reflecting the current Central American market rate of interest.

3. INTERNAL RATES OF RETURN ON INDIVIDUAL LOANS HAVE TENDED TO APPROXIMATE THE FACE INTEREST RATE OF THE LOANS

The entire cash flow streams for six loans originated and paid off during the 1981 to 1985 fiscal years were analyzed to determine the internal rate of return for each of them. The result of the analysis is illustrated below:

Loan No.	Sub-Borrower	Interest Rate	IRR
5-17-3	Industrias Sesamo	15.0%	15.3%
5-19-3	COHDEFOR	15.0%	13.5%
5-20-1	Cardamonera Int'l	15.0%	16.2%
5-20-2	" "	12.0%	11.6%
5-20-3	" "	12.0%	15.0%
5-25-1	Cafe Oriental	12.0%	13.0%

Only short-term loans were examined due to the large volume of transactions and the long period that must be analyzed to trace a loan from disbursement to final liquidation. For

EXHIBIT IV-1
LAAD De Centroamerica
Summary Of Key Operating Percentages
1976 To 1985

	76	77	78	79	80	81	82	83	84	85
Return on Portfolio	9.3	9.3	10.1	11.1	11.3	12.9	14.2	13.5	12.0	12.7
Cost of Money	3.5	3.6	3.7	4.7	7.1	7.7	8.3	5.7	4.7	4.3
Operating Expenses	3.1	2.6	2.9	2.8	2.6	2.8	3.7	4.1	4.6	5.1
Reserve for Losses	1.0	1.1	1.6	2.0	1.7	2.0	3.7	4.2	2.6	2.5
Gross Spread	5.8	5.7	6.4	6.4	4.2	5.2	5.9	7.8	7.3	8.4
Net Spread	1.7	2.0	1.9	1.6	-0.1	0.4	-1.5	-0.5	0.1	0.8

- Gross Spread equals Return on Portfolio minus the Cost of Money

-Net Spread equals Gross Spread minus Operating Expenses and the Reserve for Losses

example, the $300,000 loan to Industrias Sesamo was outstanding from November 1982 to August 1983, and involved over 60 transactions. It was concluded that working capital loans, especially those with retention agreements, are likely to carry slightly higher internal rates of return. This is due to the fact that exports of agricultural goods are seasonal, and repayments are usually made over a relatively short period of time, causing interest payments to be made prior to the loan's maturity date. However, it is important to note that these loans do not make up a significant portion of the portfolio; thus, this higher rate of return does not substantially influence the performance of the entire portfolio, especially in light of the minor difference between the internal rates of return and the face amount of interest borne by the loans.

In the case of longer-term loans, the converse is likely to be true. The only "term" loan was given to COHDEFOR, a loan that ran from December 1981 to September 1984. Its long term was due to the fact that LAAD-CA found it necessary to reschedule the loan to keep the sub-borrower from defaulting. In this case, the internal rate of return was only 13.5 percent on a loan that carried a 15.0 percent face value. This may be due to the erratic payment schedule and the grace periods granted to the sub-borrower to assist him in getting back on his feet. Although this was the only longer-term loan examined, it is reasonable to assume that other rescheduled loans have also ended up with lower yields. As of September 1985, 43 percent of the outstanding LAAD-CA portfolio had been rescheduled. At one point in 1983, over 90 percent of the portfolio had been rescheduled.

Once a loan is made, LAAD-CA will make all reasonable efforts to collect it. LAAD-CA's reluctance to write-off a loan has no impact on its profit and loss statement. Once a decision to write-off a loan has been made, the effect is upon the balance sheet, namely, a reduction of assets.

4. THE COST OF MONEY TO LAAD-CA HAS FOLLOWED THE MARKET RATE OF INTEREST, ADJUSTED TO REFLECT THE RELATIVE PROPORTION OF OUTSIDE BANK DEBT TO AID CONCESSIONAL RATE LOANS

