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Program Evaluation of the Central and Eastern Europe Enterprise Funds

Final Report

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Submitted by
Development Alternatives, Inc.

April 1995

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Final Report

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EXECUTIVE SUMMARY

The first American enterprise funds were formed in 1990 as part of the initial U.S. commitment to support the economic transformation of the East European republics. The funds were structured as independent nonprofit corporations and given grants ranging from $55 million to $250 million. The mandate of the funds was extremely broad: to promote private sector development and help encourage a more conducive economic environment by providing financial and technical assistance in support of small and medium-sized enterprise development. Along with this broad mandate and flexible capital allocation came a wide range of expectations about what the ultimate impact of the funds might be.

This report presents the findings of an evaluation of the American enterprise funds in Bulgaria, Czech Republic, Hungary, Poland, and Slovak Republic. This is not a traditional evaluation in the sense of testing outcomes against preset programmatic objectives. Because of the way these funds were established, they have broad goals but no specific objectives by which their performance can be judged. The evaluation is as much an evaluation of the programmatic approach as it is of individual fund performance. A team of seven people from Development Alternatives, Inc. (DAI) conducted an extensive review of background information provided by the funds, USAID, World Bank, and other sources, and spent eight weeks in the field. Team members interviewed 200 individuals and visited 140 companies receiving fund investments. The evaluation took place in fall 1994, and the data presented in this report are current through September 30, 1994.

The first two funds are now almost five years old, and the other two are more than three years old. The performance records of the funds, along with the strengths and weaknesses of the enterprise fund concept, are becoming clear. The pattern of economic transformation in Eastern Europe is also becoming clear, and it is now possible to identify more carefully the proper role of enterprise funds within the larger transformation process.

Even in the countries that have progressed the most in economic transformation, such as Hungary and the Czech Republic, the sources of long-term investment capital for small enterprises are extremely limited. The funds function best as vehicles for delivering investment capital to individual businesses. In fact, no other vehicles for channeling bilateral aid appear better suited for that task than independent, flexible, private investment funds such as the enterprise funds.

However, the actual investment performance of the funds is mixed. The funds in Poland (PAEF) and Hungary (HAEF) have established effective investment programs, whereas those in the Czech Republic/Slovak Republic (CSAEF) and Bulgaria (BAEF) have been far less effective. Investment performance appears to be a combination of staff capabilities, strategic approaches adopted by the fund, and the stage of economic transformation in each country. Where country conditions are less conducive to private enterprise, funds are still able to engage in beneficial development activity, but the opportunities are more limited and the process is more difficult than in the more advanced countries. Although the capitalization of funds is large by the standards of typical USAID projects, the funds are still small when compared with the overall size of the markets they serve. As a result, even in cases where the individual investment performance has been good, the impact on macroeconomic factors is small. Still, 3,305 companies have received almost $270 million in enterprise fund investments.

According to most accounts, the initial vision of these funds was that they would follow a venture capital model, providing equity capital for privatizing companies and joint ventures. Although this has happened to a degree, the market for conventional venture capital investing is much narrower and less profitable than was originally anticipated. At the same time, the market for loans to newly emerging small firms is far more active than originally anticipated. Based on performance to date, it appears that if enterprise funds shift their portfolio mix to a more equal balance between venture capital investing and small enterprise lending, they are likely to increase their development impact without impairing their financial return.

In line with the experience of venture capital in developed markets, the greatest returns result from investments in companies that are able subsequently to sell shares through public offerings. Investments in privatizing companies and in joint ventures have been some of the best and some of the worst investments made by funds. As in most other investments, a key success factor is management. When the old management practices are retained in privatized companies, the results have generally not been positive. Similarly, when the foreign joint venture partners fail to deliver the activities expected of them (such access to markets and technology), the results have been disappointing. To date, the small loan programs appear to be moderately profitable, whereas the overall return on the large investments has been negative. However, because equity investments typically produce their returns over a longer period of time than small loans, many of the large investments have the potential to produce much greater financial gains in the future.

On an informal basis, funds can be helpful in providing policy advice or in influencing government actions. Funds have pioneered certain financing approaches and tested the mechanics and processes of investment transactions. Senior staff members of the funds often serve on advisory panels and boards with key private and public sector personnel in the host countries. Nevertheless, although enterprise funds are particularly well suited to serve as vehicles for introducing capital into these markets, they are not similarly unique in their ability to deliver technical assistance that is not related to investment. There is some value in having budgets that allocate some resources to the funds to develop host country management for funds and investee firms.

Most of the funds should be able to reduce the cost of their operations. Only the Polish fund has kept its expense structure in line with that of more conventional venture capital funds. The single factor responsible for the higher costs is the maintenance of executive office structures and investment offices in the United States. Funds should move quickly to develop host country professional staff in order to reduce costs and improve investment performance. For smaller countries, a new model needs to be developed that would substantially reduce the scope and cost of operations.

The enterprise fund program was able to get started quickly. Other international donors envy the speed at which the funds were established and began offering financial assistance. However, a side effect of this fast start was that certain structural considerations were not adequately addressed. Two types of structural problems stand out. First, little consideration was given to the long-term life cycle of enterprise funds. How should their structure and programs evolve, and what should be their character over the long term? Second, the relationship between enterprise funds and their principal investor, the U.S. government, needs clarifying. Funds must have independence to carry out their programs, yet the government needs a better way of monitoring its investment, which now exceeds $1 billion for the entire enterprise fund program.

The following table provides a summary of the portfolio make-up of the enterprise funds.

ENTERPRISE FUND INVESTMENTS
Direct Investments
Characteristics Average transaction above $500,000 Equity, loan, or combination Ownership typically split among several parties Anticipated potential for fast growth
Development Objectives Large employment potential Capital gain potential Demonstration effects Strategic improvement of a key business sector Privatization and transformation of former state enterprises
Joint Bank Lending Programs
Characteristics Average transactions between $20,000 and $200,000 Credit approval made jointly with bank Typically family or two-to-three partner ownership Some potential for fast growth, but owners usually prefer limiting growth rather than sharing equity Limited potential/fixed return for portfolio, but should cover costs
Development Objectives Large total impact through larger number of transactions Broadening the extent of private entrepreneurship Large employment potential Some opportunity for feeding into the direct portfolio Changing the behavior of banks with regard to small business clients
Small Loan Programs
Characteristics Transactions typically between $500 and $20,000 Borrowers are individuals or family business owners, may be a start-up business Programs typically cost more than their income potential
Development Objective Broadening the entrepreneur base Increasing family income Serves as a feeder for the small loan program Addresses particular niche industry need

SUMMARY OF FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

1. The absence of investment capital for the small and medium-sized enterprise market in Eastern Europe is so extensive that foreign assistance in the form of policy guidance and technical assistance alone is not likely to change the availability of long-term investment capital in the immediate future. Providing a ready source of capital directly to companies is beneficial in the transformation process, because of the immediate impact on the companies receiving the capital and as demonstration of the way capital investment takes place.

2. Placing donor capital directly into the traditional financial systems and institutions in the region has not proven effective in resolving the capital shortfall. For example, credit lines for small business lending placed by the World Bank into central banks in the region often go unused. An independent, flexible, professionally managed investment fund as contemplated in the enterprise fund concept is a good structure for introducing capital into these transitioning markets.

3. The classic venture capital investing model that formed the original approach is applicable only to a limited extent in the transitioning economies. The conditions necessary for successful venture capital investing are not present in much of Eastern Europe. There is an inadequate volume and quality of deal-flow. The exit mechanisms needed to maximize capital gains through public offerings of shares are not present or fully developed. As a result, enterprise funds have not been able to invest their venture capital funds as quickly as was anticipated, and the prospects for earning the desired returns appear limited. Funds can achieve their greatest impact when they work across a broad spectrum of the small and medium-sized enterprise market, and not limit themselves either to large venture capital investments or to microenterprise loans.

> Recommendation: The enterprise fund portfolio model should be a balance of small loan programs to achieve volume and broad coverage, and larger direct investments chosen principally for their strategic value and/or profitability.
>
> Recommendation: Strategic investments that are particularly supportive of the economic transformation are investments in financial institutions. Although these investments might be more difficult than other types of direct investments, they are likely to produce greater secondary impacts because:

- They can be a platform for expanding the small loan activities;
- They produce leverage by accepting deposits;
- They become visible demonstrations for the rest of the financial system; and
- They have improved prospects for becoming sustainable. In addition,
- By obtaining a banking license, enterprise funds might overcome certain operating limitations to which they now are subjected.

4. The economic environments in the host countries vary considerably by country and are less favorable than those in the United States or Western Europe. However, the host country conditions have not proven to be an insurmountable barrier to successful investing. Investments in those transitioning markets require extensive local knowledge and hands-on monitoring, which is possible only by having

the investment personnel in the host country. The training of host country investment staff is one of the most important functions a fund can perform.

> <u>Recommendation</u>: Funds must establish an investment philosophy based on a clear understanding of the host country's business, legal, and policy environments and not simply mirror the approach of other funds.

> <u>Recommendation</u>: By making an explicit effort to develop trained host country staff, funds can improve their investment performance, reduce costs, and make a lasting contribution to the economic transformation of the region. Newer funds should not repeat the mistake of placing separate investment staffs in the United States.

5. The principal value of enterprise funds in economic transformation is at the firm level. Because of their small size in relation to the size of host country economies, funds are not likely to have a measurable impact on macroeconomic variables and therefore should not be held to such a standard. If USAID's development objectives are only at the policy and macroeconomic level, enterprise funds are not a useful vehicle for achieving those objectives.

6. Although enterprise funds appear to be the best structure available for providing investment capital to businesses in Eastern Europe, there appears to be little in the way funds are structured and operate that gives them a particular advantage in carrying out broad-based technical assistance when compared with other possible alternatives.

> <u>Recommendation</u>: Funds should continue to limit their use of technical assistance grants to activities related to investment, including the development of professional staff for funds and investee companies.

7. The most appropriate measurable impacts of fund activities are their direct impacts on the investee companies. These include revenue and employment growth, financial leverage, and demonstration effects of specific investment actions. The impact of funds on the economic policy environment results from personal interactions with business and government leaders and through certain demonstration effects, rather than through formal policy dialogue.

> <u>Recommendation</u>: USAID and the funds should agree upon an acceptable set of impact measures and consistent definitions and methodologies for measuring impacts without resorting to a "one size fits all" approach to performance monitoring.

8. Development impact and commercial viability are not contradictory objectives. No lasting development impact results from an investment that is not sustainable. To date, funds have not produced rates of return that are high by any market standard. However, the investment programs of HAEF and PAEF seem to be sound, whereas CSAEF's investment program is performing poorly. For BAEF it is too soon to tell. The early results of BAEF are not positive, but, if it can continue its recent pace of investing while reducing costs, its future could be positive.

> <u>Recommendation</u>: Funds can and should be judged on their financial performance, recognizing that these measures must be viewed in a long-term context.

9. Operating costs for the funds have been higher than necessary. The largest single avoidable cost has been the U.S.-based investment staff, but most funds now have substantially downgraded this activity. The statutory requirement for a U.S. board of directors, combined with the government's reporting requirements, suggests the need for a large U.S. executive staff. However, from the perspective of program performance, this U.S.-based executive structure often adds little. Reporting can be handled from the field or through a contractor relationship.

10. The most important factors in raising additional capital are a track record of successful investing and an experienced investment team in place. Since the most likely source of additional capital will be institutions such as the European Bank for Reconstruction and Development and investors already in the region, a U.S. office is not critical to fund raising.

> Recommendation: Funds should move as quickly as possible to transfer most operational functions to the host country. Newer funds should avoid the mistake of establishing investment offices in the United States (see #4 above).

11. The speed and flexibility that result from the independence inherent in the private corporate structure of funds are essential to the effective implementation of the investment programs. It would be extremely difficult to carry out similar investment activities using more traditional USAID contractor mechanisms.

12. The current U.S. government monitoring system is not working. Funds are subjected to an excessive degree of monitoring, whereas the government has neither adequate information on performance nor adequate safeguards commensurate with the $1 billion investment the enterprise fund program represents.

> Recommendation: Funds should adopt consistent financial reporting and establish acceptable methods of gauging financial performance and development impact. An independent third party review of portfolio quality should take place approximately every three years.

> Recommendation: The function of board activities should be strengthened to increase the protection afforded to the taxpayer investment. Board members should be encouraged to participate more directly in periodic monitoring visits with U.S. government officials to ensure that they provide oversight appropriate for their trustee role.

13. Neither the funds nor the U.S. government has a clear sense of what should happen to the funds over the long term. The current grant agreements call for decisions to be made about the disposition of funds between the 10th and 15th year of their operations. Most of the funds with less than $60-$75 million will have difficulty achieving financial self-sufficiency. Yet it is not clear that financial self-sufficiency should even be a high priority goal. Furthermore, if enterprise funds are withdrawn from a country or if they are converted into another type of institution, it is not clear what happens to the U.S. government's investment.

> Recommendation: The U.S. government must examine carefully its long-term objectives with regard to the enterprise fund program and should develop a clear policy on its sustainability and disposition.

SUMMARY OF COLLECTIVE COMMENTS OF THE ENTERPRISE FUNDS

(The following statement was prepared by enterprise funds in response to the report.)

The preparation of a report evaluating the enterprise funds for Central and Eastern Europe requires a great deal of knowledge about economic conditions and the transformation under way in the five countries subject to the review — Bulgaria, Czech Republic, Hungary, Poland, and Slovak Republic — as well as the operation of investment funds, business management in general, and the variety of means the enterprise funds use in achieving their developmental and commercial goals. The difficulties experienced by the contractor in preparing this report are understandable, given that the purpose of the evaluation was unclear and a traditional USAID evaluation approach is ill suited for the task of reviewing enterprise funds.

Taken as a snapshot in time, this report has difficulty accommodating the dynamics of enterprise fund evolution from 1989, when the concept was conceived, through 1994, when the funds had matured into established organizations. Furthermore, the report tends to take a least common denominator approach that obscures differences among enterprise funds dictated by the different economic, political, and social conditions each fund faces in its respective host country.

The managers of the enterprise funds spent countless hours assisting in the evaluation process and submitted in the aggregate 90 pages of detailed comments on the first draft of this report alone. The four individual critiques were remarkably consistent in their responses, and it was surprising to see that most of these comments, which provided corrected information or otherwise sought to put statements in proper perspective, were ignored. This inability to grasp the significance of information essential in evaluating enterprise funds is the largest failing of this report. Although the final draft reflects some factual improvements, it still misses the point on what the enterprise funds are, how they operate, and what they have achieved. This understanding is essential to make constructive recommendations for newer enterprise funds.

In evaluating the individual enterprise funds and the enterprise fund concept, the evaluation team should have addressed these key questions: Have the enterprise funds, with a small amount of capital relative to the economies in which they operate, succeeded in carrying out their legislative mandate to help effect the transformation of the economies of Eastern Europe through speedy and direct support to private enterprises? Is the enterprise fund structure, with a management team of investment professionals overseen by an independent board of directors consisting of private-sector individuals with extensive experience, an effective one? Essentially, is the enterprise fund experiment working — that is, is it a more effective means of providing U.S. government assistance? Knowledgeable observers of private sector development in Central and Eastern Europe agree that the answers to these questions are yes.

The report's failure to appreciate the role of the enterprise funds' board of directors both in setting direction and in serving as a control mechanism on behalf of U.S. taxpayers' interests leads to faulty conclusions. The active involvement of the boards, combined with annual independent audits by internationally recognized accounting firms, regular review by USAID, and comprehensive annual reports presented to Congress and the public, ensures transparency and public oversight of the enterprise funds. In addition, periodic reviews conducted by the General Accounting Office and the Inspector General are made available to congressional and administrative committees and briefings are provided by the enterprise funds to congressional and other governmental officials.

Similarly, the strength of the enterprise funds (and the most important factor in their sustainability) lies in their management. The funds have achieved effective management through a strong U.S.-based management team that recruits and trains a strong in-country investment capability. Over time, the in-country office must become the focal point of investment analysis and decision. The role of the U.S. office varies slightly by fund, but for all it serves essential functions.

Have the enterprise funds made mistakes? Can they make improvements? Again, the answers are yes. This learning experience, which fund executives already share among themselves, and the ability to adjust quickly are key elements in the enterprise funds' dynamic approach ensuring success in diverse countries that are undergoing vast economic transformation. Unfortunately, this report presents much data in a vacuum and does not examine the most important questions in any depth. The individual responses of the enterprise funds included within the space limitations permitted in Annex B discuss these issues and others that were previously raised more specifically. This report should be read in light of this summary and those comments.

CHAPTER ONE

INTRODUCTION AND BACKGROUND

APPROACH TO THE EVALUATION

This is a report on the evaluation of four American enterprise funds in Eastern Europe. The evaluation was conducted from September 1 to December 31, 1994, by a team from Development Alternatives, Inc. (DAI), under USAID contract number AEP-5451-I-00-2059-00. The scope of work (attached as Annex A) called for an evaluation that would examine:

- The development impact of the enterprise funds;
- Their financial performance and sustainability; and
- The replicability of the enterprise fund concept.

A seven-person team spent eight weeks in the field analyzing the work of the funds from three perspectives: the internal operations of the funds (including costs of operations), the investment portfolios of the funds, and the business and economic policy environments of the countries in which the funds are located. During the evaluation, team members reviewed files and documents of the funds, interviewed senior management and investment officers employed by the funds, visited approximately 140 firms that have received fund investments, and interviewed 200 individuals who have knowledge of the funds and/or the economic environment in which the funds operate.

The task was complicated for a variety of reasons, but one particular problem resulted from the way enterprise funds were formed. Unlike most other USAID projects, there was never a project paper, RFA/RFP, or other means by which specific operational objectives were established. Enterprise funds were authorized under the Support for East European Democracy (SEED) Act of 1989, which set forth the broad goals and the structural form for enterprise funds. The grant agreements, which provide the funding, identify programmatic activities for funds but establish no targets against which performance is to be measured. For the first two years of the program, funds were not required to report on activities other than to secure an external audit and prepare an annual report. Funds do maintain records on revenues and expenses, and on the financial performance and operating characteristics of their investments. However, funds are not required to track other types of impact data that USAID considers relevant to the evaluation. For data that are collected, definitions and methodologies are often not consistent from fund to fund. As a result, the evaluation team spent a considerable amount of time compiling or restating data that ideally would have been available from the outset. The USAID staff is aware of this problem. Therefore, another aspect of the evaluation was to test a variety of possible performance indicators and recommend ways USAID might improve its monitoring of these and similar funds.

This evaluation examines the specific experiences and performance of the four funds and from that examination draws conclusions about the program overall. It should be recognized that these generalizations do not always apply to all funds and that significant variations occur and exceptions exist. Nevertheless, the conclusions and recommendations in this report are drawn from team's analysis and observations, and represent the team members' best attempt to synthesize their findings.

Some funds have taken issue with some conclusions of the evaluation. Comment letters by the funds are included as Annex B.

HISTORY OF THE ENTERPRISE FUND PROGRAM

As part of the SEED Act of 1989, Congress authorized the creation of the Polish American Enterprise Fund (PAEF) and the Hungarian American Enterprise Fund (HAEF). Subsequently, USAID allocated money to create two additional funds: the Czech and Slovak American Enterprise Fund (CSAEF) and the Bulgarian American Enterprise Fund (BAEF). With the division of Czechoslovakia in 1993, the CSAEF was divided into two funds under a single holding company, thereby creating the Czech American Enterprise Fund and the Slovak American Enterprise Fund. However, CSAEF still operates largely as a single entity and will be treated that way in much of this report.

The SEED Act sets forth only the broadest of guidelines for forming and operating these funds. They are incorporated as U.S. nonprofit corporations operating under the guidance of a board of directors made up of a combination of U.S. and host country directors. A wide range of activities are permitted including debt and equity investments, leasing, grants, technical assistance, and policy guidance. The principal target of the funds is small and medium-sized enterprises. A total of $440 million has been obligated for the funds in the following amounts:

PAEF — $250 million (of which $10 million is authorized for technical assistance only)
HAEF — $70 million (of which $10 million is authorized for technical assistance only)
CSAEF — $65 million (of which $5 million is authorized for technical assistance only)
BAEF — $55 million (of which $5 million is authorized for technical assistance only).

Many of the early investments of the funds took on a "venture capital" character. Virtually all of the funds found that investing in the large privatizing state enterprises is a hazardous undertaking fraught with unpredictable traps and impediments. A few of these early investments have proven highly profitable, but many have been disappointing. Overall, the volume of investment transactions has fallen short of initial expectations.

The SEED Act had no formal requirement to create loan funds for small enterprises, and most funds did not initially emphasize the small enterprise segment of the market. But the local market demand for small loans has become more apparent to the funds, whereas the larger investments have proved to be more risky and problematic. All of the funds now have or are evolving to a three-tier investing strategy:

- **Direct Investments** — equity or debt/equity combinations in larger amounts to privatized enterprises or joint ventures;

- **Joint Bank Lending Programs** — dual purpose schemes to direct credit in the $20,000 - $200,000 range to small businesses as well as to encourage bank lending of that type; and

- **Small Loan Programs** — for less than bankable-size small business loans, as well as lending programs to a specific industry.

In dollar amounts the large transactions dominate the investment portfolios of the funds. In numbers of transactions, however, the small investments outweigh the large ones by a wide margin.

The enterprise funds wrestle with a constant dilemma: commercial viability versus development impact. Although the two are not necessarily contradictory, funds believe they must choose between investment strategies that emphasize financial return and those that place greater premium on non-financial impacts.

A hallmark of the enterprise funds is their independence. As originally structured, funds were accountable only to their boards of directors, with only limited government oversight on the use of their capital. In 1993, by agreement with Congress, USAID was given greater oversight responsibility but has limited approval authority over specific fund actions. Grant agreements prohibit certain types of investments (military and abortion equipment and services, and export of jobs from the United States). Funds must obtain USAID approval to undertake major structural changes, create subsidiaries, invest in financial entities, and finance defense conversions. USAID must approve technical assistance activities not specifically associated with project financing. However, USAID has no approval authority over most program activities including investment policies and actions, staffing, and operating budgets.

The relationship between the funds and various entities in the U.S. government needs clarifying. Funds must now report to USAID twice annually, and must agree to periodic evaluations and site visits by USAID and its designees, as well as by the General Accounting Office and the Office of the Inspector General. Funds also receive regular visits by congressional delegations. Under the current arrangement, funds are monitored to an excessive degree. Yet the substance of this monitoring is not adequate for USAID's needs, and it is not clear who within the U.S. government really has authority and responsibility for the enterprise fund program.

Each fund has established a dual office structure — senior executives in the United States and a delivery mechanism in the host country. The offices of the funds vary in size. Typically, the U.S. office consists of a president/chief executive officer, a chief financial officer, and support staff; while the host country staff consists of a senior operating officer, investment staff, and other program and support staff. At the beginning, some funds also had U.S.-based investment staffs as an intake point for possible U.S. joint venture investors. This arrangement has often proved to be a source of problems, and many funds have eliminated or substantially downgraded their U.S.-based investment function.

The enterprise funds have no owners or shareholders. Their boards of directors play both an advisory and a trustee role, and to varying degrees become engaged in operational aspects of the programs. Only U.S. directors vote on major actions such as substantial changes to a fund's structure. Initial board members are designated by the President of the United States, but congressional confirmation is not required. When board members are changed, funds must seek the advice of the President. Members typically have strong business and political credentials. There is no statutory requirement for host country directors, but only BAEF has no host country directors. As trustees, the boards are particularly important because they represent the principal oversight for taxpayer funding.

The original SEED Act legislation is silent on the ultimate disposition of these funds. In 1993, modifications were made to the original grant agreements specifying that at a point between the 10th and 15th year of their operations, a decision would be made in consultation with Congress and the Administration about the ultimate disposition of the funds. Funds are to be given one year of advance notice prior to liquidation.

The original group of enterprise funds was part of a unique historical event — the transformation of the East European countries from command to market economies. The funds became one of the most visible manifestations of the U.S. pledge to support the transformation. As such, they have brought considerable political good-will to the United States. At the same time, this political dimension created two serious problems. First, the announcement of the funds created an avalanche of requests for money from would-be business owners, putting a great strain on the funds during their start-up phase. Second, there was a great deal of disappointment and negative publicity in the countries when people discovered that the funds were requiring repayment of the capital with interest. At present, the funds appear to enjoy a generally positive image in host countries, but they must be very sensitive to their role as profit-driven investors and instruments of U.S. government policy.

Two of the funds, HAEF and PAEF, have established programs that are delivering beneficial development services to their respective countries. In both the Slovak Republic and Bulgaria, country conditions are such that the funds, if properly redirected, could be important contributors to the economic transformation taking place there. In the Czech Republic, economic transformation has proceeded quickly although the Czech fund has not established a viable program. As a result, even if the Czech fund were to improve its performance substantially, it would still be marginal to the economy of the Czech Republic.

The performance of each fund is summarized below.

Hungary

HAEF has developed a portfolio of equity investments that are a combination of commercially viable and developmentally beneficial companies. Under Hungarian law, because HAEF is not a bank, it is not permitted to make loans. Therefore, virtually all of HAEF's direct investments are in equity. HAEF was instrumental in aiding with the creation of the Budapest Stock Exchange and participated in several initial public offerings of former state enterprises. Three of these investments have produced significant gains, giving HAEF the highest financial return of all the funds. HAEF investment activity has been aided by a very healthy local economy.

HAEF has a highly competent staff of Hungarian and American investment professionals. As shareholder, it participates actively in the management and supervision of its investee companies. Among its investments are some excellent demonstrations of the transformation of inefficient state enterprises to world-class competitive manufacturers.

HAEF invested $5 million in a small loan program run through bank intermediaries. The funds were quickly disbursed, and HAEF has not added to the funding. HAEF has a separate microenterprise loan fund of $400,000.

HAEF has used its technical assistance funds to support a range of activities including individual company assistance, an effort to improve land ownership registration, a highly regarded videotape program on starting businesses, and a visitor center for the Budapest Stock Exchange.

HAEF's programs were badly disrupted by highly visible incidents in 1993 that almost caused the program to be terminated. One involved the creation of an investment banking subsidiary (EurAmerica Capital Corporation), which gained notoriety for its highly paid staff and its far-flung program activities. HAEF has now sold its investment with a small gain. Despite its political gaffes, EurAmerica has succeeded in securing more than $70 million in investment capital for Hungarian businesses. In another incident, HAEF was criticized for using its technical assistance funds to pay a portion of the salary of an American who had been recruited by the Hungarian government to work in its privatization program. Because of the criticism, this individual has resigned.

Poland

PAEF is the largest and most innovative of the enterprise funds and has by far the most complex structure.[1] Having more than three times the initial capitalization of the other funds gave PAEF some advantages in setting its investment strategy. However, it is to the credit of management that PAEF has built a series of innovative and beneficial programs.

Its Enterprise Credit Corporation, which makes loans to small new companies, is by far the greatest single success of the enterprise fund program. PAEF has also made three strategic investments in the financial services sector, and has made other strategic investments in construction, food processing, publication, and manufacturing sector.

PAEF has attracted $100 million in additional investment from the European Bank for Reconstruction and Development (EBRD) and private investors.

PAEF has created a separate management company, Enterprise Investors, which is a limited partnership with PAEF and EBRD as the general partners and key management personnel as limited partners. All of PAEF's personnel are actually employees of Enterprise Investors. The fund itself is charged a fixed management fee of up to $2 million, which places a cap on the administrative costs charged to PAEF. Enterprise Investors also receives a management fee for the non-governmental capital it manages.

PAEF's use of technical assistance funding is varied. Funds were used to train bankers participating with the Enterprise Credit Corporation, create microenterprise lending programs, support enterprise clubs, and assist its investees.

Bulgaria

BAEF has had difficulty getting started. Begun in 1992, it is the newest of the five enterprise funds. The private enterprise market is much less developed in Bulgaria than in the other countries, limiting this fund's potential investment opportunities. Total investment lags far behind original expectations. Its first two large investments failed, resulting in about $2 million in losses. However, by reorienting the program toward small new enterprises in selected sectors, BAEF seems to be recovering. BAEF has two promising joint venture investments in the agribusiness sector.

BAEF was instrumental in bringing Opportunity International into Bulgaria to create a microenterprise program known as Nachala. BAEF funds the loan capital and part of the operating cost, and Opportunity International contributes to supporting operations through its other fund raising. BAEF also has a promising program for financing small hotels and tourist homes, and has recently launched a joint lending program with local banks.

Overall, however, the pace of investing activity in Bulgaria has been much slower than in the other countries. The pace of investing by BAEF has increased rapidly over the past year, and its future appears more promising. However, BAEF appears to be greatly overstaffed, particularly considering that much of the transaction volume is generated by an independent Nachala staff, and, as a result, the costs

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[1]PAEF's structure is so complex, in fact, that analyzing the flow of funds through its various subsidiaries, affiliates, partnerships, and investments is extremely difficult.

of BAEF are out of line with the performance. Its problems are not beyond repair and will warrant attention if the recent growth in activity does not continue.

Czech Republic and Slovak Republic

CSAEF is failing to achieve either commercial success or development impact. The investments are suffering major losses, and are generally marginal both in market and in development terms. The Czech fund has been plagued by an inordinate degree of staff turnover, and has failed to put an effective investment team in place. CSAEF relies heavily on the MBA Enterprise Corps for its investment staff. Although the individuals are talented and capable, CSAEF is using the Corps in a manner for which it is not particularly well suited.

CSAEF appears to have given development impact a higher priority than other funds, yet its actual impact has been marginal. CSAEF's portfolio is more geographically dispersed than that of any other fund. It has explicitly targeted geographic areas of need and sectors such as energy and agriculture. In the beginning, CSAEF chose to avoid retail and service investments in favor of manufacturing, but this decision effectively excluded the fund from the one market segment that has been most hospitable to small enterprises in Eastern Europe. CSAEF initially relied more on loans than equity investments to generate a flow of investment income quickly.

Its use of technical assistance funds has been limited. Most of the expended funds have been used to pay the cost of the MBA Enterprise Corps and the start-up cost of its joint loan program.

The current condition of the Czech enterprise fund poses a dilemma for both CSAEF and the U.S. government. The United States is scheduled to withdraw its assistance to the Czech Republic in two years, raising a question about the future for the Czech fund. It is not strong enough to stand on its own, and USAID is not likely to add to its capital. Given the depth of the problems present in CSAEF, it will take a major effort to make this organization productive. There is no reason why enterprise funds necessarily should withdraw from a country when other USAID activities cease. However, given the problems present within CSAEF and the pace of transformation in the Czech Republic, even if the problems of the Czech fund could be resolved, it will continue to have only a minimal impact there. In the Slovak Republic, where there is a continuing need for U.S. assistance, an effort to strengthen the Slovak enterprise fund would be warranted. CSAEF needs an overhaul of its corporate structure, staffing, and program direction. The principal focus would be to bolster the delivery capability in the Slovak Republic.

CHAPTER TWO

THE DEVELOPMENT IMPACT OF ENTERPRISE FUND ACTIVITIES

This chapter, along with Chapters Three and Four, responds to questions posed in Attachment D to the scope of work (see Annex A of this paper). In some instances, these questions have been restated and the sequence changed to improve the presentation. These questions are stated as "Inquiry Areas" with the essential conclusions presented as "Findings." The findings are further amplified in the narratives.

Chapter Two reviews the impact the enterprise funds are having on the development and transformation of the emerging market economies of Eastern Europe. Gauging this impact is difficult for a variety of reasons. The original directives to the funds never set forth specific criteria or objectives by which impact should be defined or measured. The SEED Act established the following broad guidelines for the enterprise funds:

- "To promote development of the private sector, including small businesses, the agricultural sector, and joint ventures with the United States and host country participants; and

- "To promote policies and practices conducive to private sector development through loans, grants, equity investments, feasibility studies, technical assistance, training, insurance, guarantees, and other measures."

USAID has now developed criteria by which it defines development impact, and this chapter concludes with consideration of enterprise fund performance based on those factors. In general, funds are (or can be) effective at providing capital for individual enterprises and development projects, but it is very difficult to demonstrate significant impacts beyond each fund's individual investing programs. Since enterprise funds were never required to track anything but financial performance, even where impacts may be of a quantifiable nature, accurate data for measuring impact do not exist.

Inquiry Area # 1: **Are enterprise fund programs helping to broaden the access to capital for entrepreneurs?**

Findings: **Enterprise funds are helping to broaden access to capital for entrepreneurs by investing in enterprises that have few alternatives. The funds have invested more than $267 million, a high percentage of which has gone to small and medium-sized enterprises. Enterprise funds are more effective at providing capital to private businesses than are other international organizations such as EBRD, World Bank, and EC Phare. Nevertheless, even under the best of circumstances, enterprise funds are able to help only a small percentage of the newly emerging private enterprises in the region.**

A total of 3,305 loans and investments have been made to private businesses since the inception of the program. Table 1 summarizes the amount of investing undertaken by the funds by category of investment. Most of the investments by the funds have gone to small and medium-sized businesses.[2]

TABLE 1

ENTERPRISE FUND TRANSACTION SUMMARY
(program transactions through FY 1994, including relending and reinvesting activity)

PROGRAM	NUMBER	TOTAL VALUE	AVERAGE SIZE
HUNGARY			
DIRECT PORTFOLIO	31	$36,561,160	$1,179,392
SMALL LOAN PROGRAMS	166	$6,677,390	$40,225
MICRO-LOAN PROGRAMS	47	$294,316	$6,262
SUBTOTAL	244	$43,532,866	$178,413
POLAND			
DIRECT PORTFOLIO	30	$104,850,000	$3,495,000
ENTERPRISE CREDIT CORP	2,787	$64,817,321	$23,257
PRIVATE EQUITY FUNDS	13	$27,675,207	$2,218,862
SUBTOTAL	2,817	$197,342,528	$70,054
CZECH REPUBLIC			
DIRECT PORTFOLIO	22	$7,552,000	$343,273
JOINT BANK LENDING	18	$1,651,027	$91,724
SUBTOTAL	40	$9,203,027	$230,076
SLOVAK REPUBLIC			
DIRECT PORTFOLIO	27	$12,192,000	$451,556
AMERICAN LOAN PROGRAM	17	$1,092,000	$64,235
SUBTOTAL	44	$13,284,000	$301,909
BULGARIA			
DIRECT PORTFOLIO	5	$3,058,600	$611,720
KOMPASS PROGRAM	1	$ 66,500	$66,500
NACHALA (MICRO-LOANS)	135	$677,584	$5,019
SMALL HOTEL PROGRAM	15	$332,166	$22,144
DAIRY PROGRAM	4	$38,700	$9,675
SUBTOTAL	160	$4,173,550	$26,085
TOTAL DIRECT PORTFOLIO	115	$191,888,967	$1,668,600
TOTAL SMALL/MICRO	3,190	$75,647,004	$22,230
TOTAL INVESTMENTS	3,305	$267,535,971	$76,048

[2]In the enterprise fund context, there is no precise or consistent definition for "small and medium-sized enterprises." However the definitions most often used by USAID as follows: microenterprise — under 10 employees; small — 10 to 50 employees; and medium — 50 to 100 employees.

Of the 3,305 investments, 115 are direct investments and 3,190 were made through the small and micro loan programs. All of the small and micro loan clients are small businesses. The loans average $22,230. With regard to direct investments, most are in companies that fall within a small or medium-sized range, with only a few exceptions. HAEF made three investments totaling $7.5 million in companies that now have sales in excess of $100 million.[3] Two other HAEF investments and three PAEF investments are in companies with sales in the $25-$50 million range. All but 13 of the investee companies of the five funds had revenues of under $10 million in 1993. None of these companies had revenues in those magnitudes at the time the investments were made. Excluding one $28 million investment by PAEF, the direct investments average $1.4 million each.

A very high percentage of the investees of the enterprise funds would have been unable to obtain financing elsewhere. Many borrowers fit a risk profile such that they might have difficulty obtaining financing even in more advanced market economies. The evaluation team visited 40 direct investee companies and 100 small loan borrowers. In virtually every case, the interviewers were told that the fund's capital was instrumental in starting or expanding the business. In the case of small loan borrowers, companies consistently criticized banks for requiring too much collateral, for being unwilling to make loans of longer than 6 to 12 months, and for generally having little interest in the small clients. Meetings with bankers confirm that very little financing is available for small companies seeking loans for longer than one year. Most of the companies visited had used the capital to successfully expand production, revenues, and employment.

Virtually all of the small loan borrowers are single-owner family businesses, partnerships of friends and relatives, or self-employed individuals. In Poland and Hungary, companies with fewer than four employees existed prior to 1991; however, most of the small loan clients had been in business for only a year or two at the most when they received fund financing. Typically, the funds receive very little collateral other than the assets purchased with the loan. Often businesses do not have fully developed business plans when they first apply. The Enterprise Credit Corporation in Poland has developed an application form (now being adopted by Polish commercial banks), which has the effect of creating a business plan for the client as part of the application process. Most fund loans are for terms of one to five years.

With regard to the larger transactions, options for financing are similarly limited. Only Hungary has any significant amount of private venture capital, although small funds are beginning to form in the Czech Republic and Poland. Even there, however, much of the privately managed venture capital actually originates from more public institutions such as EBRD or is guaranteed by the U.S. Overseas Private Investment Corporation (OPIC). The small amount of truly private capital is simply seeking a window on this new market. When interviewed, managers of these private funds showed little interest in transactions under $3-$5 million, and praised the enterprise funds for their willingness to consider investments under $3 million. They generally acknowledged the leadership role played by the funds by being first into the market. The European Venture Capital Association issued a report that cited the funds as "the most significant single activity in the region."[4]

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[3]All three of these companies were participation in the initial public offerings of former state enterprises. HAEF has subsequently sold almost half of its original holdings in these companies, realizing a 100 percent gain on the investments.

[4]European Venture Capital Association, Minvervastraat 6, 1930 Brussels, Belgium.

As the economies in the region improve, one certainly would expect the financing options to expand. However, there is no evidence that for the foreseeable future a wide range of viable financing options is likely to be available for the small and medium-sized enterprise sector.

No other donor programs serving the region reach the small and medium-sized enterprise sector with capital more effectively than the enterprise funds. The World Bank has established credit lines within many central banks to be used for financing small enterprises. Most of the lines are unused because of their complexity and rigidity. EBRD will not consider applications under about $5 million. EBRD's total disbursement for the five countries for all types of transactions are approximately $257 million, compared with $267 million for the enterprise funds. The European Union has created subsidized interest rate lending programs for small businesses throughout the region. When available, these funds are in great demand because of their lower cost, but the funding is limited.

According to EBRD data, $9.04 billion in direct foreign investment entered the five countries between 1989 and 1993. Enterprise fund investments represent approximately 3 percent of that total. However, a substantial part of the direct investment represents major multinational corporate joint ventures such as the General Electric investment in Tungstram (Hungary), Ford and General Motors' investments in several automobile plants, various hotel and airline investments, and loans directly to governments. In Poland, for example, $2.8 billion had been invested by foreign companies as of the end of 1993. Included in this amount are investments by Fiat ($180 million), Coca-Cola ($170 million), and International Paper ($120 million). Over $800 million can be attributed to eight individual transactions by similar multinational corporations. Although a precise calculation is not possible, it would appear that a very small part of that is available to small and medium-sized enterprises.

Other donor agencies in the region were envious of the speed with which the funds became operational, and the flexibility and independence allowed in the programs.