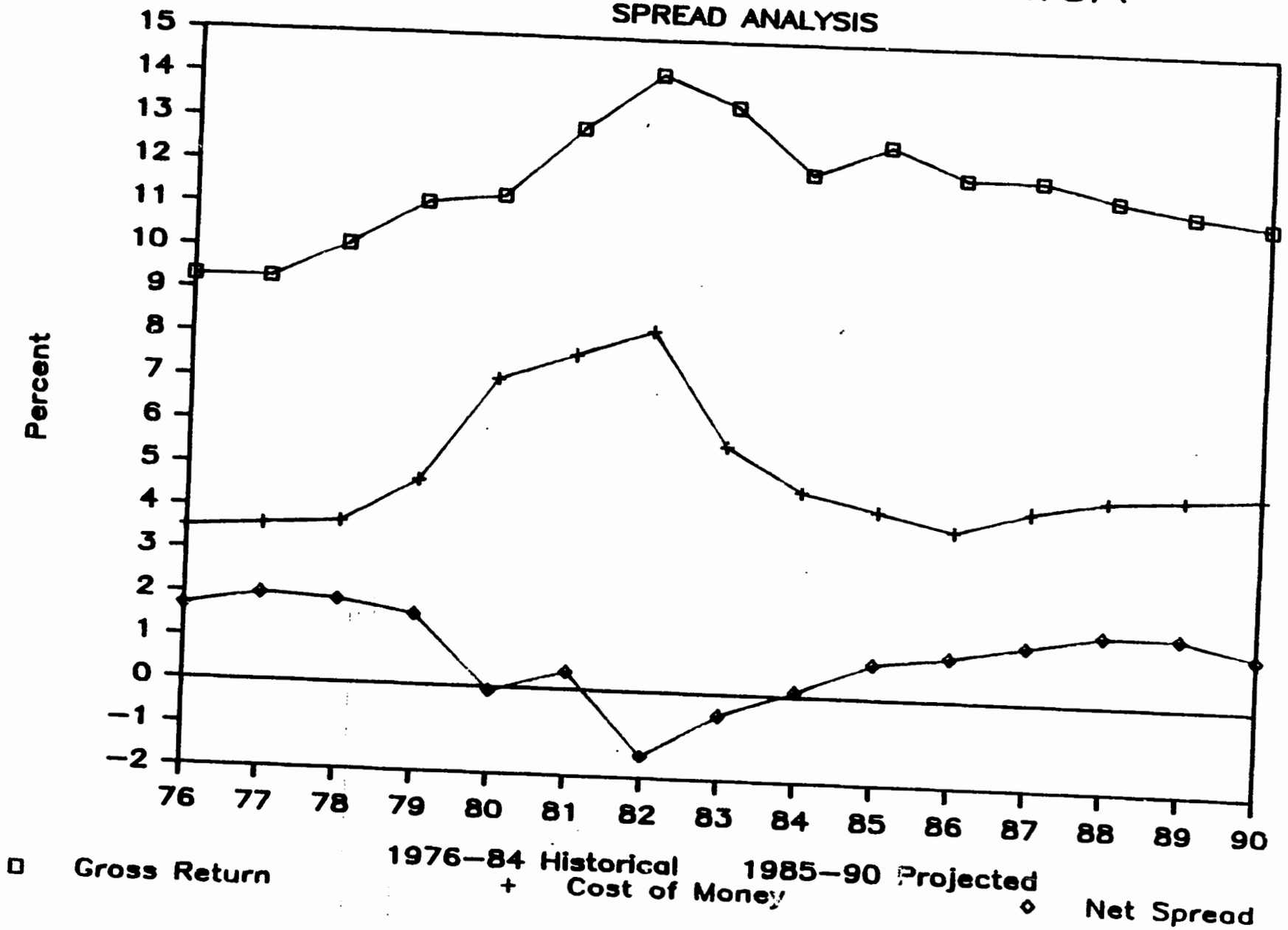
As can be seen in Exhibit IV-2, the cost of funds to LAAD-CA behaved in a pattern similar to that of the return on portfolio. However, Exhibit IV-1 shows that the gross spread remained closer to 8 percent from 1983 to 1985, as compared to the 6 percent figure that was typical of the period up to 1982.

This gross spread was a direct result of the fact that, from 1980 to 1982, LAAD-CA significantly increased its outside borrowings, which climbed from zero in 1978 to a high of

EXHIBIT IV–2

LAAD DE CENTROAMERICA

SPREAD ANALYSIS



$5.6 million in 1981. These borrowings were obtained at more than twice the cost of the AID loans, raising the average cost of funds from about 4 percent, for the period 1976 to 1979, to well above 7 percent for 1980 to 1982. This increase was not equally compensated by an increased yield on the loan portfolio, and the gross spread did not increase until the cost of money began to drop in 1983.

The 5-year forecast for the period covering 1986 to 1990 calls for a stable cost of money, averaging slightly less than 5 percent. This projection assumes that the AID will approve a loan for $12 million at 4 percent with 25 percent co-financing obtained from outside banks at about 9 percent.

5. THE 25 PERCENT CO-FINANCING REQUIREMENT HAS DECREASED LAAD-CA'S RETURN ON ITS PORTFOLIO AND INCREASED THE RISK

LAAD-CA cannot make money on a loan from a commercial bank bearing 9 percent interest. This can be calculated by referring to the figures for 1985 in Exhibit IV-1 and replacing the 4.3 percent cost of money with 9 percent. The result is a net spread of negative 3.9 percent.

If the interest on co-financing is raised to 12 percent, which is a possible scenario over the next 5 years, the net spread decreases even more. Passing on the increased cost to the sub-borrower is not considered by the evaluators to be a viable option, and this is discussed in Chapter III of this report.

There are several other factors that make the co-financing requirement a burden on LAAD-CA. By forcing LAAD-CA to go into the market to compete for short- and medium-term financing, AID increases the level of uncertainty and, therefore, the risk. The AID loans are granted at fixed interest rates and afford LAAD-CA a source of financing with predictable cash flows. This allows LAAD-CA to enter into longer-term loan agreements with its sub-borrowers, knowing that the cash flows required to service their debt will not fluctuate from year to year. As a result, LAAD-CA can be more aggressive in its lending policies, since the only unpredictable element lies in their collections from sub-borrowers, but not in the repayments to creditors.

Another negative result that follows from the above argument is that when LAAD-CA is faced with a higher level of risk, it must react to this by maintaining higher cash reserves to protect itself against a liquidity problem in the event of an interruption of its cash inflows. The funds that are thus tied up in liquid assets are not available for lending. In this sense, the leverage factor, i.e., bringing in additional new

funds to lend to non-traditional agribusinesses, sought by AID is somewhat diminished.

The evaluation team recommends that AID drop the co-financing requirement from the conditions placed upon the new loan. This is necessary to provide LAAD-CA with a stable source of financing for the future, a period likely to be as unpredictable as the past 10 years have been.

If AID considers it important to maintain the level of external financing at $16 million, it is possible to calculate a weighted-average cost of funds that LAAD-CA would be indifferent to, given the assumption of equal risk. Calculated in the simplest manner, this interest rate would be 5.25 percent--$12 million (75 percent of total borrowings) at 4 percent and $4 million (25 percent of total borrowings) at 9 percent; (.75 x .04)+(.25 x .09)=.0525.