Inquiry Area #2: **Are enterprise funds effective as catalysts for the development of the financial sector?**

Findings: **To date, funds have not substantially affected operations in the countries' financial sector and could do more in that regard. Only PAEF has chosen to invest directly in the creation of local financial institutions. Others have undertaken programs in conjunction with local banks that demonstrate investment techniques and train host country financial professionals.**

PAEF has created one new financial institution and is a major investor in two other financial institutions. The Polish American Mortgage Bank (PAMBank) is the only mortgage bank in Poland. Created by PAEF, its purpose is to demonstrate the use of home mortgage financing as a means of financing home ownership. PAMBank is still in its infancy, and does not yet have wide market penetration. Macroeconomic factors and legal impediments limit the usefulness of home mortgage financing, but PAEF views this as a long-term investment to bring about fundamental systemic change in Poland.

The First Polish-American Bank (FPA) of Kraków is a private bank in which PAEF holds a 62 percent ownership interest. With guidance from PAEF, FPA has upgraded its management systems, expanded its marketing, and is establishing itself as a specialized lender for private businesses. PAEF used its technical assistance funding to hire FPA's American president and its chairman. FPA has reversed its earlier loss position and earned a profit of $765,000 in 1993. At the end of 1994, its shares were listed on the Warsaw Stock Exchange. Current plans now call for linking Enterprise Credit Corporation with FPA, creating a country-wide system for small business lending.

PAEF purchased a 20 percent interest in the Bank Rolno-Przemylowy (Agriculture Bank) using funds received from U.S. agricultural commodity sales. This bank specializes in financing small village infrastructure projects (water, electrical, and gas systems), food processing companies, and farm equipment. PAEF has assisted this bank in improving its operations through upgrades in management systems and strategic planning.

Citing both the capitalization required and the legal restrictions, none of the other funds has attempted to invest directly in a host country financial institution. Because of the unique nature of financial institutions in facilitating growth of private enterprise, funds should make a special effort to expand their investments in the financial sector despite the inherent difficulties.

All of the enterprise funds have established joint lending programs with banks. The programs are designed to provide small enterprise financing and training for participating bankers. Enterprise Credit Corporation, a subsidiary of PAEF formed specifically for small enterprise lending, is the greatest single success of the enterprise fund program.

These initiatives are described in detail in Annex C. Altogether, these joint lending programs account for 2,989 loans valued at $74 million. Almost 100 bankers have received credit training through these initiatives and another 200 have participated in shorter seminars. It appears that some of the systems and practices developed through these initiatives are being copied by other banks.

Enterprise Credit Corporation created the Windows program, which consisted of 10 loan origination windows in regional banks in Poland. Each bank assigned loan officers to work in conjunction with Enterprise Credit Corporation staff to originate and service small business loans. Enterprise Credit Corporation paid for the training of 75 loan officers and for the installation of management systems in the banks. Loans are identified and reviewed by banks, and funded by Enterprise Credit Corporation. The interest income and risk are shared by Enterprise Credit Corporation and the bank. To date, 2,787 loans totaling $64.8 million have been disbursed by Enterprise Credit Corporation. Some banks are now beginning to expand their small business lending without being part of the Windows program, and Enterprise Credit Corporation is being linked to a private bank partly owned by PAEF.

HAEF allocated $5 million for a joint lending program that has resulted in 167 loans for $6.7 million, including relending. Even though this program is in great demand, HAEF has not expanded the funding for it. HAEF cites limits on its total capital as the reason for this decision.

The joint lending program in Bulgaria has just started. Training of bank officers took place in December 1993, but the first loans were not approved until September 1994. Banking laws in Bulgaria and the difficulty of negotiating program agreements with banks have placed major impediments in the way of this effort.

Czech and Slovak programs have been largely ineffective. Both programs attempted to train great numbers of bankers and borrowers, in an effort to get country-wide coverage. The result has been that the programs were lost in large institutions, and only 35 loans have been made to more than 2,000 potential applicants.

Inquiry Area #3: **How effective are the enterprise funds at attracting additional private investment?**

Findings: **Cumulatively, enterprise funds have helped attract more than $200 million in capital to their markets, with most resulting from work of HAEF and PAEF. A fund's ability to attract outside capital is directly related to investment performance and the credibility of the investment team. The more successful funds should be able to increase leverage as they become more established.**

Enterprise funds attract private funds in three ways: as leverage capital under management of the fund directly, as co-investors in individual projects, and as shareholders in public or private offerings. PAEF has attracted the most outside capital through investment partnerships. HAEF created a subsidiary to raise capital through public offerings, and, although it succeeded in its purpose, the impact was overshadowed by negative publicity. CSAEF has attracted co-investments from EBRD and Japan International Development Organization (JAIDO).

PAEF has attracted $100 million in leverage capital, which it invests along with its enterprise fund capital. This capital has been placed into two private equity partnerships (Polish Private Equity Fund I & II). The funds were received from Creditanstalt, EBRD, and several U.S. pension funds. A management fee is paid to PAEF's management for investing these funds. Typically, PAEF and the two partnerships will invest approximately one-third each to fund a new equity investment. Presently $33 million in partnership funds have been invested in 16 projects.

HAEF has been the only fund to participate in public offerings to any great extent. HAEF was active in helping structure several offerings by state-owned enterprises as part of the Hungarian privatization program. The offering statements issued by the companies made explicit reference to HAEF's proposed participation as a shareholder. HAEF and the companies both believe that HAEF's presence in these share offerings added credibility and improved market acceptance of the shares, thereby helping to bring other investors to the market. In addition, HAEF created an investment banking subsidiary, EurAmerica Capital Corporation, to assist companies structure public offerings. EurAmerica became the focus of negative press reports because of high management salaries, and HAEF eventually sold its ownership for a small profit. Public share offerings by HAEF and EurAmerica clients have generated in excess of $100 million in private investment.

In Poland, PAEF participated in the structuring of a public offering for a privatized regional bank in Lodz. PAEF was originally slated to purchase a substantial share of the offering. However, when it was brought to the market, the offering was oversubscribed. PAEF therefore decided not to participate, but led others to the market.

Certain individual investments by funds have helped bring substantial amounts of co-investment into the market. CSAEF recently participated in two investments that received $15 million from JAIDO and EBRD. CSAEF invested $1.1 million in Tesla for a 19 percent share and $1.2 million in CES Uniweb for a 17 percent share. Four of the joint venture investments visited by the evaluation team had received about $55 million in private investment by the outside partner (see Inquiry Area #4).

Additional leverage has come from the private investment component of each fund transaction. There are no accurate data by which this leverage can be measured.

Inquiry Area #4: **What other beneficial impacts, such as employment, privatization, and the expansion of private enterprise, have resulted from enterprise fund investments?**

Findings: **The fund investments do result in beneficial impacts at the microeconomic level, but the impact at the macroeconomic level is small.**

Companies in which enterprise funds have invested collectively employ 77,839 people.[5] It is impossible ultimately to prove that these jobs were created or sustained solely as a result of fund investment. Funds do not always keep consistent records on employees when investments are made. Furthermore, with many of the direct investments in privatizing enterprises, the first step is to reduce overall employment as part of restructuring, so job creation may not be an immediate goal of the direct investments. The small loan borrowers, however, are relatively new, and virtually all are adding employees. Table 2 calculates the average investment or loan amount per employee.

TABLE 2

EMPLOYMENT AND FUND INVESTMENT

INVESTMENT	HAEF	PAEF	SAEF	CAEF	BAEF
Direct Investments					
Employees	10,319	11,300	2,870	914	N/A
Investment per Job	$3,543	$11,728	$4,248	$8,263	
Small Loans					
Employees	961	50,000 (est)	217	411	847
Loan per Job	$7,255	$1,296	$2,516	$1,961	$1,316

Small loan programs tend to have a greater positive impact on employment than do the larger direct investments. The small loan programs collectively employ about 52,436 people, while the direct investments employ 25,403. As a ratio of total investment, the small loan programs employ one person for every $1,442 invested, while the direct investments employ one person for every $7,553 invested. Further, the small loan program funds are recycled faster (Enterprise Credit Corporation capital of $28 million has been lent an average of 2.29 times) so a smaller amount of capital is needed for the employment benefit.

Companies in which enterprise funds have invested account for about 1.5 percent of private sector gross domestic product in the region. Based on revenue data provided by the funds, the total revenues

[5]These data were provided by the funds and have not been independently verified.

of all investee companies were approximately $1.2 billion in 1993, and private sector gross domestic product for the same period was about $81 billion.

Enterprise funds have had a positive impact in certain privatization projects, but overall the enterprise funds have had a tiny impact on the overall privatization process. Funds have invested in about 30 first- or second-stage financing of privatized state enterprises. HAEF helped structure public offerings of five state enterprises undergoing privatization, and has invested in several other privatized companies that are not publicly traded. In Poland, there has been no mass privatization, but PAEF has developed an effective program to finance management and employee buy-outs of state enterprises. This Capital Market Privatization has converted six former state enterprises into private companies. In the Czech Republic and Slovak Republic, the privatization process did not permit CSAEF to be part of first-stage privatization, but CSAEF now has investments in four second-stage financing designed to expand the productivity of these enterprises. In Bulgaria, most of the state enterprises are still either owned by the state or controlled by insiders from the Communist regime.

One important lesson emerges from a review of privatization investments. Privatization by itself does not guarantee any improvement in operations, management, or productivity. Many privatized firms continue to retain the inefficient practices of the past. Investments in privatizing firms must result in a complete transformation of those firms. Some of the better privatization investments by funds include Fotex, Pick, and Petofi (HAEF); and Hydrotest and W. Kruk (PAEF). The CES Uniweb and Tesla investments by CSAEF appear promising, but are still in the early stages. CSAEF's investment in NZ Foundry (Slovak Republic) is encountering great difficulty because of an inability to transform the operating environment. Notwithstanding a policy to the contrary, funds investing in privatizing enterprises would be well advised to secure effective control if not majority interest.

Some of the most promising investments made by funds are joint ventures with outside firms. These include:

Loranger — A U.S. automobile parts manufacturer supplying the Ford plant in Hungary (HAEF).

Petofi — A packaging company owned jointly by company management, HAEF, and the Italian DeBenedetti Group.

CES Uniweb — A textile manufacturer bringing Swiss manufacturing and marketing capability together with a privatized Czech textile company (CSAEF).

DPA-Donneley — A printing joint venture between the U.S. printing company, R.H. Donneley, and the Polish-American Printing Association owned by PAEF, to produce high quality magazines and color inserts in Poland.

Struma Fruit — An agricultural processing facility operated in Bulgaria by Tri-Valley Growers.

Many of the joint venture investments of the funds entail substantial private investment by the outside partner. Some of the more significant transactions are the following:

Joint Venture	Value of Private Investment
DPA-Donneley Printing (Poland)	$10,000,000
CES Uniweb (Czech Republic)	$13,200,000
Petofi (Hungary)	$30,000,000
Loranger (Hungary)	$1,250,000

Although joint ventures can at times be an effective way of attracting capital, management, markets, and technology, at other times they have been a major problem for funds. Early on, it was expected that joint ventures between U.S. companies and host-country enterprises would be a major part of the investment activity. In particular, it was felt that individuals with family or cultural links to the region would flock to the region eager to make investments and transfer technology. In fact, the demand by U.S. investors, and particularly the culturally linked investors, was much lower than expected. Some of the U.S. joint venture partners were not adequately investigated by funds as part of the review process. Some of the investments that originated in the United States were incompatible with local market conditions.

Among the more significant joint venture failures have been:

Rogerson Aviation — HAEF lost $660,000 financing a helicopter transportation service.

Ameribif — CSAEF has established a $364,000 reserve (75 percent) against this investment, which was to reprocess animal waste into animal feed and fertilizer. The owner attempted to place the company in a community that resisted it because of odor generated by the facility, and never obtained an operating license.

AgManagement — This joint venture attempts to use frozen calf embryo technology to upgrade cattle breeding stock in the Slovak Republic. The U.S. partner has been unable to produce the markets as promised, and CSAEF has not taken reserves against this loan, but is experiencing major problems with the borrower.

MaPain Bakery — BAEF lost $1.7 million in a joint venture investment with a French firm that went bankrupt, causing losses for BAEF, a major French bank, and the French government. BAEF did not take adequate precautions to protect against this possibility and has since changed its procedures.

Leader Gasket — This is a Slovakian joint venture between a U.S. manufacturer and CSAEF. The company is a success in terms of revenue and employment, but, because the investment was badly structured, CSAEF is not likely to get any significant financial benefit from the transaction.

Inquiry Area #5: **Have enterprise funds had an effect on promoting government policies and practices conducive to private sector development?**

Findings: **Actions by the funds have been helpful in smoothing the process toward market transformation through specific transaction-related demonstrations. Enterprise funds have engaged in formal policy dialogues with host governments only to a limited degree.**

Enterprise funds influence policy change subtly through informal discussions with senior government officials and leading business people. Board members frequently serve in senior posts in government and are influenced by the exposure they have while serving on fund boards. Similarly, senior staff of the funds often participate as members of commissions or in conferences and seminars, thereby expanding knowledge of private enterprise practices.

Investments that create efficient, world-class competitors can serve as important demonstrations of sound business practice. Many of the state-owned enterprises in the region are dark, dirty, noisy, wasteful, inefficient, and hazardous. The more efficient and competitive enterprises in which the funds have invested can serve as important models for the region. Workers, managers, vendors, and government officials all benefit from seeing these world-class companies, although it is impossible to say whether these demonstration effects go beyond the immediate company environment. The best firms the evaluation team visited include Petofi, Pharmavit, Alfa, and Loranger (Hungary); DPA-Donneley, First Polish-American Bank, and Computerland (Poland); CES Uniweb (Czech); TLC (Slovak Republic); and Struma Fruit (Bulgaria). See Annex F for individual case studies.

Enterprise funds believe that their transactions often open doors allowing others to follow more easily. Financial transactions are often difficult to conclude because the procedures are not known in these transitioning economies. In many cases, the funds are among the first to undertake a particular type of transaction, which may be simple in the United States but requires an extraordinary effort in Eastern Europe. Filing security interests and perfecting liens are routine procedures in the United States, but in Eastern Europe the procedures are not well defined. This deters many Western investors because it may mean that collateral cannot be repossessed. Enterprise funds have been willing to accept the risk associated with this uncertainty while helping establish more standard procedures, and are demonstrating that successful investment can take place even in the absence of a fully developed policy environment.

Inquiry Area #6: **How effective are the technical assistance programs of funds in the training of enterprise fund employees, potential and current investees, and the general public about capitalism and the manner in which the private sector operates?**

Findings: **Although certain specific technical assistance activities of enterprise funds are beneficial and effective, there appears to be little in the way funds are structured and operate that gives them a particular advantage in carrying out broad-based technical assistance when compared with other possible alternatives.**

Along with their investment capital, funds have received supplemental technical assistance grants of $30 million. The prevailing view within the funds and at USAID is that without these supplemental grants funds might not undertake some difficult investments and would avoid altogether most of the nonfinancial assistance they provide. However, some of the best technical assistance funds provide is an outgrowth of their direct investing through serving on boards of investee companies. Furthermore, some of what has been classified as technical assistance is really organizational and program development for the funds themselves.

Some funds have used technical assistance grants to advance the public's education and awareness of private enterprise activity. HAEF funded the videotape production of a course on starting a business. This course was broadcast on television in Hungary and was well received. The course has been used in other training courses in Hungary and has been adapted for use in other parts of the region. Both HAEF and PAEF have made grants to management institutes to introduce business courses and M.B.A.-type degree programs. In Hungary, however, HAEF has some concern that the presence of its grant has enabled the management institute to delay a necessary cost-saving restructuring, so HAEF is now withdrawing its support. PAEF funds two nongovernmental organizations to create a network of young entrepreneur clubs and to introduce market economics programs into high schools. BAEF has created and supports the Young Entrepreneur's Award, a nationwide competition, and has organized Outward

Bound to help develop leadership skills. In general, however, funds have not used their technical assistance funding to carry out innovative activities that expand private enterprise practices.

HAEF and PAEF are actively involved as advisors to their investee companies, but generally do not charge the cost of that advice separately to the technical assistance grant. As members of the supervisory boards, HAEF senior staff are credited with introducing innovative practices into those operations. This type of activist investing is a common practice in conventional venture capital funds. CSAEF, in contrast, has a philosophy that any company worthy of receiving an investment should not need technical assistance.

Funds can play an important role in expanding the cadre of trained and experienced host country investment professionals. This is being done with considerable success in Hungary and Poland. In both cases, most investment staff are host country nationals. A fund that emphasizes the training of host country professional staff will realize benefits in three ways: a better quality investment portfolio, a potential for reduced operating costs, and the long-term benefit of imbedding the investment capability in the host country permanently. A major shortcoming of the programs of CSAEF and BAEF has been their greater reliance on the MBA Enterprise Corps as a substitute for the development of host country staff (see Inquiry Area #13). With regard to the provision of technical assistance for policy advice, public education, advocacy, and similar actions designed to promote market-based economics, the enterprise fund structure appears to carry with it no particular advantages over other approaches used by USAID and other donor organizations.

PERFORMANCE INDICATORS

As part of its effort to develop systematic measures for evaluating performance of all of its projects, USAID's Bureau for Europe and the Newly Independent States (ENI) has developed performance indicators against which all activities are to be judged. Enterprise funds fall within the Strategic Assistance Area 1: Economic Restructuring. The following summarizes the indicators the evaluation team was requested to review and the team's findings with regard to those indicators.

1.1 Establish a Business Environment that Supports Private Sector Growth

Funds have little impact on the establishment of policy or enactment of legislation. To the extent that funds are pioneers in certain types of financial transactions, they have a non-quantifiable impact on the development of procedures necessary to establish a market economy.

Funds have leveraged over $200 million in private investment.

1.2 Promote Efficient Use of Resources

Certain fund investments result in an improved efficiency in the use of resources, but no specific data are available to quantify the impact. Investments have resulted in equipment upgrades that are more energy efficient — for example, HAEF lent Budapest Veneer Company $860,000 to replace an inefficient gas-fired boiler and kiln system with one that burns waste wood from the manufacturing process. There is no systematic replication of these processes.

CSAEF has invested in three small hydroelectric power stations. The total energy output of the three is an insignificant amount of the countries' total energy usage.

1.3 Transfer State-Owned Assets to the Private Sector

Approximately 12 investments in Poland and Hungary were part of first-stage privatizations of state-owned enterprises. The total value of privatized assets was approximately $30 million.

1.4 Facilitate Expansion of Private Sector Enterprise Development (Post-Privatization Expansion Plus New Start-Ups)

Fund financing has helped with the creation and expansion of 3,305 private enterprises. Virtually all of these enterprises are expanding into markets previously dominated by state-owned enterprises. Accurate data do not exist that will indicate how many of these are expanding into international markets. However, of the 115 larger direct investments, about 40 percent are engaged in exporting to a significant degree.

Through the joint lending programs of the funds, about 15 financial institutions now provide capital to small and medium-sized enterprises.

No data exist to indicate how much new capital is available to small and medium-sized enterprises.

Foreign direct investment associated with fund investments exceeds $60 million.

To date, approximately 70 of the 115 direct investment firms appear to be operating in a commercially viable manner. Of the 3,190 micro and small loan borrowers, it is estimated that at least 90 percent, or 2,871, are commercially viable.

1.5 Promote a Responsive, Efficient, Private Financial Sector

One cannot prove that funds' actions are a significant factor in improving the functioning of markets; in establishing transparent and open financial markets; in establishing policy, legislation, and procedures necessary to a market-based financial system; or in establishing systems to regulate private commercial banking.

The PAEF has created one private financial institution (Polish American Mortgage Bank) and has helped strengthen two others with its investments.

CHAPTER THREE

FINANCIAL PERFORMANCE AND SUSTAINABILITY

Enterprise funds are a type of financial institution, and, as such, financial performance is an important measure of effectiveness and efficiency. This chapter contains three important analytical elements. First, the evaluation team believes it is important to change financial reporting methodology employed by the funds. The funds' financial audits are presented using the accepted accounting practices for nonprofit organizations. However, this reporting method obscures some critical aspects of analysis. For example, when funds receive capital from their grants to invest in companies, the money is reported as income. The only offsetting expense associated with that "income" is investment losses or reserves. Operating expenses for the funds are covered by either investment income or grant funds. Consequently, the audited financial statements may show a "profit" even while investment activities may be generating losses. The methodology developed in Inquiry Areas #7, #8, and #9 present financial performance in a manner more consistent with for-profit investment funds.

Second, Inquiry Area #9 compares the administrative costs of enterprise funds with those of other types of investing or lending activity. These comparisons should be taken with care. There are no existing organizations with structures, missions, and environments exactly like the enterprise funds. Enterprise funds are neither purely venture capital institutions nor micro and small enterprise lenders, but a blend of both. Furthermore, the activity mix varies considerably by fund. The information presented here should be viewed as setting the boundaries for broad comparisons, but should not be viewed as necessarily setting the standard for fund performance. Over time, better measures may emerge, as the operating pattern of funds becomes more established.

Third, Inquiry Area #11 considers the prospects for financial sustainability of enterprise funds. The data used throughout this chapter are taken from the funds' audited financial statements for the fiscal years from inception through September 30, 1994. For Poland, the PAEF and Enterprise Credit Corporation have been consolidated into a single entity.

Inquiry Area #7: **What has been the financial performance of the enterprise fund portfolios?**

Findings: **The financial performance of funds varies considerably. HAEF has the highest return, followed by PAEF. CSAEF and BAEF both have negative returns. Financial returns are produced in three ways: interest and dividends, realized capital gains or losses from the sale of equity investments, and unrealized gains or losses (or reserves for loss) on investments retained by the funds. Table 3 shows the financial performance by each fund.**

Financial results to date appear weak, but need to be viewed in context. Funds employ conservative valuation accounting by which capital gains are recorded only when an objective market event establishes a basis for revaluing the investment, while losses or reserves are established whenever an investment appears troubled or impaired for any reason. As a result, losses surface more quickly than winners for venture capital funds.

TABLE 3[a]

INVESTMENT RETURN BY FUNDS
($000)

FUND	FY 1991	FY 1992	FY 1993	FY 1994
Hungary				
Investment Income	$640	$1,017	$1,309	$2,353
Unrealized Capital Gains	0	292	0	2,653
Less Loss Reserve	0	500	2,520	0
Net Investment Income	$640	$809	-$1,211	$5,006
Average Performing Assets	$14,240	$30,426	$37,822	$38,811
Net Investment Yield	4.49%	2.66%	-3.20%	12.90%
Poland				
Investment Income	$2,351	$3,950	$5,346	$4,911
Less Loss Reserve	25	4,298	4,620	2,551
Net Investment Income	$2,326	-$348	$726	$2,360
Average Performing Assets	$70,824	$110,783	$117,043	$125,968
Net Investment Yield	3.28%	-0.31%	0.62%	1.87%
Czech/Slovak Republics				
Investment Income[b]		$305	$767	$1,133
Less Loss Reserve		200	1,400	2,750
Net Investment Income		$105	-$633	-$1,617
Average Performing Assets		$6,784	$16,231	$23,874
Net Investment Yield		1.55%	-3.90%	-6.77%
Bulgaria				
Investment Income			$154	$150
Less Loss Reserve			$1,869	$140
Net Investment Income			-$1,715	$10
Average Performing Assets			$2,051	$4,557
Net Investment Yield			-83.62%	0.02%

[a] This table compares interest, dividends, and capital gains with the average performing assets. Administrative costs are not included in these calculations. "Average performing assets" was calculated by adding beginning and ending cash, investments, and small loans, and dividing by two.

[b] Investment income is shown net of interest expense, incurred in a hedging arrangement through the Slovak central bank. This scheme allows the fund to make crown-denominated loans without incurring exchange risk, but grosses up the interest income and interest expense of the fund by equal amounts.

With regard to PAEF and HAEF, a substantial part of the performing assets are in equity investments, which are structured to return capital gains in the long run, and not current income. The funds' performance is not atypical for the industry for a fund in its fourth year. HAEF had a respectable 12.9 percent return in 1994, although this can be attributed to investment gains that may not repeat on a consistent basis. PAEF has yet to sell any investments, but expects to value certain investments upward in 1995 as the result of public share offerings.

The financial performance of CSAEF and BAEF is much worse than that of HAEF and PAEF. CSAEF has a greater percentage of its investments in loans, which should produce more current income and therefore a higher investment yield. Despite increasing investment income, CSAEF's loss reserves have increased even faster, producing an overall loss of 6.77 percent in 1994. Furthermore, a review of the portfolio by the evaluation team concludes that the prospects for offsetting capital gains in the future are unlikely.

BAEF's poor financial performance results from both a low level of overall investing activity and large losses on two of its early investments. In FY 1993, BAEF established reserves of almost $1.9 million, representing 84 percent of its total investments to date. For FY 1994, BAEF produced essentially a break-even return on approximately $4.5 million in performing assets.

Inquiry Area #8: What is the pattern of administrative expenditures by the funds, and how do these expenditures affect the overall return of enterprise funds?

Findings: When administrative expenses are taken into account, the overall return for funds is negative in almost every time period. However, PAEF and HAEF stand out as having a substantially better performance than CSAEF and BAEF.

Table 4 extends the analysis from Table 3 by presenting the administrative costs of each fund, comparing them with the investment return, and calculating the overall return of each fund:[6]

The administrative costs of the funds ranged from almost $1.9 million to $4.4 million in FY 1994. When those costs are subtracted from the investment yield of the portfolios, the overall return of the funds is negative in almost every case. However, the performance of PAEF and HAEF stands out as significantly better than that of CSAEF and BAEF. HAEF produced a positive overall return of 5.5 percent in 1994, while PAEF's loss was 1.65 percent of performing assets. In comparison, CSAEF has produced an overall loss that averages about 20 percent per year for the past three years. BAEF's large losses in FY 1993, combined with average annual administrative expenses of $1.8 million per year, result in losses and administrative costs that exceed the average performing assets of the fund.

[6]For this analysis, "administrative expenses" include all payroll, occupancy, business expenses, professional services, program development, depreciation, and other general expenses. It does not include technical assistance costs charged to the separate technical assistance grant.

TABLE 4

ANNUAL ADMINISTRATIVE EXPENSES AND OVERALL RETURN FOR EACH FUND ($000)

FUND	FY 1991	FY 1992	FY 1993	FY 1994
Hungary				
Net Investment Income	$640	$809	-$1,211	$5,006
Administrative Costs	$2,127	$2,761	$3,704	$2,901
Net Income	-$1,487	-$1,952	-$4,915	$2,105
Average Performing Assets	$14,240	$30,426	$37,822	$38,811
Overall Return	-10.44%	-6.42%	-13.00%	5.42%
Poland				
Net Investment Income	$2,326	-$348	$726	$2,360
Administrative Costs	$3,063	$4,939	$4,160	$4,443
Net Income	-$737	-$5,287	-$3,434	-$2,083
Average Performing Assets	$70,824	$110,783	$117,043	$125,968
Overall Return	-1.04%	-4.77%	-2.93%	-1.65%
Czech/Slovak				
Net Investment Income	—	$105	-$633	-$1,617
Administrative Costs	—	$1,738	$2,302	$2,484
Net Income	—	-$1,633	-$2,935	-$4,101
Average Performing Assets	—	$6,784	$16,231	$23,874
Overall Return	—	-24.07%	-18.08%	-17.17%
Bulgaria				
Net Investment Income	—	—	-$1,715	$10
Administrative Costs	—	—	$1,763	$1,869
Net Income	—	—	-$3,478	-$1,859
Average Performing Assets	—	—	$2,051	$4,557
Overall Return	—	—	-169.58%	-40.79%

Inquiry Area #9: How do the funds' administrative expenditures compare with those of other similar investment entities?

Findings: Only PAEF has an administrative expense level that is line with standard venture capital measures. Using microenterprise loan programs as an upper boundary, BAEF's expense level even falls outside of that range. (Note the qualifiers at the introduction to Chapter Three.)

Since investment programs and entities vary considerably in size and type, one useful standard for comparison would be expenses as a percentage of capital or investment activity. Venture capital funds are typically managed by a management team that receives a fixed fee plus a percentage of the return. The administrative costs run approximately 3 percent of a fund's total capitalization.[7]

Venture capital funds typically receive a substantial portion of their pledged capital initially, and can use the capital and earned interest to pay administrative costs. Enterprise funds originally expected to receive their total capital authorization as an initial grant, but were prohibited by regulations of the Office of Management and Budget (OMB). Funds are permitted to draw money from the grant based on actual need, for investing or administrative costs. As a result, funds feel they have been deprived of the prospect for earning income from the large idle balances.

Table 5 calculates funds' annual administrative expenses as a percentage of initial capitalization, the measure that is normally used for venture capital funds (this table excludes technical assistance grants from the capitalization).

TABLE 5

ADMINISTRATIVE COSTS AS A PERCENTAGE OF INITIAL CAPITALIZATION

FUND	INITIAL CAPITAL	FY 1991	FY 1992	FY 1993	FY 1994
HAEF	$60,000,000	3.5%	4.6%	6.2%	4.8%
PAEF	$240,000,000	1.3%	2.1%	1.7%	1.9%
CSAEF	$60,000,000	—	2.9%	3.8%	4.1%
BAEF	$50,000,000	—	—	3.5%	3.7%

As a percentage of initial capital, PAEF is operating within a range that is comparable to conventional venture capital funds, while all of the others exceed that range. HAEF's higher 6.2 percent is largely the result of extremely high legal and professional costs, which peaked at $880,000 in 1993. CSAEF's costs have increased over the period, in part because of the division of the country. CSAEF maintains the largest U.S. staff, and also maintains a full staff in Prague and in Bratislava. BAEF's costs are significantly lower than the other funds, but because of its lower capitalization level, as a percentage of capital its expenses are comparable to those of CSAEF.

[7]A normal management fee would be 2.5 percent of initial capital, and another 0.5 percent for expenses such as audits, reporting, supplies, and materials.

PAEF's lower cost ratios result from two factors: a much higher total capital base and the creation of Enterprise Investors, an independent management company that has fixed its total compensation from PAEF at a maximum of $2 million. This lower management cost to PAEF is offset by PAEF's greater unrealized loss in the equity of its affiliate funds, which are also paying management fees to Enterprise Investors.[8] In addition to the management fee paid to Enterprise Investors, PAEF's administrative costs also include the costs of operating Enterprise Credit Corporation.

As an alternative measure, it has been suggested that funds should be judged based on administrative costs as a percentage of the funds expended from their grants. However, this measure tends to exaggerate the expense picture during the start-up phase, because the fixed costs of initiating the program are compared with a low level of investment activity. The evaluation team believes that the most appropriate measure uses performing assets as the measure for comparing both income and expenses of enterprise funds. Table 6 calculates the administrative costs as a percentage of average performing assets.

TABLE 6

ADMINISTRATIVE COSTS TO AVERAGE PERFORMING ASSETS

FUND	FY 1991	FY 1992	FY 1993	FY 1994
HAEF	14.9%	9.1%	9.8%	7.5%
PAEF	4.3%	4.5%	3.6%	3.5%
CSAEF	—	25.6%	14.2%	10.4%
BAEF	—	—	85.9%	41.0%

As long as a fund is not fully invested, the ratio of administrative costs to net performing assets will exceed the ratio of administrative costs to initial capitalization. Furthermore, there is no measure against which these ratios can be compared that is as well established as the venture capital measure.

One recent study has compared the overall operating costs of 12 Third World microenterprise loan programs, using average performing assets as its base, although there are some important distinctions between the nature of their assets and operations.[9] Microenterprise loan funds typically have total operating costs (defined as administrative costs plus loan loss reserves) that range from 10 percent to 21 percent of their average performing assets.

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[8] Enterprise Investors' total costs greatly exceed $2 million, and are covered through fees paid by PAEF and the affiliated investment partnerships. PAEF itself owns a share of those partnerships, and is showing an unrealized capital loss on its investment because of the additional payments to Enterprise Investors made by the investment partnerships.

[9] This analysis draws on a report entitled "Maximizing the Outreach of Microenterprise Finance: the Emerging Lessons of Successful Programs," by Robert Peck Christen, Elisabeth Rhyne, and Robert C. Vogel. This paper was published in draft in September 1994 under the auspices of the Consulting Assistance on Economic Reform Project. Data on which Tables 4 through 9 are based appear in Annex E.

TABLE 7

TOTAL OPERATING COSTS TO AVERAGE PERFORMING ASSETS

FUND	FY 1991	FY 1992	FY 1993	FY 1994
HAEF	14.9%	9.8%	16.4%	0.6%
PAEF	4.4%	8.3%	7.5%	5.6%
CSAEF	—	28.6%	22.8%	21.9%
BAEF	—	—	172.4%	44.1%

As can be seen, HAEF's and PAEF's cost ratios generally fall below the acceptable microenterprise performance range, whereas CSAEF's cost ratios have been at the top end of the acceptable range for the past two years. BAEF's costs greatly exceed those of microenterprise lending programs, but if its lending volume increases and its costs remain unchanged, its ratios will improve.

Comparing enterprise funds with microenterprise loan programs has great limitations. Loan funds make very small loans for short periods of time, usually at high rates of interest. Funds invest using a wide range of approaches and investment sizes. In general, it is felt that microenterprise lending is more costly and loss prone than other forms of investing. Given that, it would seem that most other forms of investing should have lower costs and higher returns than microenterprise lending. Therefore, one could conclude that the microenterprise lending results should set an upper limit of acceptable cost ratios.

Inquiry Area #10: To what extent does portfolio performance correlate with various portfolio categories or investment strategies?

Findings: Investments that are sold through public share offerings produce the highest returns. Other categories producing identifiable outcomes include small loans, privatizations, and joint ventures.

To date, investing in initial public offerings have been the most profitable, and this is consistent with the venture capital experience in the United States.[10] HAEF is the only fund that has sold equity investments. Overall, it has sold investments in eight companies. Of those, one produced a loss, four produced gains, and three were sold at their original cost. In addition HAEF has taken unrealized losses or reserves against 14 other companies, and has unrealized gains on two others. In other words, losses have occurred in half of HAEF's investments, and gains in 20 percent of the cases. However, large gains in three investments offset the losses in all of the others. In two of those cases, HAEF purchased its shares when they were first brought onto the market. In one case, HAEF invested through an earlier

[10]A study of venture capital prepared by the International Finance Corporation indicates that on the average investments that are sold through public offerings return 7.1 times their original cost, while for all other forms of exit (except liquidation) the return is about 2.0 times. See "Venture Capital: Lessons from the Developed World for the Developing Market." IFC Discussion Paper # 13, by Silvia B. Sagari with Gabriela Guidotti.

private placement and the firm subsequently went public. PAEF expects to realize gains in FY 1995 as one or more of its investments become publicly traded.

This suggests that in locations where stock markets or other mechanisms for public share offerings are not present or active, large capital gains will not be possible. In fact, the evaluation team concludes that venture capital investing by itself is likely to result in a program that is disappointing in both financial and development terms.

Small loan programs are usually denominated in dollars, and in most instances they are priced to produce an annual yield of 10 percent to 15 percent in dollars. For the most part, the losses or reserves have been modest — under 5 percent of average assets. Therefore, funds with a substantial volume in small loan programs appear to be showing positive returns on those programs. However, because funds generally do not allocate their costs to different programmatic activities, it is not possible to isolate the income and expenses for these programs. The Enterprise Credit Corporation (Poland) has been established as a separate subsidiary, and, as such, it is possible to analyze revenues and expenses for the small lending activity. For FY 1994, Enterprise Credit Corporation produced a small profit while PAEF's overall program produced a loss. Although Enterprise Credit Corporation's return is not high, it does exceed the return being realized by all of the venture capital investment programs except that of HAEF. During the start-up phase, the costs of training participating bankers was paid with technical assistance funds, but now Enterprise Credit Corporation covers its operating cost through investment income.

Even though definitive data are not available, it appears that the small loan programs could be, on balance, moderately profitable, whereas venture capital investments have on the whole produced losses to date. However, the venture capital investments do offer the prospect of greater profits in the future, whereas loan programs will likely remain at their present level of profitability.

The evaluation team examined specific attributes of the investments to determine whether a correlation exists between specific types of investments and their performance. Joint venture investments and privatization investments produce great extremes. These categories account for some of the best and some of the worst investments. In a privatization investment, it is important to be able to effect a complete transformation of the business environment before making an investment. This means having effective control over management and making an investment that is large enough to bring about the complete change. HAEF's investment in Petofi stands out as one of the best privatizations, while CSAEF's investment in the NZ Foundry is one of the worst.

Joint ventures were the most successful when the U.S. (or foreign) partner was strong and brought to the deal monetary and non-monetary resources that did not exist in-country. Too often, however, the U.S. partner was not given adequate scrutiny and was not able to deliver promised markets or other resources. In at least two cases, the funds were victims of outright fraud, and in at least three other cases, the U.S. partners could not deliver the critical aspect of the venture for which they were needed most. In one instance, CSAEF's investment in Leader Gasket seems to have contributed to making the firm prosper, but because CSAEF negotiated a bad deal for itself, it may never realize any significant financial benefit from the investment.[11]

[11]The U.S. partner is permitted to take a "management fee" equal to 7 percent of revenues, which effectively eliminates any profit for CSAEF and any other future investor.

Generally, start-ups are considered to be higher risk because of the lack of operating history and company track record. In these transforming economies, it is not clear just how one defines start-up. When new companies are emerging from older state-owned firms, a matter of critical importance is whether they retain the old management, processes, and policies. The privatization failures result most often when the "new" company is functionally no different from the old one. A joint venture such as the Loranger project in Hungary is a "start-up," but it comes with experienced management and an established market. Most of the small loan clients have been in business for very short periods of time, and yet the loss rates on these investments appear to be within an acceptable range. Therefore, relative to other risk factors and options, investing in a "start-up" company does not, by itself, appear to change the overall loss expectation.

In theory, funds are free to finance joint ventures, privatizations, start-ups, and established companies as they see fit, but in practice they must pursue what their market has to offer. The voucher system used for privatization in the Czech Republic and the Slovak Republic excluded institutional investors such as the funds from owning these companies. In Hungary, only banks can make loans, so HAEF opted to invest almost exclusively in equities. In Bulgaria, privatization is stalled and few foreign investors are entering the market. These factors have led BAEF to develop several small loan funds while nurturing large cooperatives that may eventually be investees.

Although the type of deals were limited by country environments, many losses cannot be attributed simply to adverse country conditions. Some losses should be expected as a result of normal market activity. Even when an investment is properly analyzed and underwritten, losses can result from unexpected market turns. However, losses have also resulted from staff errors and sloppy handling. USAID should reasonably expect that the funds will operate with competent and experienced professionals and adequate systems and controls.

Inquiry Area #11: Can enterprise funds become sustainable from their investment income?

Findings: **Positive trends in the performance of PAEF, combined with its substantial initial capital, indicate it will reach a sustainable operating level soon. HAEF could achieve financial sustainability; for CSAEF, it appears unlikely; and for BAEF, sustainability can be achieved only if its recent growth in activity continues or it makes some critical changes.**

Full sustainability requires that funds cover operating costs and investment losses with a surplus that will increase the size of the investment fund at a rate that will be sufficient to produce future revenues high enough to cover future operating costs. Operational sustainability means that funds cover their current expenses with current income. In other words, for a fund to be sustainable over the long term, a break-even performance will not be sufficient. Its revenues must exceed its expenses and losses by a margin that will allow its income to grow at a rate that equals or exceeds the inflation rate.