6. ADMINISTRATIVE EXPENSES HAVE RISEN STEADILY OVER THE LAST 10 YEARS, BUT HAVE NOT BEEN SIGNIFICANTLY INFLUENCED BY EXTERNAL EVENTS

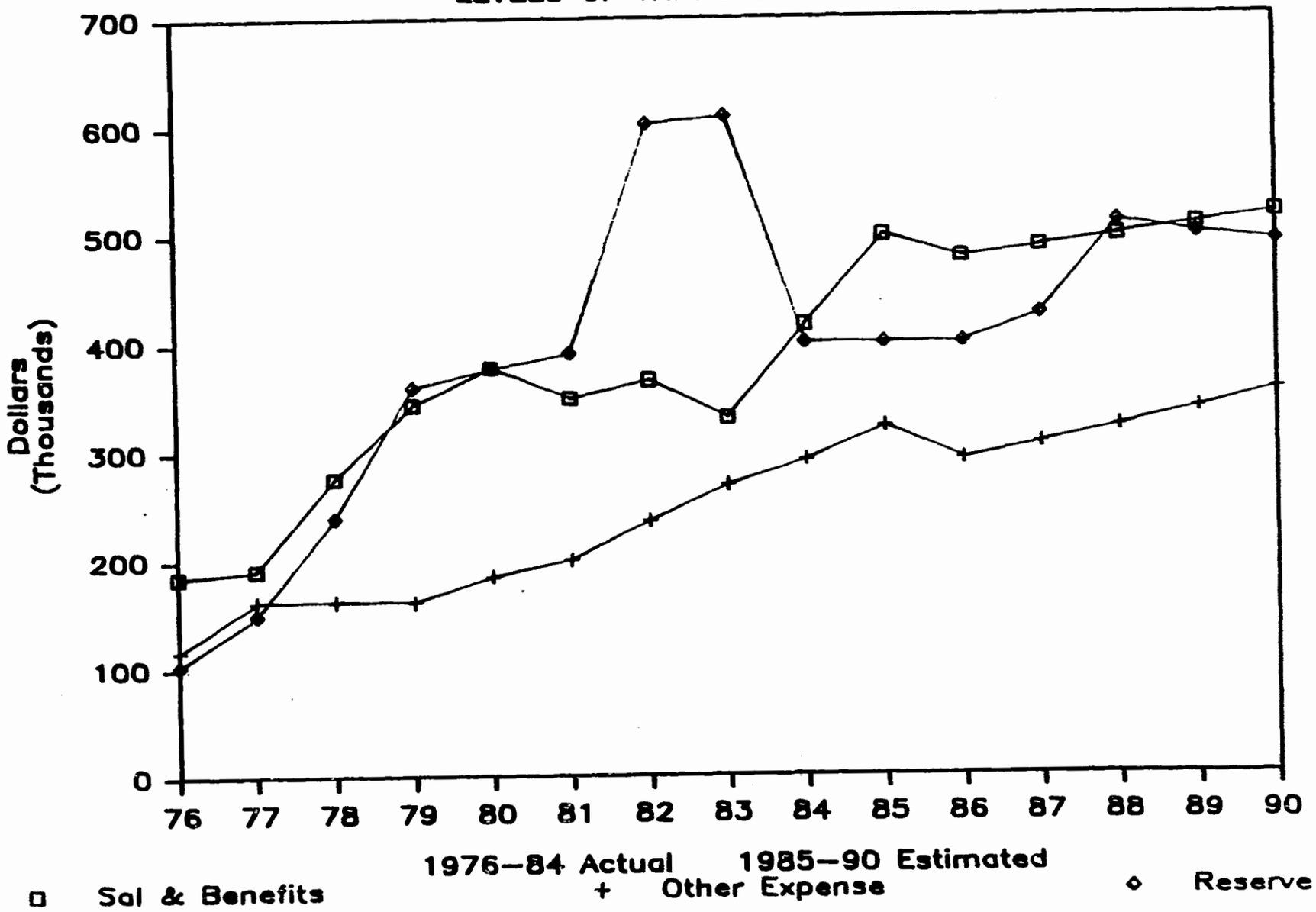
Historically, administrative expenses (exclusive of interest expenses and the reserve for bad debts) have averaged under 3 percent of the average portfolio and about 2.5 percent of average total assets. However, in 1982 these ratios began to climb, not because of an acceleration in the rate of expenditures, which in fact grew in absolute terms at a slower rate during 1980-85 than during 1976-80, but rather because of a decrease in their denominators; that is, the level of the loan portfolio, and consequently, the level of total assets declined. This decrease was attributable to the retrenchment that took place after the beginning of the deterioration in the business climate following the Nicaraguan crisis in 1979-80. By the end of 1985, operating expenses are expected to amount to 5.1 percent of average portfolio and 3.8 percent of total assets. The 5-year projections call for these percentages to decline by 1990 to 3.2 percent and 2.3 percent, respectively. This will be accomplished by controlling the amount of expenditure, but will also be materially affected by the large increase in the portfolio that will result from the infusion of the new AID loan.

Exhibit IV-3 tracks the yearly levels of salaries and benefits, other expenses, and increases in the reserve for losses. Salaries and benefits have increased in a cyclical fashion, reflecting periods of expansion in LAAD-CA's operations. The sharp increase seen between 1977 and 1980 was followed by a period of relative stability with a small decline between 1980 and 1983. It is LAAD management's opinion that a similar

EXHIBIT IV–3

LAAD DE CENTROAMERICA

LEVELS OF THREE EXPENSE ITEMS



period of stability will follow the sharp increase seen between 1983 and 1985. Over the last 5 years, salaries and benefits have increased at an annual compounded rate of 5.7 percent.