Another measure frequently used by the micro programs as well as other not-for-profit organizations in general is the percentage of expenses covered by income. This is a useful trend indicator, especially for organizations emerging from start-up, and is an approximate comparison of cash income with cash expenses. The numerator for this equation is gross investment income, including interest, dividends, and realized capital gains. (For CSAEF, offsetting interest expense is netted out.) The denominator is administrative expense as previously described.

TABLE 8

PERCENTAGE OF ADMINISTRATIVE EXPENSE COVERED BY INVESTMENT INCOME

FUND	FY 1991	FY 1992	FY 1993	FY 1994
HAEF	30.1%	36.8%	35.4%	81.1%
PAEF	76.8%	80.0%	128.5%	110.5%
CSAEF	—	17.6%	33.3%	45.6%
BAEF	—	—	9.3%	8.1%

Since many of the fund investments are not expected to pay dividends, this ratio should also be approached with some caution. This schedule does show the importance of interest income to the funds, even if it is relatively low yield. PAEF was able to cover a lot of expenses in the early years simply because it earned interest on substantial fund balances that had been drawn but not invested. Since HAEF is restricted from making loans, it has had little cash income up until FY 1994, when it received large capital gains from investment sales.

Table 9 compares investment income with total operating expenses (including investment losses), the measure used by micro programs to determine whether an institution is operationally self-sufficient. If the ratio is 100 percent or greater, it means that the program can cover its total operating costs from investment income.

TABLE 9

PERCENTAGE OF TOTAL OPERATING EXPENSE COVERED BY INVESTMENT INCOME

FUND	FY 1991	FY 1992	FY 1993	FY 1994
HAEF	30.1%	34.3%	21.0%	948.8%
PAEF	76.1%	42.8%	60.9%	70.2%
CSAEF	—	15.7%	20.7%	21.7%
BAEF	—	—	4.4%	7.5%

PAEF's investment income has exceeded its administrative expense for the past two years, and the amount of total operating expense covered by investment income is growing steadily. PAEF has more than $100 million still available to be invested, so its income is likely to continue growing. HAEF had an income surplus for 1994, but that resulted in part from large capital gains that are not continuous. However, if HAEF reduces its legal and professional expenses to a more acceptable level and invests its remaining capital as effectively as it has up to now, it should be achieve a break-even operation on a continuing basis. CSAEF's high level of expenses associated with a three-office operation, combined with a high loss level, makes sustainability unlikely.

BAEF's early record does not bode well for the prospect of sustainability. Because much of its capital still remains and its pace of investing activity has increased substantially over the past year, it would be possible to approach sustainability with a combination of reduced costs and increased investment activity and return. BAEF is the only fund that views the smaller lending activity as potentially profitable, and some of its current lending is producing yields in excess of 10 percent.

Sustainability is a function of the portfolio yield, loss rates, and operating costs. The current experiences indicates that at best funds can expect to realize a cash yield in the range of 3-5 percent per year. With funds spending an average of $2 million per year for administrative costs, a Fund will need between $40 million and $66 million in performing assets, not allowing for any investment losses. For every $100,000 reduction in administrative costs, the capitalization required for a sustainable operation drops by $2-$3.5 million.

The ratios presented here relate expenses to assets, capital, and income. In considering the administrative expense of running the funds, one must also focus on the type and effectiveness of the expenditures, in addition to the absolute cash outlay. All of the funds originally had U.S. investment staff, but found that all substantive work of this type had to be done in country. If the funds had never hired this U.S. professional staff, their costs would have been lower.

In reducing operating costs, funds need to consider the quality of staff and the cost of that quality. In an effort to reduce costs, some of the funds have used, and continue to use, MBA Enterprise Corps volunteers as investment officers for a year at a time. However, these volunteers do not give two elements that are critical for a quality portfolio, experience and continuity. Although the individual volunteers are bright, they are thrust into lead investment positions where they would be more suited to playing support roles.

Some individuals with the funds and with USAID have suggested that the sustainability issue should be framed in entirely different terms. The long-term existence of an enterprise fund is far less important than the sustainability of its products and activities. Because the economies themselves are in a state of transformation, the institutions (including financial institutions) will change too. Therefore, sustaining an enterprise fund as a permanent entity may be a far less important goal than ensuring that it leaves behind a set of beneficial practices and investments (see Inquiry Area #15).

Inquiry Area #12: How much does the enterprise fund program cost, and how do those costs compare with the benefits produced?

Findings: The net investment program expenses to date for all of the funds have been $41 million. The benefits of an enterprise fund are extensive and are both tangible and intangible, but there is no single quantitative valuation that can be compared with costs.

The appropriate measure of net program expenses is the amount of grant funds that have been consumed by operations and investment losses. Investments and other financial assets that are held by the funds are capital outlays but not expenses. Altogether, the enterprise funds were awarded grants totaling $410 million and $30 million for technical assistance. Of that, $241 million in investment/operating funds and $17 million in technical assistance funds have been drawn by the funds, leaving about $187 million remaining in the investment and technical assistance grant accounts. Funds currently hold about $200 million in performing assets, meaning that the net program cost to date has been approximately $59 million.

Two adjustments or qualifiers should be noted when considering this method of cost determination. First, the current book value may not accurately reflect the liquid value (although there is no expectation that assets need to be turned to cash in the near future). Second, these are financial and not economic or opportunity costs.[12] However, these calculations do clarify the notion that far less than the entire obligated capital has been used thus far to create development benefits.

Table 10 summarizes the amounts of funding obligated, expended, and invested by each fund, and relates the net program expenditures to certain identifiable benefits resulting from those investments.

TABLE 10

TOTAL PROGRAM INVESTMENT, EXPENDITURES, AND BENEFITS, AS OF 9/30/94
($000)

ITEM	HAEF	PAEF	CSAEF	BAEF
Investment				
Grant Obligated (Capital)	$60,000	$240,000	$60,000	$50,000
Grant Obligated (Tech. Asst.)	$10,000	$10,000	$5,000	$5,000
Grant Drawn (Capital)	$46,352	$149,891	$33,941	$11,773
Grant Drawn (Tech. Asst.)	$5,155	$9,401	$1,844	$401
Performing Assets as of 9/30/94				
Cash and Equivalents, Net	$7,043	$3,981	$7,699	$3,892
Small Loans	4,863	27,816	1,303	$974
Direct Investments	26,867	87,945	14,731	$628
Other Equity Investments	38	11,946	0	0
Total	$39,158	$131,688	$23,732	$5,494
Expenditures				
Net Grant Expended	$7,194	$18,203	$9,209	$6,279
Tech. Asst. Expended	$5,155	$9,401	$1,844	$401
Total Funds Expended	$12,933	$27,604	$11,503	$6,680
Quantifiable Benefits				
Employees of Investee Firms	11,280	61,300	4,412	847
Country Average Wages	$3,804	$2,328	$2,532	$1,368
Implied Wage Benefit	$42,090,120	$142,706,400	$11,171,184	$1,158,696
Identifiable Leverage	>$100,000,000	>$100,000,000	$15,000,000	Indeterminate

[12]Opportunity costs are difficult to define and measure. Since U.S. assistance Eastern Europe was deemed of high priority when the funds were created, the best indicator of opportunity costs is probably the benefits of alternative USAID programs that might have been financed in the region. Given the region's limited absorptive capacity at the time and the political urgency to do something, it is most likely that opportunity costs for the enterprise fund expenditures are low.

Other less quantifiable benefits include:

- The "announcement effect," which the enterprise fund program represented as the first concrete evidence of the U.S. commitment to the economic transformation of the region;

- Seminars, training programs, and individual business advice that have been rendered in the course of the funds' investment outreach efforts;

- Training of more than 200 host country professionals, including bankers and staff personnel; and

- Demonstrations of sound business practices that have been associated with enterprise fund investments. In addition,

- As the first funds in the region, they have opened doors for other investment funds and individual businesses, contributing to the improvement of business conditions in the region.

The evaluation team attempted to refine its cost/benefit analysis by isolating costs according to their functional activity. For the most part, this was not possible since the funds do not account for their costs in a way that makes such an analysis possible. The funds contend that they spend a considerable amount of time and money on the administrative and reporting burdens of USAID, and on receiving evaluation, monitoring, and other visitor groups. Although this may be true, none was able to provide any realistic estimate of that cost. HAEF estimates that these burdens have added $1 million to the cost of operations, and are the principal justification for maintaining large U.S. staff operations.

The study also attempted to judge which types of activities funds are most and least suited to perform, and whether alternative structures are better suited for the performance of the funds' activities. In general, the team concluded the following:

- An independent, professionally staffed, and locally based entity such as is contemplated by the enterprise fund concept is the best structure for providing capital to private businesses in these transitioning markets.

- The original vision of funds as principally high performance venture capital investors was not a correct vision for much of this transitioning region. Funds that have recognized the emergence of the small companies and focused on that portion of the market have generally produced greater impacts with no greater cost or investment loss. Investment programs for these markets can realize their greatest beneficial impact when they make an explicit and balanced effort to invest across a spectrum of transaction sizes and forms.

- In most instances, the benefits provided by funds could have been achieved at a lower cost.

- Enterprise funds have not proven to be particularly effective at providing technical assistance beyond that which they provide to their investee companies, and their limited efforts at influencing public policy have often been more harmful than beneficial.

CHAPTER FOUR

REPLICABILITY OF THE ENTERPRISE FUND CONCEPT

Inquiry Area #13: **What are the country conditions that are most favorable and most detrimental to the success of enterprise funds?**

Findings: **Country conditions have a great influence on the types of investment opportunities that are available, but success is more a function of a fund's ability to undertake an investment strategy that is compatible with the local market conditions and to build a competent, professional investment team that understands the local market.**

A minimum condition for a successful fund operation is the presence of at least a small private enterprise market. However, that alone does not guarantee success. The fund must undertake a professionally competent investment strategy that is compatible with the local market.

Bulgaria has the least conducive country conditions of the countries surveyed. The government has changed five times since 1990. There has been very little privatization of the state enterprise sector, and many companies that were privatized came under the control of a group of powerful insiders from the former regime. The legal, financial, and institutional structures have undergone little transformation. Inflation approaches 100 percent a year, and the currency is deflating at a comparable rate. Above all, only recently has there come to be a private sector of any significant size. BAEF's initial strategy was directed toward larger venture capital investments, but it found very few. Those it did undertake turned out to be problems.[13] BAEF's initial difficulties arose from a combination of an investment strategy that turned out to be inappropriate for the country and mistakes by the investment staff. Only when BAEF reoriented its strategy toward the small loan market did it begin to achieve a significant volume of investments.

The Czech Republic has perhaps the most conducive country conditions in all of Eastern Europe, yet the CAEF has one of the worst performance records. Although certain factors inherent in Czechoslovakia's transformation limited CSAEF's program at the beginning, policies and approaches employed by CSAEF were the greatest contributors to its poor performance. In contrast to Hungary and Poland, Czechoslovakia did not have a private enterprise tradition prior to 1991, so there was no latent market. Czechoslovakia undertook a rapid mass privatization using a voucher program that excluded entities such as enterprise funds from participating. Therefore, CSAEF's potential market was limited at the beginning. CSAEF's Board of Directors then set policies that further limited the market potential by making service and retail businesses a low priority. The objective in setting this policy was to promote manufacturing, but the policy's effect was to greatly limit market opportunities for CSAEF. Since service and retail businesses were the types of smaller private enterprises that emerged first, CSAEF was not addressing that new market segment.

However, the greatest single factor responsible for the poor CSAEF record is that it has failed to build an effective management and investment team in country. The fund has had four different senior officers in Prague in four years. It relies on the MBA Enterprise Corps to function as its investment

[13]BAEF's high loss rate is primarily the result of errors by its own investment staff on one large investment, and not specifically the result of conditions in the country.

officers. Since MBA Enterprise Corps members typically serve for one year, this arrangement has resulted in an inordinate amount of staff turnover and a lack of in-depth knowledge of the local market.[14]

Looking to newer enterprise fund locations such as Romania, Albania, Ukraine, Russia, and Central Asia, one should expect country conditions that resemble Bulgaria more than the Czech Republic or Hungary. Private enterprise is still less established, macroeconomic factors are less stable, and institutional reform still lags. Experience to date suggests that funds should focus more on the small transactions with the new private enterprises, while limiting the larger transactions to key strategic investments.

Enterprise funds have found that the absence of a fully developed policy environment is not an insurmountable barrier. Certainly business is more difficult to conduct when information is limited and unreliable, when the legal system is untested or unresponsive, when government regulations and other impediments interfere with business, or when corruption is rampant. These extra complications do argue for a cautious approach and for developing a staff of knowledgeable locals who can navigate the complex web of impediments.

The legal and policy structure may well force a particular investment strategy. Limits on ownership rights by outsiders, or the absence of an active stock market, might limit the usefulness of equity investing. A highly volatile or rapidly depreciating currency might eliminate the prospect for debt financing denominated in local currency. Conditions in a highly chaotic, hostile, or dangerous environment such as Tajikistan would not be suitable for an enterprise fund, or for any other program of rational, long-term investing.

Inquiry Area #14: **Are there market size considerations that limit the usefulness of enterprise funds?**

Findings: **A country with a very small private market will have only limited investment opportunities for an enterprise fund. Since a fund as currently configured requires a large capital investment, USAID should develop an alternative model, emphasizing lower costs and lower capitalization, which would be more suitable for smaller countries.**

A certain critical mass must be present in a market to ensure the prospect of cost-effective staffing and operations. One cannot justify the cost and effort of establishing an investment program if investment opportunities are very limited. There are two dimensions to the problem. First, sustainability requires a steady flow of income from a large pool of invested capital. Under current cost configurations, capitalizations well in excess of $50 million are needed to achieve sustainability. At the same time, neither market demand nor U.S. policy interests can justify investments of those magnitudes in smaller countries.

It is certainly possible to visualize an institution that combines a joint lending program modeled after Poland's Enterprise Credit Corporation, a microenterprise program modeled after Bulgaria's Nachala, and selected strategic investments that are of a somewhat larger scale. By limiting the overall

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[14]This is not intended to be a criticism of the MBA Enterprise Corps. It is, however, being used improperly in the Czech Republic and the Slovak Republic. Corps members interviewed agree with this finding.

operating costs of such a program to perhaps $1 million per year, the activity could be sustainable with a capitalization of $20-$30 million.

Multiple country programs may offer some possibility for realizing economies of scale, but the gains would be limited. The presence of competent investment professionals in the host country is one of the most important success factors for a fund. Centralizing that capability to serve several countries would diminish the effectiveness of the investment staff. CSAEF, the only multiple country program that was reviewed, has higher rather than lower costs. By revising and standardizing the reporting requirements of funds, it would be possible to centralize many of the administrative functions in a service bureau for several funds. This might produce savings for the program overall, but would not by itself solve the sustainability for the funds.

Smaller, lower cost, independent funds, possibly supported by contract technical assistance during the start-up phase, are likely to provide greater benefits in the long run than larger centralized multi-country programs.

Inquiry Area #15: **At what point in the transformation might the usefulness of enterprise funds cease, and what happens to them at that point?**

Findings: **What is important is for funds to continue evolving with the local market, continually searching for both developmentally relevant and commercially viable activities to undertake. Funds should make themselves a part of the host country financial landscape, eventually evolving into a local financial institution if possible.**

As transformation proceeds, eventually the public policy justification for enterprise funds subsidized by taxpayer funds will disappear. Already USAID is slated to withdraw from the Czech Republic. Conditions in Hungary, Estonia, Slovenia, and Latvia suggest that USAID may withdraw from those countries in a few years as well. Certainly, it makes little sense to start new funds in the more advanced countries, but it does not necessarily follow that funds should be withdrawn or liquidated concurrent with USAID program withdrawal. Still, as countries advance beyond the assistance threshold, the timetable for eventual withdrawal or conversion of funds should be accelerated.

Enterprise funds should not be precluded from competing with the emerging private financial markets, so long as the competition is not unfair and destructive. A successful transformation means that banks are lending to private enterprises, private equity funds are investing, and public share offering are facilitated by an active stock market. These improvements appear incrementally and can be hastened along by active competition.

In Poland, Enterprise Credit Corporation has reached a critical turning point. Its track record was established in the Windows program, which was done in collaboration with banks. To induce participation by banks, Enterprise Credit Corporation subsidized their costs. Last year, Enterprise Credit Corporation withdrew its subsidy, and now banks claim they can serve the small business market independent of Enterprise Credit Corporation. In response, Enterprise Credit Corporation has established independent loan origination offices and is continuing to lend to small businesses, in effect competing with local banks. Enterprise Credit Corporation now plans to affiliate with the First Polish American Bank of Kraków, thereby creating a country-wide small business loan origination system within a private bank. We believe that this is a positive event. Enterprise Credit Corporation/First Polish American Bank plan to operate on a commercial basis. It is better to encourage the development of the Enterprise Credit

Corporation/First Polish American Bank small business lending rather than requiring it to withdraw simply because it competes with other banks.

In Hungary, several private equity funds are now active, but for the most part they consider transactions under $3-$5 million to be uneconomic. Furthermore, there seems to be more capital than the market can absorb in the larger end of the market. These fund managers acknowledge that HAEF performs an important role by continuing to serve the smaller end of the equity market. HAEF is seeking additional USAID funding to reach a sustainable size. HAEF's proposed strategy calls for using part of this new funding to leverage private capital in a commercially competitive fund targeting a full spectrum of equity transactions from $500,000 to $5 million. From a purely commercial point of view, one could justify placing additional capital in HAEF because it a proven, effective investment team in place.

Admittedly, these distinctions are not clear-cut. Funds should not be relegated to the position of serving a market no other institutions will serve. At the same time, the development mission of enterprise funds requires that they continue to push into underserved segments of the investment market, not simply gravitate to the most commercially viable segments.

Many people within the U.S. government have expressed the view that enterprise funds should be liquidated at the close-out point and the money returned to the U.S. Treasury. That approach poses at least two types of problems. First, the investments of the funds are not easily liquidated. Selling an entire portfolio in a short time period will likely produce only a fraction of its value, while liquidating over time will require ongoing administrative costs to monitor investments during the liquidation phase. Furthermore, the impression within host countries is that the enterprise funds are grants to the countries, and efforts to withdraw the money will likely produce loud protests. The objections might diminish if the money taken from the enterprise fund program were to be channeled into other activities in the country.

A more appropriate long-run strategy would be for a fund to evolve into a locally based institution. With the exception of PAEF, the current structure of funds is not viable over the long term. Financial sustainability cannot be achieved given the expense burden of the U.S.-based operation. There are two broad options could be justified:

1. Funds transform themselves into a local financial institution, either commercial or nonprofit.

2. Funds gradually decapitalize through the provision of services, eventually folding as money is used up.

Given the choices, the evaluation team favors the first option where possible. The development impact of the enterprise fund program would be enhanced through the creation of a commercially viable local financial institution. Funds should undertake investments in the emerging private financial sector and should look upon these investments as being more than simply another direct investment. That way, even if the enterprise fund is ultimately withdrawn from the country, its impact can remain in the form of an improved local financial institution.

If other funds are established in the future, the U.S. government might consider a different approach to capitalization. For instance, in the Small Business Investment Corporation (SBIC) program, the Small Business Administration supplements private investment capital funds with a combination of share purchases and loans. By purchasing preferred stock in an SBIC, the Small Business Administration has a mechanism for directly intervening in the management of problem SBICs, and for those that are successful it has a potential for financial gain along with the private shareholders.

Inquiry Area #16: **What should be the proper relationship between the U.S. government and the enterprise funds?**

Findings: **Enterprise funds are part of the U.S. assistance effort in Eastern Europe, and the current confused relationship between USAID, other U.S. agencies, and the enterprise funds must be resolved. However, this resolution brings into play some very complex relationships and may require changes to the statute.**

When enterprise funds were started in 1990, they were set up to be operationally independent of USAID. There were no specific reporting requirements, and USAID had no monitoring or oversight responsibility. Starting in 1993, USAID was given monitoring responsibility but has no authority to influence operations. The Inspector General, General Accounting Office, and Congress also monitor the funds. Currently, the monitoring of funds is excessive, and yet much of the information the U.S. government is getting does not satisfy its needs. Furthermore, USAID country representatives do not know how they can or should incorporate fund activities into the overall country programs.

Funds need to retain their independent operational status, but the U.S. government needs a way of intervening when funds are failing. Traditional USAID controls over contractors, such as approvals of annual budgets and work plans, approvals of personnel changes, and limitations on procurement actions, would make investing in these markets impossible. At the same time, the U.S. government has almost no ability to intervene even when performance is consistently substandard. A compromise arrangement might be grant agreements that incorporate a five-year program operating cycle, allowing for renewal of those that show positive performance and for restructuring or closing those with substandard performance.

The structure of enterprise funds places a great deal of importance on the boards of directors as the trustees for government funds. This evaluation is not suggesting that this trustee role be usurped by a governmental oversight mechanism. However, the current structure has no viable back-up system that can be triggered in the event of a failure at the board level. The intent of the recommendations concerning monitoring is to reduce the burden on the funds, improve the quality of data available, and provide some fail-safe mechanism to protect U.S. government funds. The suggestions offered here are only one possible solution to the problem.

The function of board activities should be strengthened to increase the protection afforded to the taxpayer investment. Board members should be encouraged to participate more directly in periodic monitoring visits with U.S. government officials to ensure that they provide oversight appropriate for their trustee role.

As part of the enterprise fund grant agreements, USAID has waived some provisions that are normally part of its grants and contracts. Among the typical waived provisions are restrictions on the methods and sources of purchasing equipment and supplies, requirements for matching funds, limits on the use of earned interest, conversion of funds into local currency, and requirements for grant proposals and pre-award audits. These waivers are collectively referred to as the "notwithstanding authority," because of the way they are stated. The evaluation team has been asked to comment on these waivers and how they have affected the success of funds' operations.

The evaluation team believes that the waiver of operational limitations is necessary for the rapid start-up of the programs and efficient investing of the capital. However, two exceptions stand out. First, although it was useful to waive the necessity of a grant proposal and budget for the program start-up in 1991, there is not the same urgency for new enterprise funds. It would be appropriate to require new funds to submit proposals and budgets as a condition for receiving grant funds. Second, by reinstating at least some provisions of OMB Circular A-122 (Cost Principles for Nonprofit Organizations), it might be possible to have the independent auditors verify program performance as part of their audits.

Four aspects to reporting and monitoring need to be addressed. Ideally, the funds, working in conjunction with USAID or another appropriate U.S. government entity, can arrive at an acceptable approach to these matters:

(1) **Consistent Financial Reporting.** Funds should establish a method for reporting investment returns and operating expenses along the lines set forth in Chapter Three of this report.

(2) **Measures of Financial Performance.** Over time, as the performance patterns become more established, it should be possible to identify the acceptable performance ratios for such factors as investment return (or loss) and administrative costs.

(3) **Measures of Development Impact.** More consistent measures and methodologies for reporting impacts should be adopted, as discussed in Chapter Two.

(4) **Third Party Portfolio Quality Review.** It is appropriate and necessary that the U.S. government have the benefit of an independent third-party review of investment portfolio quality approximately every three years.

Funds have taken issue with the approach taken in this evaluation and some of its conclusions. If the funds feel that the this evaluation focuses on the wrong monitoring and evaluation factors, it is incumbent on them to develop an acceptable alternative.

CHAPTER FIVE

LESSONS LEARNED

The following is a summary of the key lessons learned by the enterprise fund evaluation.

1. The enterprise fund structure broadly conceived is one of the best mechanisms for introducing investment capital into small and medium-sized enterprises in transitioning economies. However, the operational philosophy of enterprise funds as high performance venture capital funds has only limited applicability in the formerly Communist countries of Eastern Europe and the former Soviet Union.

2. Enterprise funds can realize their greatest impact when they target a range of different sectors and investment approaches, without limiting themselves to either microenterprise at one extreme or high performance venture capital at the other extreme. An appropriate blend of the two will produce the best combination of financial success and development impact.

3. Commercial success and development impact are not conflicting objectives. Although it is generally believed that the small loan programs are a financial drain, investments in small enterprises have in fact been more profitable than the venture capital investments in most cases to date. The ultimate return on small loan programs is somewhat limited, but thus far the venture capital programs have produced more losses than gains.

4. The most successful funds are those that have built a strong, capable investment staff in the country. Ideally, the staff should be headed by an investment manager from the host country who also has extensive training and experience in business investing. If it is not possible to find a qualified investment manager from the host country, the U.S. or European manager should build a team dominated by host country professional staff.

5. Enterprise funds are not particularly well suited to be instruments for modifying government policy. As providers of technical assistance for enterprises and development institutions, they could be as effective as alternatives (such as contractor or nongovernmental organization programs) but to date have not shown any unique skill in that regard.

6. In general, the funds have cost more to administer than is necessary to accomplish their objectives. The greatest avoidable expenditure is the cost of maintaining a U.S. executive structure and U.S. investment offices. Newer funds should move quickly to transfer the investment and management capability to the field staff and to develop a host country capability for the long term.

7. The absence of a fully developed economic policy environment is not an insurmountable barrier to private enterprise investing. The presence of a knowledgeable and competent professional investment staff in the host country, combined with an investment strategy that matches the evolving market conditions, is the most important precondition for success.

8. The initial group of enterprise funds was created in the early stage of economic transformation of the region. There was a rush to show that the United States was prepared to support the transformation efforts, so enterprise funds were established quickly and with little advanced planning. Although that may have been appropriate at the time, as new funds are started, greater effort should be made to understand local market conditions in those countries and to tailor a program that is consistent with market needs and of an appropriate scale.

ANNEX A

SCOPE OF WORK

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ATTACHMENT A

STATEMENT OF WORK FOR THE EVALUATION OF THE ENTERPRISE FUNDS

I. Background

The Support for East European Democracy (SEED) Act of 1989 established the Polish American Enterprise Fund (PAEF) and the Hungarian American Enterprise Fund (HAEF), as private, nonprofit entities designated by the President, to promote the development of the private sector in Eastern Europe. Though not provided for under the SEED Act, the Czech and Slovak American Enterprise Fund (CSAEF) and the Bulgarian American Enterprise Fund (BAEF) were also established under the same guidelines. Their purpose is to promote:

1) development of the private sector, including small businesses, the agriculture sector, and joint ventures with the United States and host country participants; and

2) policies and practices conducive to private sector development through loans, grants, equity investments, feasibility studies, technical assistance, training, insurance, guarantees and other measures.

The enterprise funds were established to help develop the indigenous private sectors of the CEE countries. They accomplish this by providing risk capital in situations where the financial markets in their respective host countries are still evolving and the business environment is so perilous that foreign investors are reluctant to commit funds. Their approaches vary from venture capital to micro loan programs. The funds operate autonomously from the US government (USG) and determine their own strategic goals and objectives in complying with the SEED Act provisions.

II. Introduction

All of the enterprise funds to date were established through grant agreements. They are set up as Delaware non-profit, membership corporations with no authority to issue stock. The boards of directors are selected by the Administration and only the US members can decide substantive issues such as amendments to the By-Laws and the Certificate of Incorporation, dissolution of the Corporation and final disposition of its assets. In the event of liquidation, fund assets are to be distributed for one or more specified eligible purposes or be distributed to the Federal government for a public purpose. The date and manner of dissolution will be a decision made by the Administration after consultation with Congress and the enterprise funds.

Monies are issued to the enterprise funds through a letter of credit mechanism. Based on periodic disbursement requests, USAID issues electronic funds transfers. On a monthly basis, each fund is required to submit a SF-272, Federal Cash Transactions Report, which reconciles beginning and ending balances with monies received and disbursed during the reporting period. Each fund has been given three years in which to disburse its authorization or these funds may revert back to the USG. As a practical matter, most of the funds are finding it difficult to expend their grant monies in a prudent manner within the three year period. The grants for the two older funds - Poland and Hungary - which have now exceeded their initial three year terms have been extended for two additional years. The expectation is that grant terms will be extended as necessary as long as the funds are making adequate progress.

The Inspector General of USAID has the right to perform financial statement audits of the workpapers generated by the CPA firms in developing annual statements for the funds and such other audit interventions it feels are necessary. The Government Accounting Office, which also has the right to audit these entities, recently completed a performance audit of the funds and has issued a final report on their findings.

In December 1992, a Congressional hold was placed on further funding to the enterprise funds based on issues relating to the eventual liquidation and termination of the funds. The issue of liquidation was resolved in June 1993, with the Administration having sole authority in liquidating the funds, with consultation from Congress and advice from the funds' Boards.

During this period, a controversy surfaced regarding the Hungarian American Enterprise Fund's (HAEF) financial subsidiary, EurAmerica Capital Corporation (EA), a fee-based investment intermediary and advisory company. The controversy ignited when newspaper articles described salaries exceeding $350,000 per annum for two EA principals plus statements that the firm was doing business outside of Hungary. Another HAEF controversy surrounded the use of technical assistance monies to finance a salary supplement to Pal Teleki, a US citizen of Hungarian descent, who was hired by the Hungarian government on a Hungarian salary as chairman of its state property holding company, AVRT. Allegations were made about the political sensitivities and possible violations of US law involved with the USG supplementing the salary of a US citizen working for a foreign government.

In June 1993, Congress lifted the hold on all the enterprise funds, except for the Hungarian Fund, with several material conditions attached that required more stringent oversight and notification requirements on all the funds as a result of the controversy. Since that time, the HAEF restructured the terms of its joint venture agreement with EA to the satisfaction of the Administration and Congress and Pal Teleki resigned from his position at AVRT. The hold was released on the Hungarian Fund, pending adoption of the oversight conditions pertaining to all the enterprise funds.

Revised grant agreements have been signed with all four of the existing funds that include the oversight and notification requirements agreed to between Congress and the Administration.

As a result of the hold and the need to renegotiate the grant agreements, the enterprise funds received only $9.1 million during FY93 from an estimated budget of $107 million. This factor should be taken into account when reviewing the funds' performances for this fiscal year.

The funds were established to operate independently of the USG so they had the flexibility to react quickly to market conditions and in a manner most advantageous to their host countries. Because of this autonomy, each of the enterprise funds operates somewhat differently and, except for the Polish American Enterprise Fund (PAEF) and the Hungarian American Enterprise Fund (HAEF), were established at different times. The country environments in which they operate also vary substantially giving rise to the individual approaches of each fund.

A. **Polish American Enterprise Fund (180.0010.01)**. - The PAEF commenced operations in May 1990. The original authorization for the fund was $240 million but was conditionally increased by $10 million for technical assistance. The chairman of the PAEF is John Birkelund of Dillon, Read & Company and its president, Robert Faris, has many years of experience as a venture capitalist. Barbara Lundberg handles fund activities in Poland. The PAEF has offices in New York and Warsaw.

PAEF is the largest of the enterprise funds. The PAEF utilizes five special purpose operating subsidiaries to carry out specific investment and technical assistance tasks:

1) **Enterprise Credit Corporation (ECC)** - This entity was established to issue small loans (less than $75,000). The initial capitalization was $18 million with another $10 million added in early 1992. The program was initiated with the help of South Shore Bank of Chicago, a successful manager of similar lending programs in the US.

The ECC has its own separate board and administrative structure. Loans are issued through "windows" at cooperating state owned and commercial banks (12 currently) throughout Poland. The cooperating banks guarantee 50% of loan principal and share 25% in gross revenues. Loans are based on cash flow, character and some collateral. As of April, 1994, the ECC had issued 2,925 loans for a total of $73 million.

The ECC is presently considering the proposition of becoming a full service bank stemming from a number of operational and marketing considerations. The Polish National Bank has informed the PAEF that the ECC will have to acquire or merge with an existing Polish bank in order to obtain a local banking license.

2) **Polish Private Equity Fund (PPEF)** - The PPEF is a venture fund created jointly with the EBRD and other private investors, which include the Creditanstalt and leading American pension funds. PPEF makes parallel investments with the PAEF.

3) **Enterprise Investors (EI)** - EI was established to operate both the PPEF and the PAEF. The management group for this organization is made up of personnel who formerly worked for the PAEF. Payment for their services comes jointly from the PPEF and PAEF.

4) **Polish American Mortgage Bank (PAMBank)** - This organization is the mortgage banking arm of the PAEF. The initial committed capital of the PAMBank was $16 million, which consisted of $12 million equity and a $4 million, 10 year loan. The PAEF is a 50% owner of the bank with its investment of $6 million. Its Polish partners, Wielkopolski Bank Kredytowy, a full service bank. and Polservice, an engineering and residential construction firm, contributed the remaining equity. The PAEF also provided the $4 million loan.

5) **Enterprise Assistance Corporation (EAC)** - This corporation was capitalized at $5 million to implement technical assistance interventions. An additional $5 million has been conditionally granted to the PAEF for technical assistance.

B. **Hungarian American Enterprise Fund (180-0010.02)**. - The HAEF was authorized along with the PAEF by the SEED Act of 1989. Funds were first disbursed in May 1990. The current authorization for the HAEF is $70 million, $10 million of which is for technical assistance. The chairman of the board is John Whitehead, chairman of AEA Investors. Eriberto Scocimara joined the fund in April, 1994 as president. That position had been vacant since September, 1993 due to the resignation of the former president and CEO, Alexander Tomlinson. The fund has offices in Washington, Connecticut and Budapest.

The HAEF has $41 million in investments as of September, 1993. Five million of this total is a small loan program administered by the Szechenyi Bank (the small loan affiliate of the Hungarian Credit Bank) and the Mezobank (owned by a number of agricultural cooperatives and private shareholders). Aside from the small loan program with a loan range of $10,000 - $100,000 and the new, modestly funded micro loan program with a range of $1,000 - $10,000, HAEF investments generally fall within the range of $500,000 - $2,500,000. The investment portfolio, minus the small loan program, is made up of 90%

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equity and 10% loan investments covering a wide array of economic sectors. The HAEF is expected to utilize the remainder of its grant during FY94.

EurAmerican Capital Corporation (EA) - The HAEF provided the entire capitalization of $4 million to create EA early in 1992. EA provides consulting and investment banking services.

EA was restructured in August, 1993. George Gould, HAEF's vice chairman, took over as chairman of EA, after intense scrutiny by the Congress over the high salaries paid to the EA principals and other practices felt to be imprudent given the use of USG monies to establish the business.

C. **Czech and Slovak American Enterprise Fund (180-0010.03)**. - The Czech and Slovak American Enterprise Fund (CSAEF) was authorized in March, 1991, one year after the PAEF and HAEF. The fund has an authorization of $65 million, $5 million of which is to be used for technical assistance. The fund chairman is John Petty and its president is Paul Gibian. The CSAEF has offices in Washington, Prague and Bratislava. The fund shares Washington office space and some support personnel with the HAEF. The CSAEF had $28.3 million in investments as of March, 1994. The portfolio is made up of 55% loans and 45% equity.

Organizationally the CSAEF varies from the other country specific funds with its responsibility for both the Czech and Slovak Republics. When the two Republics were formed early in 1993, the CSAEF response was to create two separate, country specific funds with overlapping Boards both of which report through the parent CSAEF. The Czech American Enterprise Fund managing director position is vacant. The Slovak American Enterprise Fund is managed by Leighton Klevana. Small loan programs are established in both Republics with a loan maximum of approximately $20,000.

D. **Bulgarian American Enterprise Fund (180-0010.04)**. - The Bulgarian American Enterprise Fund (BAEF) is the most recently established of the four funds. The grant agreement was signed in November 1991, with an authorization level of $50 million. This has subsequently been increased by $5 million to provide for technical assistance interventions. Stephen Fillo has recently taken over as chairman and the fund's president is Frank Bauer. The fund has offices in Chicago and Sofia. Since its inception, the fund has made just under $3 million in investments, over 90% of which has been loans.

The fund's largest investment to date, MaPain Nevrokop, ended in the bankruptcy of its French joint venture partner, MaPain, earlier this year. The fund has written off the $1.6 million investment that was advanced to its French partner to provide for factory renovation and equipment.

The BAEF has a micro loan program operated by Opportunity International. A larger, medium size loan program is being developed by South Shore Bank of Chicago, the contractor responsible for the ECC operation in Poland.

III. SCOPE OF WORK

A. Purpose

The evaluation team will provide a formal, objective, external mid-term evaluation of the enterprise fund concept as employed by the PAEF, the HAEF, the CSAEF, and the BAEF under the Enterprise Fund Project (180-0010).

B. Issues for the Strategic Evaluation

The evaluation team's overriding objective is to assess the performance of each enterprise fund in: (1) promoting private sector development through loans, equity investments, feasibility studies, guarantees and other measures; and (2) pursuing policies and practices conducive to private sector development through use of technical assistance and other means. In completing this assignment the team should particularly consider the factors affecting the transformation of these economies from centrally planned to a free market systems. Since this is the first evaluation of the enterprise fund concept, this information will be important in determining its effectiveness as a private sector development tool.

Within this overall objective, there are four main elements to this evaluation: (1) the evaluation team will interview local business individuals, government officials, enterprise fund management and staff, and enterprise fund investees to assess the effectiveness of the enterprise funds in promoting private sector development; (2) the evaluation team will review the investment portfolios of each of the funds and assess the current financial performance and consider the long-term viability of each of the enterprise funds; (3) the evaluation team will identify positive and successful elements including comments on additionality in each of the host countries, as well as negative elements of the enterprise funds operations to date listing specific factors or local conditions that may have contributed to less than desired results including quantitative and qualitative indicators to support the team's findings; and (4) using the information compiled, the evaluation team will identify the most effective investment strategies, taking into account the resources available for each of the funds and the economic environment in which each operates, in assisting the private sector and encouraging private sector reforms in the host countries.

C. Methodology

Prior to departure, the team members shall:

(1) review background documents, including

- o project authorizations
- o grant agreements, amendments
- o each enterprise fund's certificate of incorporation, by-laws, statement of corporate policies and procedures, and accounting and financial management systems, audits and recordkeeping documents
- o trip reports
- o annual reports
- o audit reports (GAO/IG)
- o position/policy papers
- o minutes from semi-annual reviews
- o other referential or historic documents

(2) Schedule appointments, conduct interviews and hold briefings with USAID staff and other federal agency officials involved with the enterprise funds in Washington; enterprise fund officials in Washington, New York and Chicago; USAID officials, enterprise fund officials and investees in the field; and host country officials. Key resource persons include enterprise fund project manager and USAID Bureau for Europe and the New Independent States staff.

ENI/ED/EF staff will schedule briefings with the evaluation team to ensure pre-field evaluation exchanges with USAID/W officials and grantees; and to provide an opportunity for team-building.

(3) Recommend benchmarks, indicators and measures of performance effectiveness that should be applied to monitor program impact. In developing these benchmarks, indicators and other measures of performance effectiveness, the evaluation team should consider those established by the enterprise funds themselves. The suggested indicators will be submitted to ENI/PCS/PAC staff for concurrence at least one week prior to departure for the field.

(4) Propose some criterion for assessing administrative levels for each fund in comparison to the investment types/levels being undertaken by each. The criterion shall be submitted to ENI/PCS/PAC for concurrence at least one week prior to departure for the field.

(5) Propose a schedule to ENI/PCS/PAC at least one week prior to the beginning of the fieldwork detailing how the evaluation tasks will be fulfilled and by whom.