Other expenses, which are dominated by office expenses, travel and communications, have grown steadily over the years and are not likely to show any sharp variances in the future. However, they have increased at an annual compounded rate of 11.7 percent, which should be considered excessive even in light of the 20.0 percent growth rate of net income for the same period.

Factors that should contribute to the moderation of these line items are the transfer of several persons currently on the LAAD payroll to the LAAD Marketing Company payroll. LAAD Marketing's payroll is not allocated to any of the subsidiaries. The percentage of expenses allocated to LAAD-CA from LAAD headquarters is based on gross revenues and has averaged about 40 percent of LAAD-CA's total expenses in recent years.

The computer system is also to be transferred to LAAD Marketing, where it is anticipated that computer services will be offered to other companies on a fee basis. Overhead expenses are expected to be reduced as a result of the sale of the building owned by LAAD, recently sold and occupied under a leaseback agreement.

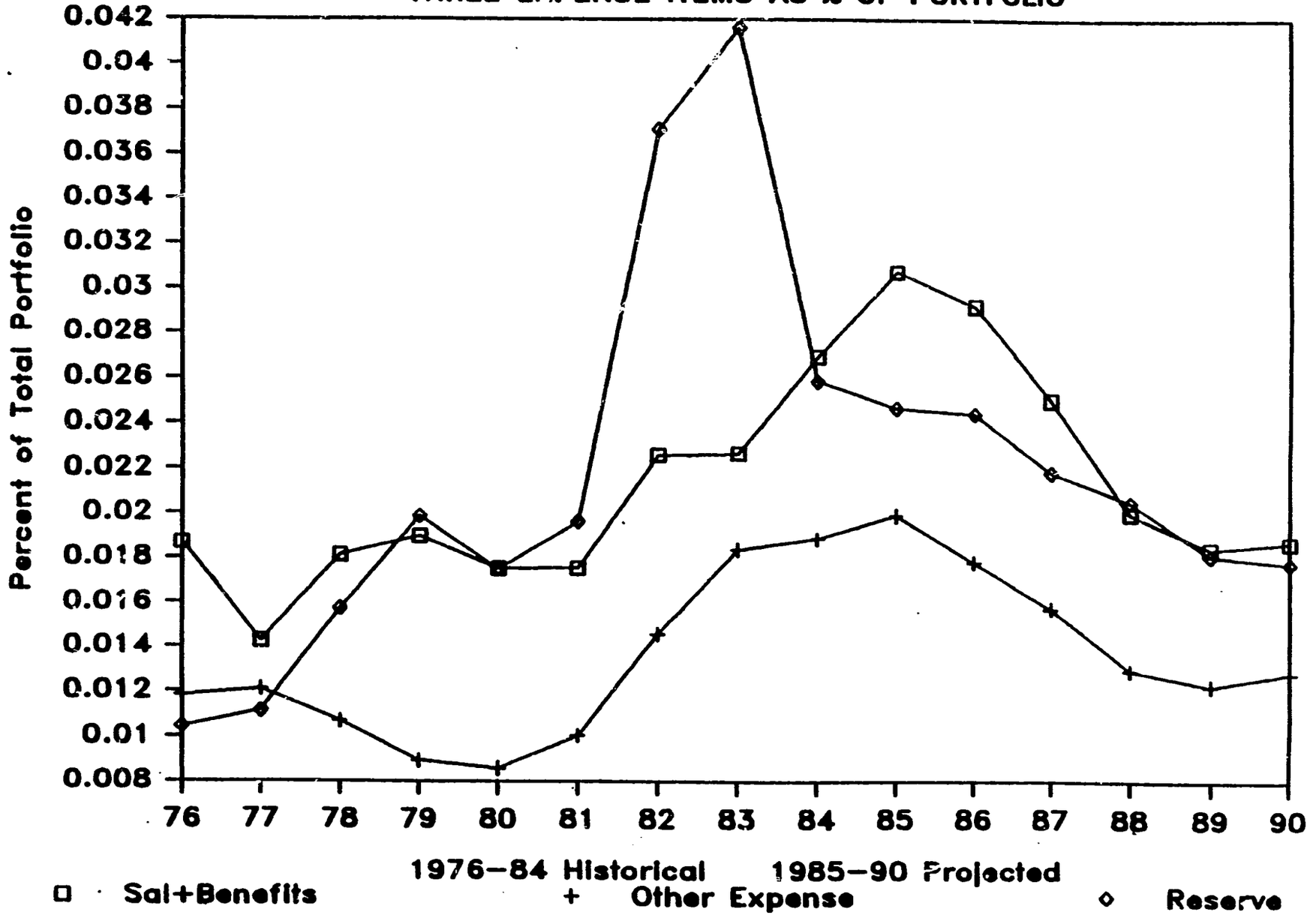
Exhibit IV-4 shows the behavior of the same expense items, but expressed as a percent of the total loan portfolio. In this analysis, it is evident that salaries and expenses have risen sharply in the last 5 years. The forecast for the next 5 years shows an equally sharp decline driven by the heavy injection of funds into the company that will increase the loan portfolio. The effect will dilute the percentage weight of the expenses, although they will not decline in absolute terms.

<u>In spite of the optimistic outlook in this area, the evaluation team believes that LAAD should implement strict control measures over its operating expenses.</u> Due to the significant rate of increase in the "other expenses" category, the evaluation team recommends that LAAD should implement a special monthly report detailing the specific components of these line items, comparing them to the budget for the month, and explaining in writing any major variances from budget. The report should also include a forecast showing the year-end estimates for these items. The forecast should be updated monthly and compared to the budget for the year to help identify significant deviations that might not be immediately evident in the

EXHIBIT IV—4

LAAD DE CENTROAMERICA

THREE EXPENSE ITEMS AS % OF PORTFOLIO



monthly comparisons of actual to budget. The report should include planned corrective actions.