(6) Propose criteria which will be applied to measure the impact of the funds on small business recipients, and whether such funding is available from other sources or whether an external source of funding continues to be required. The suggested criteria will be submitted to ENI/PCS/PAC for concurrence at least one week prior to departure for the field.

(7) Propose criteria for selecting a sample of firms to be interviewed in each country to include those that have been successful and those firms which have failed. The suggested criteria and a proposed questionnaire to be used in interviewing large, medium and small firms will be submitted to ENI/PCS/PAC for concurrence at least one week prior to departure for the field. The samples shall be representative of all enterprise fund direct investees, taking into account the following variables: (a) size of enterprise, (b) location, (c) sector, (d) size of investment and ownership stake, and (e) type of investment (start-up, privatization, expansion of existing enterprise, or joint venture, both US and third-country).

At a minimum, the sample will include:

(A) Polish investment portfolio

o Fourteen firms (approximately 50% of the total) shall be interviewed and analyzed including: (1) Bank Rolno-Przemylowy; (2) First Polish-American Bank; and (3) Polish American Mortgage Bank. The assessment should be expanded to analyze and determine the demonstration effects and impact these banks are having on access to capital.

o Enterprise Credit Corporation: On-site visits shall be conducted in Warsaw, Krakow and two other regional centers which are representative of rural areas. A minimum of ten firms shall be interviewed and surveyed in each of the four regions to provide a representative sample. The sample will include questions to analyze developmental impact of the enterprise funds.

(B) Hungarian investment portfolio

o Using the above stated sample representation criteria, the team shall interview and analyze fourteen of the total firms in the direct investment portfolio.

o The team shall interview and analyze 20 percent of the indirect investment small loan portfolio (approximately 100 firms total).

(C) Czech investment portfolio

o The team shall interview and analyze four firms in Prague which are in the direct investment portfolio.

o The team shall interview and analyze 50 percent of the remaining direct investment loan program firms with emphasis on firms elsewhere in the country, not in Prague (approximately 20 firms total).

(D) Slovak investment portfolio

o The team shall interview and analyze 50 percent of the direct and indirect loan portfolio (approximately 30 firms total).

(E) Bulgaria investment portfolio

o The team shall interview and analyze all firms in the direct investment portfolio.

o The team shall interview and analyze 20 firms having micro loans.

During the field work, the evaluation team shall conduct an extensive field program review in Poland, Hungary, Czech Republic, Slovak Republic, Bulgaria including meetings with U.S. Embassy and USAID Representative officials, meetings with the management and boards of directors of the enterprise funds both in the U.S. and field offices, meetings with investees, host country business individuals and members of the host governments involved in privatization, private sector regulation and banking, and meetings with other donor representatives active in the host countries.

Poland

In Poland, the team members shall visit:

Warsaw:
USAID REP Office, PAEF Office
US Embassy, Economics Officer
EBRD Representative
Enterprise Credit Corporation (Small Loan Program)
Bank Rolno Przemyslowy
Polish American Mortgage Bank (PAMBank)
Wielkopolski Bank Kredytowy (Polish participant in PAMBank)
Polservice (Polish participant in PAMBank)
National Bank of Poland - Restructuring Grant
Creditanstalt (Austrian Bank partner in PPEF)
IESC Representatives
(Various Investees/Technical Assistance Recipients - to be determined)
(Government Officials - to be determined)

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Krakow: First Polish American Bank in Krakow
Polish American Printing Corporation
(Various Investees - to be determined)
Enterprise Credit Corp. - Regional Window
Polish American Enterprise Club

(Other Cities/Regions: Investees, government officials at municipal and vovoidship level, ECC regional windows operations and technical assistance recipients to be determined.)

Hungary

In Hungary, the team members shall visit:

Budapest: USAID REP Office, HAEF Office
US Embassy, Economics Officer
EBRD Representative
EurAmerica Capital Corp.
Szechenyi Bank (Small Loan Program)
Mezobank (Small Loan Program)
Szigetvar Savings Cooperatives (Micro Loan Program)
Foundation for Enterprise Development (Micro Loan Program)
InvestBank (Micro Loan Program)
Industrial Craft Union (Micro Loan Program)
IESC Representatives
Center for Private Enterprise Development (tech assistance)
(Various Investees/Technical Assistance Recipients - to be determined)
(Government Officials/Country Representatives to be determined)

(Other Regions: Investees and Regional Loan Offices to be determined.)

Czech Republic

In the Czech Republic, the team members shall visit:

Prague: USAID REP Office, CAEF Office
US Embassy, Economics Officer
EBRD, JAIDO Representatives
EC-Phare Business Centers
MBA Enterprise Corps Representatives
CEEP Entrepeneur Centers
IESC Representatives
Komercni Banka - (Small Loan Program)
(Various Investees/Technical Assistance Recipients - to be determined)
(Government Officials/Country Rep to be determined)

(Other Regions: Investees and Regional Offices to be determined.)

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Slovak Republic

In the Slovak Republic, the team members shall visit:

Bratislava: USAID REP Office, SAEF Office
US Embassy, Economics Officer
EBRD Representatives
CEEP Entrepeneur Centers
MBA Enterprise Corps Representatives
IESC Representatives
Slovak Poln. Bank - (Sm. Loan Program)
(Various Investees/Technical Assistance Recipients - to be determined)
(Government Officials/Country Rep to be determined)

Brezno: Land Records Information Center

(Other Regions: Investees/Regional Offices to be determined.)

Bulgaria

In Bulgaria, the team members shall visit:

Sofia: USAID REP Office, BAEF Office
US Embassy, Economics Officer
Opportunity International - Small Loan Program
Medium-Sized Loan Program (South Shore Bank)
(Government Officials/Country Rep/Technical Assistance Recipients - to be determined)

(Other Regions: Storks -- a recipient of a major investment by the fund -- and other Investees to be determined.)

A list of contacts in the US, Poland, Hungary, the Czech Republic, Slovakia and Bulgaria is included in Attachment B. This list is not exhaustive. Given the high degree of autonomy granted to the enterprise funds, the project office does not have a detailed knowledge of this activity. The evaluation team should feel to talk with any party it feels is important to this undertaking.

The team members will meet with the USAID Representative, or designee, for orientation in each country at the beginning of the field evaluation. The USAID Representative Office will also schedule host government and enterprise fund meetings in addition to assisting the evaluation team in any way necessary. The team members will present a summary of preliminary findings to the USAID Representatives in each country (Poland, Hungary, Czech Republic, Slovakia and Bulgaria) prior to departure.

D. Deliverables

At least one week prior to departure, the evaluation team will submit a draft work plan to ENI/PCS/PAC for concurrence. The work plan will include (1) recommended benchmarks, indicators and measures of performance effectiveness that should be applied to monitor program impact (this should consider the benchmarks and indicators established by the funds themselves); (2) a proposed method for assessing administrative levels; (3) proposed criteria to measure the impact of the funds on small business recipients; (4) a proposed schedule detailing how the evaluation tasks will be fulfilled and by whom; and (5) proposed criteria and questionnaire for interviewing and analyzing a representative sampling of enterprise fund investees.

The team will propose measures for testing the impact, effectiveness, and efficiency of assistance delivered and test them against the cases sampled.

The contractor shall produce a report which includes the following:

(1) identifies successful activities or accomplishments including additionality stemming from the enterprise activity to date and impact at the firm level;

(2) alerts the reader to possible problem areas;

(3) identifies, in order of priority, economic factors, local conditions, types of assistance and components of the enterprise fund concept that appear to be most effective;

(4) identifies, in order of priority, economic factors, local conditions, types of assistance and components of the enterprise fund concept that appear to be least effective;

(5) where appropriate, suggests, in order of priority, new initiatives or complementary assistance that could be used to further impact project objectives whether undertaken by the enterprise funds or some other independent assistance activity;

(6) specifically lists, in order of priority, the major findings and conclusions, and lessons learned from this evaluation; and

(7) specifically lists, in order of priority, the types of enterprise fund activities that appear to be either most or least effective to enhancing the likelihood of program sustainability subsequent to USAID's cessation of funding.

The goals are to determine if the enterprise fund concept is having an impact on country-specific needs in developing the private sector; to determine the impact of enterprise fund activities in the firms that have received funds; and to determine under what circumstances this concept or variation on this concept might be successful in other country contexts. In addition, the team will assess the financial performance of the enterprise funds and their ability to sustain themselves after grant monies have been exhausted. The team will propose mechanisms for streamlining fund operations, while maximizing impact on private sector development. Specific questions to be addressed by the team are included in Attachment C.

Immediately after return from the field, draft summary findings and conclusions will be verbally presented to ENI staff at a preliminary briefing. A draft final report will be submitted not later than 21 days following the team's return to the US for USAID/ENI review. Subsequent to ENI/ED/EF and ENI/PCS/PAC concurrence in accepting the draft report, an ENI bureau review meeting will be scheduled (within approximately six weeks after receipt of the draft final report).

Subsequent to the ENI bureau review meeting, comments will be requested from the grantees. USAID's and enterprise fund management comments will be given to the evaluation team within approximately eight weeks following receipt of the draft final report. Within 14 days of receipt of those comments, the evaluation team will prepare and submit a final report that responds to USAID's and the enterprise funds' comments.

Seventy copies (69 bound and one loose leaf) of the draft final report and one hundred copies of the final report (99 bound and one loose leaf), not to exceed 25 pages (including an Executive Summary of findings and conclusions not to exceed three pages) will be submitted by the contractor to ENI/PCS/PAC for distribution.

The Executive Summary will clearly state the evaluation's major findings and summarize conclusions drawn. The draft and final reports will be presented in hard copy and on a diskette in Word Perfect 5.1 format. Additional material shall be submitted in Annexes, as appropriate, including bibliography of documents analyzed, list of agencies and persons interviewed, list of sites visited, acronym list, scope of work, etc.

Based on the results from the completed evaluation and all other pertinent data, the evaluation team will prepare a Project Evaluation Summary. The summary will include action decisions approved, evaluation abstracts, purpose of activity, purpose of evaluation and methodology used, findings and conclusions, and recommendations. The format will be specified by ENI/PCS/PAC. The summary will be submitted at the time of draft report submission and will be presented both in hard copy and on a diskette in WordPerfect 5.1 format which we can modify.

Any information obtained from the Enterprise Funds under this evaluation process, or information included in the above deliverables are only to be disclosed to USAID Officials.

ATTACHMENT B

CONTACTS

* = must visit/interview
** = should try to visit/interview

UNITED STATES

USAID

*	1.	Mike Brooks, Project Manager, ENI/ED/EF
*	2.	Karen Brown, ENI/ED/EF
*	3.	Gordon West, ENI/ED
*	4.	Debbie Prindle, ENI/PCS/PAC
**	7.	Jim Elliot, ENI
**	8.	Cressida McKean, CDIE
**	9.	Mark Karns, ENI/ED
**	10.	Frank Almaguer, D-AA/M/HR (Former D/RME)
**	10.	David Merrill, Amb.Designate-Bangladesh (Former D-AA/EUR)
**	11.	Pat Shapiro, ENI/PER/ER (legal environment of CEE)
**	12.	Laurie Landy, ENI/PER/ER (banking environment of CEE)
**	13.	Desk Officers, ENI/ECA
**	14.	Jim Hansley, ENI/ED/EF
**	15.	Ray Solem, AFR/ONI/TBCV

STATE

*	1.	Ralph Johnson, D/EEA
*	2.	Pat Nelson, D/EEA
**	3.	Designated Desk Officers

OTHER FEDERAL AGENCIES

**	1.	Juhan Jackson, Treasury
**	2.	Jay Burgess, Commerce
**	3.	Designated USDA officials
**	4.	Maria Oliver, et. al., GAO

ENTERPRISE FUND U.S. Offices

*	1.	Robert Faris - President, CEO (Polish Fund - New York)
*	2.	Norm Haslun - CFO (Polish Fund -New York)
*	3.	Eriberto Scocimara - President, CEO (Hungarian Fund - Connecticut)
*	4.	Tom Hughes - CFO (Hungarian Fund - Wash, DC)
*	5.	John Petty - Chairman (Czech/Slovak Fund - Wash, DC)
*	6.	Richard Dine - Chief Inv. Of. (Czech/Slovak Fund - Wash)
*	7.	Brad Miller - CFO (Czech/Slovak Fund - Wash, DC)
*	8.	Frank Bauer - President, CEO (Bulgarian Fund, Chicago)

* 9. Nancy Schiller - CFO (Bulgarian Fund, Chicago)
* 10. Robert Odle (Weil, Gotshal & Manges - Wash. DC)
* 11. Richard Turner - South Shore Bank (PAEF-ECC - Chicago)
* 12. One or more US board members of the funds, as appropriate or available
* 13. Opportunity International - Ken Vander Weele/Roger Voorhies

INTERNATIONAL

United Kingdom (London)

* 1. Marlow, CEO of Venture Capital Firm, III (feasibility study team on co-investing with the CSAEF and HAEF)
* 2. Guy de Selliers, EBRD - Involved with PAEF PPEF
* 3. Barker, EBRD - feasibility study team on co-investing with the CSAEF and HAEF
* 4. Agouchi, EBRD - feasibility study team on co-investing with the CSAEF and HAEF

Poland

USAID Representative Office

* 1. Don Pressley, USAID Representative
** 2. John Mayshak

Polish Fund - Warsaw

* 3. Barbara Lundberg, General Director
* 4. George Langnas, Senior Vice President
* 5. Host Country Board Members
* 6. B. Belusic, Controller
* 7. PAEF Investment Analysts (as appropriate)
* 8. M. Kulczycki, President, Enterprise Credit Corporation
* 9. ECC Staff, Loan Officers, CFO (as appropriate)
* 10. Joe Conti (PAEF senior banking advisor)
** 11. Todd Kerstin (PAEF banking advisor)
* 12. Lech Gajewski, President, PAMBank
* 13. Gregory Karachuk, Senior Loan Officer

Polish Fund - Krakow

* 14. Ralph Kravitz, President, Polish Amer Bank of Krakow
* 15. William Sloan, Advisor to Polish Amer Printing Corp

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Hungary

USAID Representative Office

* 1. David Cowles, USAID Representative
* 2. Linda Chung

Hungarian Fund - Budapest

* 3. Charles Huebner, Managing Director
* 4. L. Olah, Director of Investments
* 5. Z. Fekete, Director of Operations
* 6. E. Timar, Small Loan Administrator
* 7. Host Country Board Members
** 8. Local Staff/Analysts (as appropriate)
** 9. Members of Blue Ribbon Commission (technical assistance)
** 10. Julia Rowney, Inter Mgn Center Director (tech assistance)
* 11. Eriberto Scocimara, President, CEO, Hungarian Fund

Czech Republic

USAID Representative Office

* 1. Lee Roussel, USAID Representative
* 2. Ivo Bennes
* 3. John Rogers

Czech Fund - Prague

* 4. (Vacant), Managing Director, Czech Fund
* 5. Local Board Members
* 6. Jeanne Hilsinger, CSAEF Holding Co., Director of Development
* 7. Local Staff/Analysts, as appropriate
* 8. Komercni Bank Officials (joint lending program)

Slovakia

USAID Representative Office

* 1. Pat Lerner, USAID Representative
* 2. Loren Schulze

Slovak Fund - Bratislava

* 3. Leighton Klevana, Managing Director
* 4. Douglas Swaim, Senior Investment Officer
* 5. Local Staff/Analysts, as appropriate
* 6. Solv.Poln Banka Officials (joint lending program)
* 7. Paul Gibian, President, CEO, Czech/Slovak Fund

Bulgaria

USAID Representative Office

* 1. Jerry Zarr, USAID Representative
* 2. John Babylon

Bulgaria Fund - Sofia

* 3. Searl Vetter, Managing Director
* 4. Mark Neal, Investment Officer
* 5. Local Staff/Analysts, as appropriate

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ATTACHMENT C

EVALUATION QUESTIONS

The evaluation team's report shall provide a concise, analytical examination of these issues for the enterprise funds in Poland, Hungary, Czech Republic, Slovakia and Bulgaria. The team should use the agreed benchmarks to draw their conclusions which in turn should consider the stated goals of the funds themselves (see Attachment A, paragraph III.D (3)). The evaluation should consider the age of each of the enterprise funds, their capitalization levels, and the comparative stage of the transition economy in which each operates,

A. Developmental Impact

Determine the effectiveness of the enterprise funds in assisting the private sector using the following specific criteria:

1. As a catalyst for development of the financial sector. Ascertain whether there is evidence of a demonstrative effect of the funds on the business communities of their host countries, in general, and on the financial services sector, in particular. Cite specific examples to document your rationale. Investigate and determine whether enterprise fund activities have attracted private sector investments funds, banks and/or other financial intermediaries to establish business operations in their host countries. Evaluate whether enterprise fund investment activities (e.g. cash flow lending versus collateralized lending) have served as models or instigated similar activities by other banks or investment companies operating in the host countries. Provide examples to support your findings.

If possible, document the impact on employment, overall lending and equity investment in the enterprise funds' host countries and the impact in firms interviewed. Cite specific characteristics of particular investments or loan programs which appear to have been particularly beneficial in promoting capitalism and the private sector (i.e. start-ups, privatizations, joint ventures, small or micro lending programs).

2. Broadening access to capital (equity and debt) for entrepreneurs. Investigate and determine whether the enterprise funds are addressing the small and medium size business sector prescribed in the SEED Act. Ascertain whether the enterprise funds are providing financing for risky but otherwise well conceived business plans which would not otherwise have had access to financing. Cite specific alternate sources of financing in each country and contrast the investment programs of those institutions with the approaches taken by the enterprise funds. What was done well? What could have been done better? Cite specific cases.

3. Leveraging capital resources. Determine the effectiveness of the funds in attracting joint private investors, particularly from the US. Evaluate the results of joint efforts with other donors (e.g., EBRD, Japan, EC PHARE, etc.). Evaluate whether the presence of the enterprise funds lowered the perceived risk or, in effect, helped "legitimize" the host country marketplace in the eyes of private investors. Investigate and determine the effectiveness of the enterprise funds in attracting additional foreign investment, either directly or through affiliated financial intermediaries. Verify whether the presence of an enterprise fund as a buyer in an Initial Public Offering enticed otherwise reticent buyers into the host country marketplace. Cite examples to support your rationale.

Provide documentation to show whether the presence of enterprise funds have detered private investors. Investigate and ascertain whether the enterprise funds might avoid conflict or bidding situations with private sector investors and still hope to be self-sustaining. Evaluate and determine when the private sectors of the host countries will be developed to the point where the enterprise funds will no longer be required (i.e., when will there be adequate levels of equity and credit financing available from the private sector to preclude the need for the USG financed enterprise funds). Provide specific examples to support your findings.

4. As policy advisor to the host government. Ascertain whether the enterprise funds have had an effect on reducing impediments to private sector activity through policy discussions with the host governments. Cite specific cases.

5. Business development through education and training. Evaluate the effectiveness of the use of investment and non-investment related technical assistance to train enterprise fund employees, potential/current investees and the general public about capitalism and the manner in which the private sector operates. Cite specific examples to show what was done well. What could have been done better?

6. Compare the administrative levels of the enterprise funds to their developmental impact. To the degree practicable and quantitatively supportable, develop a cost/benefit relationship between the administration incurred by the enterprise funds to the benefits derived by the host country private sectors. Evaluate and cite examples to document the value added by the enterprise funds when contractors are utilized to undertake an investment activity (e.g., small lending program). If feasible, determine the cost/benefit relationships of the enterprise funds versus contractor administered programs addressing the similar goals and objectives.

B. Financial Performance and Sustainability:

Evaluate the financial performance and likelihood for sustainability of each enterprise fund using the following criteria:

1. Profitability of portfolio categories. Document specific cases to show the profitability of the various portfolio categories:
   (a) venture capital type equity or equity/debt transactions;
   (b) stock selections from listed companies or IPOs;
   (c) small loan programs; and
   (d) micro loan programs.