7. THE CURRENT RESERVE IS ADEQUATE TO COVER THE RISK OF COMMERCIAL LOSSES ON THE LAAD-CA PORTFOLIO

The reserve, calculated in accordance with standard accounting procedures, is reviewed annually by the independent auditors, Price Waterhouse & Co., and has been found to be satisfactory. Management aggregates the loans into various categories according to their payment performance and applies a reserve percentage that increases in proportion to the duration of the delinquency. The percentages used are based on guidelines established by the Comptroller of the Currency for banks and other lending institutions. The percentages are as follows:

Loan quality	Percentage
Acceptable	0 percent -- no reserve
Other Assets Especially Mentioned 1/	10 percent
Substandard	25 percent
Doubtful	50 percent
Loss	full reserve

The standards used to assess loan quality are applied consistently across the entire portfolio. Price Waterhouse, LAAD's auditors for 10 years, noted that they are often more conservative than LAAD management in assessing loan quality, and there have been disagreements regarding rating particular loans. Price Waterhouse sets these ratings based on considerable knowledge regarding LAAD's borrowers. Price Waterhouse also uses country risk analysis, to help determine whether they have properly assessed the portfolio in a particular country. As auditors, Price Waterhouse must feel comfortable with the assessments to be able to publish the audit without citing exceptions.

The reserve was maintained at relatively moderate levels until the collapse of the Nicaraguan economy in 1980 forced LAAD-CA to place the loans in that country on non-accrual, reflecting management's belief that the loans will not be repaid. The reserve was therefore quickly increased in order to provide for the eventual loss of the entire principal. At

1/ Based on slow payment history, insufficient collateral, neglect of care by borrower.

present, the total reserve is $2.7 million, and with the reserve for Nicaragua accounting for $1.9 million of that total, $800,000 is reserved to cover losses on the remainder of the portfolio. The evaluators believe that this level of reserve is consonant with the level of risk faced in the region, and reasonable, given the process (described above) that is used to determine the reserve.

Management has decided to write-off the Nicaraguan loans in equal installments over 5 years, starting in 1985. This will not have an income statement effect, since deductions from the portfolio are also deducted from the reserve. The reserve will be increased yearly by 2 percent of the value of the agribusiness portfolio, but the actual balance will only increase about 1/2 of 1 percent per annum, due to the offsetting effect of writing-off the Nicaraguan portfolio.

Several years ago, AID encouraged the buildup of liquid assets in order that LAAD-CA protect itself in the event of another Nicaragua-like catastrophe. AID's covenants, however, stated that LAAD-CA could not accumulate liquid assets in excess of its net worth. LAAD-CA has had liquid assets exceeding net worth during the last several years when what is termed the "portfolio mismatch analysis" was applied. As of October 31, 1985, however, the liquid assets, valued at $6.7 million, were brought under the level of the firm's total net worth of $8.1 million. Therefore, LAAD-CA is currently performing in accordance with this covenant.

Annual reserve expenses went from about $100,000 per year in 1976 to $600,000 per year in 1982 and 1983, underscoring the extent to which management perceived an increase in risk in the area. The absolute level of the reserve on the balance sheet went from $300,000 in 1976 to $2.4 million in 1983. <u>The new level of risk is not an indication of the sub-borrowers' inability to pay, but rather of the emergence of sovereign risk as a new and formidable factor to be dealt with by companies doing business in Central America</u>.

Sovereign risk is defined as the risk generated by factors exogeneous to the operations of the sub-borrowers. The most important elements of sovereign risk are political instability, volatile exchange rates, and scarcity of hard currency. The devastating effect of the Nicaraguan crisis on LAAD's portfolio has already been discussed. Deteriorating exchange rates make it more difficult for non-exporting sub-borrowers to repay on their loan obligations, especially if there are no dollars available in the Central Bank at any price. In addition, declining exchange rates for local currencies tend to dilute the dollar value of LAAD's security, since it usually takes real estate or fixed assets as collateral for loans.

8. SOVEREIGN RISK HAS FORCED LAAD-CA TO CHANGE ITS BUSINESS STRATEGIES AND HAS CREATED DISTORTIONS IN THE WAY THE COMPANY OPERATES

When management at LAAD-CA realized that sovereign risk would have to be contended with for the foreseeable future, they had to implement measures to protect the company financially against the sort of national disaster that destroyed the Nicaraguan portfolio. It is impossible to estimate a figure adequate to protect the company against the loss of the portfolio of an entire country. It is, perhaps, better to think in terms of liquidity. In 1981, LAAD-CA began to build its liquidity rapidly in the form of time deposits and marketable securities. While LAAD had previously not invested extensively in such instruments, the balance reached almost $7 million by 1983. At present they comprise 32 percent of total assets, and are approaching one-half the value of the loan portfolio.

A significant consequence of this policy has been the corresponding shift in the composition of gross income. Exhibit IV-5 shows how the percentage of gross income derived from marketable securities and time deposits rose from under 10 percent between 1976 and 1980 to over one-third of the total by 1984. Over the last 5 years, gross interest income from the loan portfolio declined at an annual compounded rate of 4 percent. It is particularly disturbing to note that in 1984, income from liquid assets reached $1,019,000, nearly 91 percent of net income. In essence, high-yielding investments in World Bank bonds made by LAAD in 1980 are the principal factor keeping LAAD afloat today, if no other expenses are imputed to them.

The problem is somewhat more complex, however. It must be realized that these investments have been largely involuntary, and that LAAD-CA would have preferred to free up the funds for lending. Nevertheless, prudent management practices have dictated the need for adequate liquidity at a time of highly uncertain cash flows, and one of the consequences of this policy has been this reallocation of income-producing resources. The liquid assets that make up the reserves will be turned into loans in Central America only when the risk there subsides.

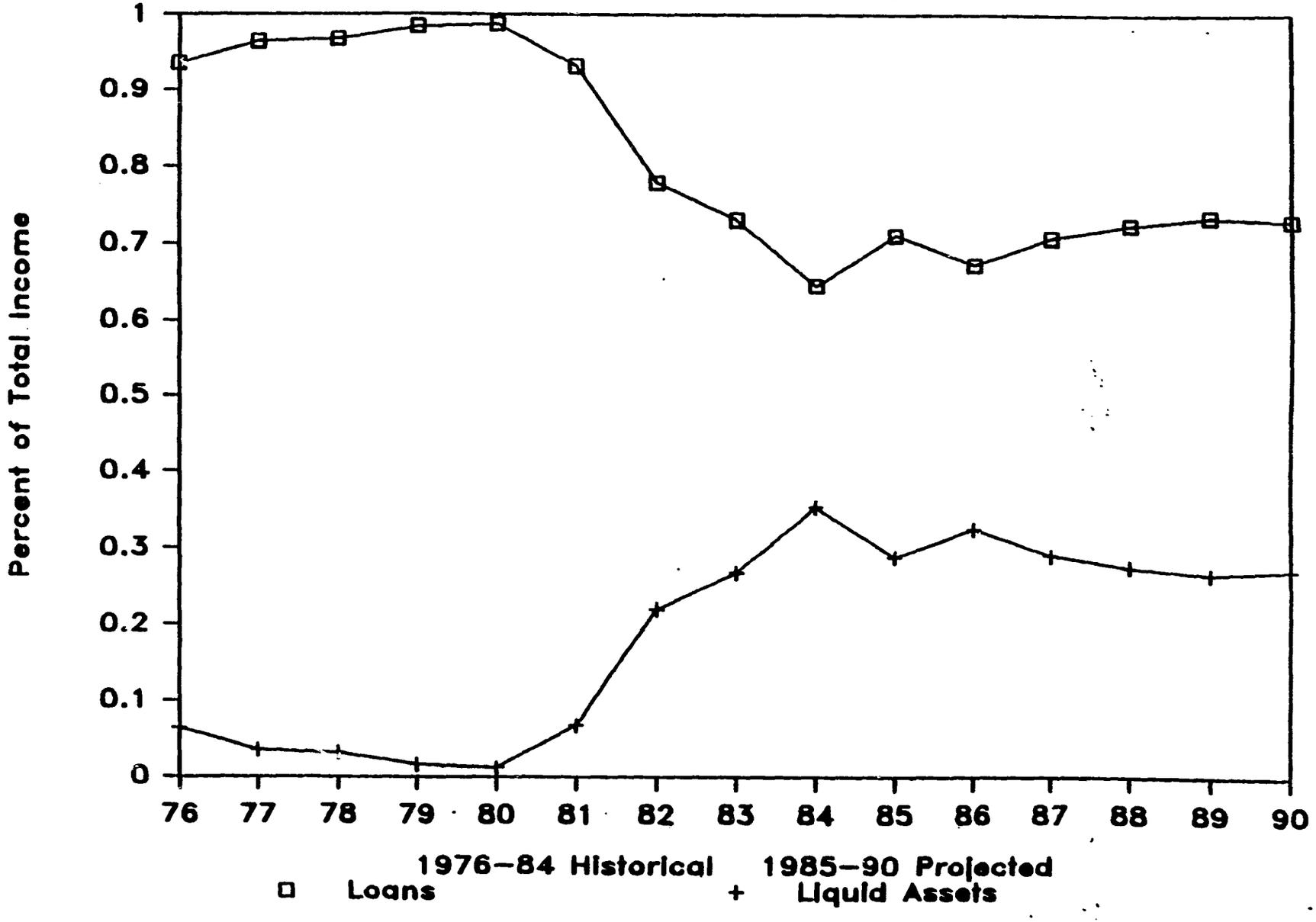
9. PROVIDING A RETURN TO SHAREHOLDERS HAS NOT BEEN THE PRINCIPAL MOTIVATING FACTOR BEHIND LAAD'S DIVIDEND POLICY

The dollar amount of the dividends is not large enough to be financially significant to the LAAD shareholders, most of whom are large corporations. The shareholders are not motivated by the possibility of earning a large return on their investments in LAAD, but rather, by an interest in being involved in

EX IV-5

LAAD DE CENTROAMERICA

SOURCES OF GROSS INCOME



the development field in Latin America and the Caribbean. According to LAAD's chairman, it could more appropriately explained as a sort of altruism--an interest in being a good corporate citizen.

Dividends are also viewed as a symbol of corporate well-being. This is particularly important to the investment community. Creditors are looking for symptoms that the company is healthy and moving ahead. Without this, LAAD could have trouble raising funds from commercial sources.

Internally, dividends are a sensitive issue. Management prepares recommendations regarding common stock dividends for approval by the Board. In part, these dividends act as a means to transfer funds from one subsidiary of LAAD to another, balancing the financial requirements of the corporation as a whole.

10. THE NET SPREAD IS ONLY MARGINALLY ADEQUATE FOR THE PURPOSE OF BUILDING EQUITY AND MAINTAINING ACCEPTABLE PROTECTION AGAINST SOVEREIGN RISK

Exhibits IV-1 and IV-2 illustrate the fact that the percentage net spread, that is, the amount left over after covering the cost of money and all operating expenses, has not exceeded 2 percent in the last 10 years. The sensitivity of the net spread to the overall performance of the company is clearly visible during the years corresponding to the Nicaraguan crisis and the simultaneous rise in the cost of money, as a result of the worldwide increase in interest rates. When the Nicaraguan portfolio went on non-accrual in 1980, the net spread dropped to zero. It recovered briefly in 1981, only to be forced down again in 1982 and 1983 by the substantial increases in the reserve for losses, discussed earlier. During this period, it almost reached a negative 2 percent level before becoming positive again in 1984.

11. LAAD-CA WILL BE UNABLE TO SUPPORT ANY INTEREST RATE ON THE AID LOAN THAT IS MUCH IN EXCESS OF 4 PERCENT, AND, THUS, REQUIRES CONCESSIONAL FINANCING

If the new AID loan is granted at 4 percent, like the previous two loans, the spread will stabilize at around 1.5 percent. Exhibits IV-6 and IV-7 show how higher interest rates would affect the net spread generated by LAAD-CA. A 6 percent loan would provoke a decline in the spread. An 8 percent loan would cause the spread to permanently go negative in 1987. With a 10 percent loan, this would happen in late 1986. It is unlikely that severe cost control measures could pull LAAD-CA

EXHIBIT IV–6

LAAD DE CENTROAMERICA

EFFECT OF DIFFERENT INTEREST RATES

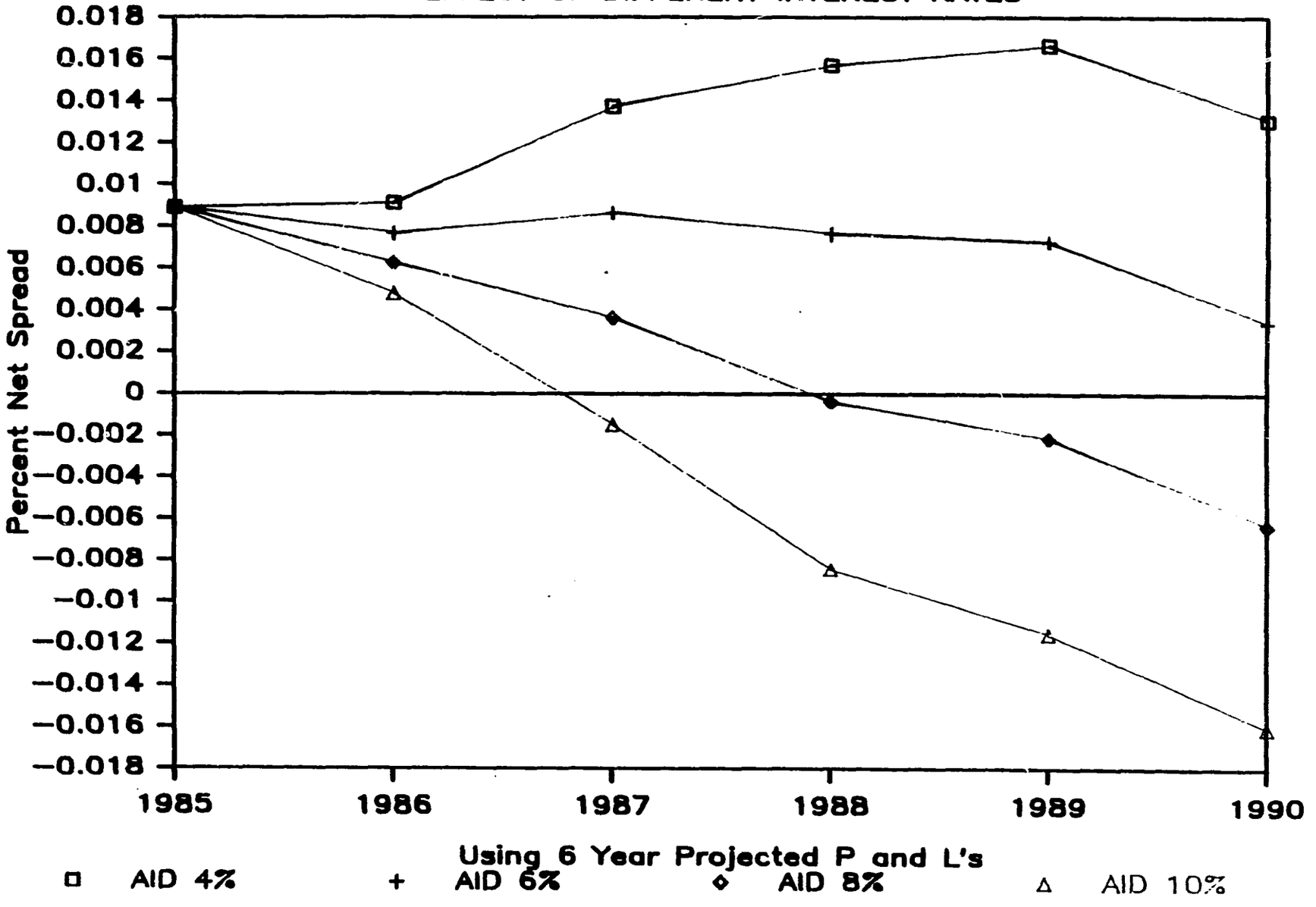


EXHIBIT IV-7
Effect Of AID Interest Rates On Profitability
(Using A 4 Percent AID Loan As A Base)

	1986	1987	1988	1989	1990
4 Percent AID Loan:					
Interest Cost Increase	---	---	---	---	---
Percent Gross Spread	8.1%	7.6%	6.9%	6.5%	6.2%
Net Interest Spread	0.9%	1.4%	1.6%	1.7%	1.3%
5 Percent AID Loan:					
Interest Cost Increase	1.9%	5.7%	8.5%	9.8%	9.9%
Percent Gross Spread	8.0%	7.4%	6.5%	6.1%	5.8%
Net Interest Spread	0.8%	1.1%	1.2%	1.2%	0.8%
6 Percent AID Loan:					
Interest Cost Increase	3.7%	11.5%	17.0%	19.6%	19.9%
Percent Gross Spread	7.9%	7.1%	6.1%	5.6%	5.3%
Net Interest Spread	0.8%	0.9%	0.8%	0.7%	0.3%
7 Percent AID Loan:					
Interest Cost Increase	5.6%	17.2%	25.5%	29.4%	29.8%
Percent Gross Spread	7.8%	6.9%	5.7%	5.1%	4.8%
Net Interest Spread	0.7%	0.6%	0.4%	0.3%	-0.2%
8 Percent AID Loan:					
Interest Cost Increase	7.4%	22.9%	34.0%	39.2%	39.8%
Percent Gross Spread	7.8%	6.6%	5.3%	4.7%	4.3%
Net Interest Spread	0.6%	0.4%	.0%	-0.2%	-0.6%
9 Percent AID Loan:					
Interest Cost Increase	9.3%	28.7%	42.5%	49.0%	49.7%
Percent Gross Spread	7.7%	6.4%	4.9%	4.2%	3.8%
Net Interest Spread	0.5%	0.1%	-0.4%	-0.7%	-1.1%
10 Percent AID Loan:					
Interest Cost Increase	11.1%	34.4%	51.0%	58.8%	59.7%
Percent Gross Spread	7.6%	6.1%	4.5%	3.7%	3.3%
Net Interest Spread	0.5%	-0.1%	-0.8%	-1.2%	-1.6%

out of the decline provoked by imposing heavier interest charges on its already fragile cash flow.

Exhibits IV-8 and IV-9 demonstrate the effects of higher interest rates on cash and profits. The bottom half of Exhibit IV-9 shows that increasing interest rates have non-linear, "accelerating" effects upon net income over time.

One factor not taken into consideration in these calculations are the costs of additional staff to lend and monitor a substantial increase in new resources. Even hiring one additional loan officer would have a substantial effect on cash flow.

12. THERE ARE NO REAL VIABLE ALTERNATIVES TO AID CONCESSIONAL RATE FINANCING

Borrowing from commercial banks or other financial institutions is not possible because that would not result in a positive spread. If the spread is to average about 1.5 percent over the next 5 years, adding another 4 or 5 percent to the cost of money would push LAAD-CA into a permanent operating loss position.

Obtaining deposits from the general public is not feasible either. While a demand deposit base might offer an attractive cost of funds, it cannot be done in the United States without making LAAD-CA subject to a different set of regulatory constraints and tax considerations. In Central America the picture is similar, and even if possible, would involve taking deposits in local currency, which would put LAAD-CA in an entirely different business.

The transformation of LAAD into a venture capital firm is not possible at this time. It does not possess sufficient equity and cash flow to give it enough staying power to hold out the 5 to 10 years required for an equity investment to mature and become profitable, while withstanding the effect of the collapse of other investments that failed a year or two after their creation.

It is also unlikely that LAAD will be successful in raising a significant amount of additional capital from investors. The environment prevailing in the 1970s that provided a favorable climate for LAAD to raise equity from corporate sources has changed. The enthusiasm of that era cannot be duplicated in the 1980s, and this is demonstrated by the difficulties experienced by other groups presently trying to raise funds.

EXHIBIT IV-8
LAAD De Centroamerica
Sensitivity Analysis On Cash Flow
(Expressed In Thousands Of Dollars)

	1986	1987	1988	1989	1990
Portfolio Cash Flow at 4%	(8)	108	300	389	335
Portfolio Cash Flow at 5%	(18)	63	205	269	215
Portfolio Cash Flow at 6%	(28)	18	110	149	95
Portfolio Cash Flow at 7%	(38)	(27)	15	29	(25)
Portfolio Cash Flow at 8%	(48)	(72)	(80)	(91)	(145)
Portfolio Cash Flow at 9%	(58)	(117)	(175)	(211)	(265)
Portfolio Cash Flow at 10%	(68)	(162)	(270)	(331)	(385)

EXHIBIT IV-9
LAAD De Centroamerica
Effect Of Different AID Interest Rates
On Portfolio Net Income
1986 To 1990 Estimates

(Expressed In Thousands Of Dollars)

	1986	1987	1988	1989	1990
Net Income at 4% AID	252	343	450	551	503
Net Income at 5% AID	242	298	355	431	383
Net Income at 6% AID	232	253	260	311	263
Net Income at 7% AID	222	208	165	191	143
Net Income at 8% AID	212	163	70	71	23
Net Income at 9% AID	202	118	(25)	(49)	(97)
Net Income at 10% AID	192	73	(120)	(169)	(217)

(Effect Expressed As A Percentage)

Net Income at 4% AID	---	---	---	---	---
Net Income at 5% AID	-4.0%	-13.1%	-21.1%	-21.8%	-23.9%
Net Income at 6% AID	-7.9%	-26.2%	-42.2%	-43.6%	-47.7%
Net Income at 7% AID	-11.9%	-39.4%	-63.3%	-65.3%	-71.6%
Net Income at 8% AID	-15.9%	-52.5%	-84.4%	-87.1%	-95.4%
Net Income at 9% AID	-19.8%	-65.6%	-105.6%	-108.9%	-119.3%
Net Income at 10% AID	-23.8%	-78.7%	-126.7%	-130.7%	-143.1%

If concessional financing is not made available by AID or another donor, LAAD-CA's operations and portfolio would diminish over time as it pays off outstanding obligations. It would eventually go out of business.