2. Profitability/viability of portfolio mix. Investigate and provide specific documentation to show the profitability and viability of the portfolio mix of the various enterprise funds. Viability should be viewed from a cash flow/business sustainability standpoint. Provide specific examples to distinguish between the debt/equity mix and the composition of investments in start-ups versus privatizations, versus foreign joint ventures, versus established companies. Provide additional documentation, such as breakdowns by company size, industry or other meaningful categories if such analyses support observations or conclusions of the team.

Investigate and determine the effectiveness and appropriateness of sustainability (e.g., is there a point at which the private sector has developed in the host country where the enterprise fund would cease to provide additional benefits beyond what could be provided by the private sector).

3. Administrative Level Analysis. Provide documentation which compares the investment types/levels of the enterprise funds against the administrative levels in accordance with the criterion established by the evaluation team (see Attachment A, paragraph III.D (4)).

C. Replicability of Enterprise Fund Concept:

1. Conducive country environment. Cite specific examples to show which local conditions were most instrumental to the success of the enterprise funds.

2. Detrimental country environment. Provide specific documentation to show which local conditions were most deleterious or damaging to the success of the enterprise funds.

3. Minimal conditions for an enterprise fund. Investigate and determine, in general terms, the minimal conditions which must be present for an enterprise fund to operate with any likelihood of success.

4. <u>Multiple country fund.</u> Investigate and recommend the optimal organizational structure for an enterprise fund providing services to more than one country. Cite specific examples to support your rationale.

5. <u>Small country fund.</u> Investigate and recommend organizational and operational alternatives for establishing enterprise funds with small capitalization levels (e.g.< $50 million). Provide specific examples to support your rationale.

ANNEX B

RESPONSE LETTERS FROM THE FUNDS

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HUNGARIAN-AMERICAN ENTERPRISE FUND
666 STEAMBOAT ROAD
GREENWICH CONNECTICUT 06830

May 10, 1995

Mr. Richard E. Rousseau
Chief of the Enterprise Fund Division
U.S. Agency for International Development
320 21 Street, N.W.
Room 3000, SA 15
Washington, D.C. 20523

Dear Richard:

We appreciated the opportunity to meet with DAI, State Department and the USAID officials on April 19 to dicuss DAI's revisions following comments each enterprise fund submitted in response to the first draft of the Enterprise Fund Evaluation Report and to amplify and explain our views.

While the subsequent draft of the report shows improvement, I am disappointed that the contractor chose to ignore so much of our 25-page critique of March 7th. The independent responses of all four enterprise funds totaling 90 pages consistently pointed to the same deficiencies in the draft report which, if corrected, could have substantially improved the accuracy and the usefulness of the subject report. Nevertheless, I am sympathetic with the contractor's difficulties in evaluating enterprise funds when the purpose of the evaluation was never very clear.

The enterprise funds were created under conditions existing in 1989, and they evolved as those conditions changed. It is indeed difficult for any group with little appreciation of the history and dynamics of the enterprise funds and the respective economies in which they have operated to attempt a traditional USAID program evaluation focused at a fixed point in time.

The essence of the evaluation should have been to look at how good a job the enterprise funds have done in carrying out their purposes as conceived by Congress. The funds were created to assist the development of local private sectors primarily by providing capital to individual enterprises. These enterprises had little private business experience and little or no access to capital. The economies in which these entrepreneurs were operating were beginning an unprecedented transition and were in need of the institutional infrastructure to support private commercial activity.

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Congress established the enterprise funds with the independence granted to allow them to act quickly and make the best business decisions they could with the limited information that was available at the time and under conditions that were not well-suited to traditional private business investments. Congress recognized that private investors were not ready to face the unknowns in providing financing to small and medium sized businesses in these emerging free markets. On the other hand, government programs existing at the time the enterprise funds were created generally were not designed to respond on a business-to-business basis and to face the risks that businessmen must. Enterprise funds were conceived as one way to leverage U.S. Government assistance and to serve as catalysts for private investment, which they have done. Instead of a one-time grant that would be quickly dissipated, the enterprise funds were designed to make investments that would grow and be recycled for the benefit of other entrepreneurs.

The creators of the Enterprise Funds and founding Boards had very clear ideas about the purposes of the funds. It is against these goals that the success of the funds should be judged, but these are hardly discussed -- e.g., providing capital quickly to entrepreneurs; serving as demonstrable evidence of U.S. assistance at grassroots levels; helping to build the institutions the private sector needs for growth, including the capacity of human capital to understand the basics of transactions based on market principles; introducing concepts and financial structures that facilitate market development; providing models that influence governmental decisions; recycling capital; and serving as catalysts for other investors, to mention a few.

It would likewise have been helpful if the report discussed the new directions taken by the enterprise funds as they have evolved. The ability to respond quickly and in targeted ways as conditions change is a key advantage of the enterprise funds but this dynamic was overlooked. This ability to respond rapidly is especially apparent in the diverse technical assistance programs of the enterprise funds. Providing technical assistance has been an important complement to the enterprise fund equity investment and lending activities. The enterprise funds' independence and flexibility give them the advantage of executing this form of assistance more quickly than traditional aid mechanisms would have permitted and in ways that are targeted for maximum leverage.

An important factor in HAEF's direction-setting effort is our Board of Directors and particularly our U.S. Board Members. Unfortunately and in spite of the statement of work requirement to meet with American Board Members, none were interviewed. Such interviews would have contributed to the contractor's understanding of our Board's role in providing the oversight Congress intended while achieving objectives and protecting the interests of U.S. taxpayers. Such discussions might also have been helpful to the contractor in appreciating the respective roles of management and directors in private business. For example, fund management's main responsibility is to develop a flexible, viable investment strategy adapted to rapidly changing market conditions and set up the system that ensures hands-on management and monitoring of a portfolio. Fund officers execute and implement, and the Board of Directors provide guidance and oversight. U.S. Government oversight should focus on determining if appropriate policies and procedures are in place.

Controls to protect taxpayers investment are clearly in place. In addition to Board supervision, there are rigorous auditing of HAEF results and performance by internationally recognized independent auditing firms, reviews by USAID officials, USAID's Inspector General and GAO, and the on-site visits by U.S. Government officials. This oversight would seem to provide more than adequate assurance that public funds are being used for their intended purposes. In addition, HAEF continues to provide monthly financial data and semi-annual reviews to USAID. All the Funds have to present their portfolio in their annual reports and the portfolio valuation is also checked by the Funds' auditors. Any further monitoring would only duplicate the control systems and impose additional costs without providing additional benefits.

The draft report seems to be struggling with the concept of how USAID can exercise additional control over the enterprise funds. The real question is what specifically is there for USAID to control?

If USAID is seeking to exercise control over expenses, there is very little that is discretionary once one considers the fixed costs of staff who are competent for the assignment, office space that is functional and appropriate for its purpose and other costs that are routine in operating an investment firm.

The only way to exercise control over investment decisions where the bulk of the money is -- which would be contrary to Congress' purpose in establishing the enterprise funds -- would be to go through the same exercise as HAEF's investment officers. In reality, their decisions are based on business judgment for which the control mechanism is hiring the best people with good reputations and paying them an appropriate salary. Their decisions are independently reviewed by our Board of Directors which is kept informed of difficulties. The abilities and active involvement of Board members is a key element in the success of any fund. The panoply of independent audits assures that fraud, waste and abuse is not occurring in investments or expenditures for operations.

Much of the report's discussion of investment performance measures is meaningless. This apparently stems from a lack of understanding of how investment firms operate on behalf of their investors' interests and how those investors monitor progress. It would have been interesting if the report explored how leading state pension funds such as CALPERS or the state of Wisconsin make decisions to place their capital with investment management firms and how they judge performance.

The report still suffers from confusion over the relationship between the enterprise funds' dual objectives -- developmental and commercial. In reality, there is little difficulty in balancing these objectives and achieving goals in conjunction with both. In fact, HAEF has structured its investment activity in a way that is at the same time commercially prudent and has positive developmental impact.

Despite repeated attempts by the funds to correct the misconception, the report continues to be fixated on a notion that enterprise funds originally envisioned themselves as concentrating on a venture capital approach. As we noted, there is no uniform view of "classic venture capital

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investing," and in reality the enterprise funds have drawn from a variety of tools including adaptation of venture capital models and small business lending approaches to place capital quickly in the hands of private entrepreneurs.

The report's statements on enterprise fund costs are conclusionary and not presented in a proper context. Enterprise funds face costs that are not imposed on more traditional private investment firms because of governance and reporting requirements stemming from their U.S. Government grants. This is a necessary expense that does not contribute to achievement of enterprise fund objectives of developing indigenous private sectors in their host countries.

We recognize the difficulties a contractor would have in understanding Hungarian economic conditions after only a two-week visit to the country. While Hungary has had some advantages in early economic development, it is contrary to reality to say, "HAEF's investment activity has been aided by a very healthy local economy." Knowledgeable observers recognize that Hungary has been mired in recession for much of the past four years, and HAEF's achievements have come despite those adverse macroeconomic conditions.

The report's findings that much of the information USAID has collected routinely at a great burden on the enterprise funds may not be useful is disturbing. More disturbing yet is that so much of the information we provided in the course of this evaluation was ignored. I would suggest that USAID make HAEF's earlier 25-page detailed set of comments available with this report.

If I can be of further assistance, please do not hesitate to contact me.

Sincerely,

Eriberto R. Scocimara
President & Chief Executive Officer

cc: F. Bauer
T. Dine
R. Faris
R. Johnson (Ralph)
R. Johnson (Richard)
J. Petty

Polish-American Enterprise Fund

Robert G. Faris
President & Chief Executive Officer

May 9, 1995

Mr. Richard E. Rousseau
Chief, Enterprise Funds Division
Enterprise Development Office
Bureau for Europe and the New
Independent States
U.S. Agency for International Development
320 Twenty-First Street, N.W.
Washington, D.C. 20523

Dear Richard:

I appreciate the opportunity to respond on behalf of the Polish-American Enterprise Fund to the "Program Evaluation of the Central and Eastern European Enterprise Funds." As you know, we have had numerous discussions with the contractor, Development Alternatives Inc. and representatives of USAID before, during, and after the evaluation. Our specific comments are known to DAI and USAID through these meetings, the nine pages of comments provided to them in February, and in subsequent written communication. Most of the important issues raised have been ignored.

While we believe DAI has collected some interesting data during its study, we believe that it would be dangerous/harmful to use the DAI report to set operating procedures for, or to monitor or measure the performance of other Enterprise Funds. We believe that DAI draws conclusions that are not supported by facts and that their comments exhibit a surprising naiveté about business, corporate governance or what is required to build a quality management team.

I would like to underline what all of the Presidents of the Funds involved in the DAI evaluation have previously stated:

- DAI does not understand the evolution of the Funds.
- DAI does not understand the dynamics of the Funds.
- DAI does not understand that the Funds have multiple missions.

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- DAI still does not understand the structure of the Funds and the role of a Board of Directors in a private business. (It appears that they do not even understand the dynamics and role of management in business.)

- DAI does not understand how to monitor investment funds and did not develop relevant criteria to evaluate the Enterprise Funds. As a result, the financial performance measures which DAI used are largely irrelevant and incorrect.

- DAI is not correct in assuming that USAID does not monitor relevant information on a timely basis.

After five years, the Polish-American Enterprise Fund has been evaluated by 15 different groups, some of them several times. This is the first evaluation where the process was more important than the facts and where the evaluator's indifference was totally frustrating. They did not interview the key governance body the Board of Directors. Also, they did not interview any of the private investors in PPEF who are institutions that are the largest and most knowledgeable investors in Private Funds in the world.

We are pleased to cooperate in USAID evaluations of the Enterprise Funds that are meaningful and contribute to improvements in our operations. Unfortunately, this report, after many months of work and substantial burden on the Enterprise Funds in responding, succeeded only in stating the obvious and in giving a confused, inaccurate account of the rest.

Best regards,

Robert G. Faris

RGF:dl

CH & SLOVAK
Enterprise Fund
ERICAN

May 10, 1995

Dr. Deborah Prindle,
Chief, Program Assessment & Coordination Division
Europe and New Independent States Bureau
ENI/PCS/PAC, Room 3320A New State
U.S. Agency for International Development
Washington, D.C. 20523-0057

Re: DAI Evaluation

Dear Dr. Prindle:

Enclosed please find a copy of our response to the DAI evaluation. Please note that we are responding to the draft labeled "Final Report" dated April 1995, which we received on April 14, 1995. That report did not include Annex F, Profiles of Investee Companies (listed as "in progress"). Given DAI's many inaccuracies, we cannot be sure whether the Profiles will require comment.

We continue to protest the release of the DAI report given its many errors of fact, its flawed analysis, and DAI's unwillingness to correct the draft based on the comments we and the other Enterprise Funds provided. The American taxpayer has not been well served by this process.

If you have any questions regarding our response, please let me know.

Sincerely,

Paul Gibian

Paul Gibian

Attachment

cc: Karen Brown

1620 Eye Street NW, 7th Floor, Washington DC 20006 USA
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CSAEF RESPONSE TO THE DAI REPORT

The "Summary of Collective Comments" and the individual comments of our sister Enterprise Funds (EFs) respond forcefully to many of the issues raised by DAI, to the point that the reader should question the value of the DAI report as a whole, and the validity of many of its conclusions. The report fails to evaluate the EFs in terms of the legislative mandate, ignores the importance of the Board of Directors on corporate governance, uses static analysis to draw conclusions about dynamic organizations operating in dynamic environments, and makes irrelevant comparisons between the EFs and institutions such as SBICs and banks.

DAI asks the wrong questions, makes factual errors, and draws the wrong conclusions not only as they relate to the overall EF program, but also as they relate to the performance of the CSAEF.

The CSAEF has achieved its legislative mandate of sponsoring entrepreneurship in the two Republics. Acting either as a catalyst or as a direct investor, the CSAEF has introduced the practicalities of private investment and the free market economy more broadly and sooner than would have been accomplished otherwise. More needs to be done, and we are continually adapting our program to meet the changing realities of the two nations in transition, but we are on the right track.

In four years, the CSAEF has invested in 47 companies directly and lent to over 35 companies through its joint lending programs. The CSAEF has made more direct investments in the two Republics than all of the private equity funds combined; in Slovakia, the CSAEF is the second largest U.S. investor of any type.

With each investment and loan has come significant knowledge transfer through experts provided under the Technical Assistance (TA) budget and through the hundreds of hours staff spend with the entrepreneurs, assisting the managers in the investments.

Other accomplishments: business training for over 2,000 bank lenders and entrepreneurs; bringing U.S. and Western technology and know-how through 13 joint ventures (valued at 40% of authorized investments); strengthening 3,000 jobs and over $10 million worth of exports (mostly to Western Europe).

DAI's conclusions fly in the face of the most important evaluator the CSAEF has -- other investors, who have backed their positive findings about the CSAEF with cold cash.

> The European Bank for Reconstruction and Development (EBRD) has invested over $11 million in two projects established by the CSAEF. The financial investors Flemings and the Japan International Development Organization (JAIDO) have co-invested with CSAEF in several instances. Two investments recently approved by the CSAEF Board of Directors will, if successfully completed, bring co-investment from the IFC in its first investment in Slovakia, and Renaissance Partners in its first investment in the Czech Republic.

In the face of its accomplishments and the conditions in the two Republics, one has to question why DAI is so critical of the CSAEF.

One reason could be that the CSAEF has recorded significant reserves (22% at 9/30/94) to signal the high-risk nature of its portfolio. The PAEF and HAEF also have had problem investments, but have offset those with gains on successful investments. The CSAEF has not yet recorded such gains; in part because we are one-year younger than our sister funds. More important, our earliest investments were in start-up companies, which are the riskiest type of investments and which take the longest to mature and exit.

> With the economy still in State hands, and a coupon-privatization policy that did not favor private equity investors, the decision the CSAEF faced was to take the risk of start-ups or sit on the sidelines. We chose to act, as Congress intended.

> Prior to voucher privatization, there were few publicly traded investments available in the Czech & Slovak Republics, and it was not clear that at the time the CSAEF could have played a useful role to broaden the traded market by such investing. Further, the CSAEF did not consider it important to its mission to invest in already successful large companies, since such investments would not have added enough incrementally to the success of those ventures.

Another reason seems to be that since the Czech Republic has "the most conducive country conditions in Eastern Europe" (page 33), DAI believes the CAEF should have the best performance record. Such analysis is at best superficial. In fact, it ignores the many issues which impact the longer-term performance of venture capital investments of the kind in which the CSAEF is engaged.

> Specifically, we believe that this analysis ignores the reality of the starting conditions in 1989 for private enterprise in Czechoslovakia with less than 5% of the economy in private hands compared with the 25% range in Poland and Hungary. The number of entrepreneurs and managers who had some semblance of business experience was severely limited. While the situation is improving, a shortage of good managers persists to this day. Though successful for the economy, the voucher privatization scheme effectively excluded the Fund from participating in the kinds of investments which have been successful for PAEF and HAEF. These factors must be considered in any evaluation.

Another reason is CAEF management and staff turnover; yet, DAI does not seem to give any weight to four years of continuous, respected, senior management at the SAEF.

> At the staff level, we described to DAI during their visit in the summer of 1994 our program to recruit and train more talented local investment managers for long-term positions with the Fund. This initiative began before the DAI team visited the Republics and it continues today. DAI does not mention this, but continues (as it does in so many areas) to use a static analysis in a dynamic environment. In any event, competence will continue to be our guiding principle in staff selection, not nationality.

The SEED Act charges the Enterprise Funds with "promote[ing] the development of the private sector." The CSAEF has been doing so since inception, and is a vibrant part of the U.S. foreign policy effort in the Republics. With the experience and programs we have established to date, we expect to make an even stronger contribution to this goal in the coming years.

Have we made mistakes? Of course. We have had more management turnover in the Czech Republic than we would have liked. Early on, we did not fully appreciate just how much help some investee managers would need in finance and marketing. In some instances, we did not recognize how quickly competitors would enter our investee markets. We and the other EFs needed to establish ourselves quickly in a new and uncertain market, so mistakes were to be expected.

Are there lessons to be learned that could benefit EFs just getting underway? Yes, one of which may be the importance of their Boards' addressing early on how to set priorities and develop personnel given multiple avenues available for carrying out the Fund's mission: assisting in privatization of state-owned companies, investing in young enterprises, encouraging joint ventures, developing small loan programs, undertaking technical assistance, raising private funds. By failing to address the essence of the EF experience in general, or the CSAEF's experience in particular, DAI's recommendations on these matters are of little value.

What is perhaps most frustrating is the number of misstatements of fact remaining in the DAI Report regarding the CSAEF, particularly since the CSAEF provided corrections to DAI after receiving the initial DAI draft. The most significant of these errors include (Quotations are from the DAI Report unless otherwise noted):

Page 6. "CSAEF chose to avoid retail and service investments." Not True. The only exclusion that we have stated has been restaurants and bars. As we informed DAI, over the past four years, the Board has authorized at least 11 investments with significant retail components.

Page 8. Note 2 states: "The definitions most often used by USAID [for small and medium sized enterprises are] as follows:

Microenterprise	<10 employees
Small	10-50
Medium	50-100."

No mention is made that the CSAEF direct investments average 77 employees per company. The size of a company clearly can have an effect on cost of operations. The size of a company may also affect the EF's impact on the country, yet DAI never considers whether an investment portfolio is better when focused on smaller or larger companies.

Page 14 and page 26. CES Uniweb and Tesla Y.S. investments were not privatizations, but start-ups with local and foreign companies. NZ Foundry was not a privatization, but second-stage investment. DAI calls the NZ Foundry "one of the worst" investments. Odd, considering that several U.S. foundry consultants reviewed the Foundry's operations in detail both before and after the investment was made. The latest expert opinion is that, while currently in difficulty, NZ Foundry can become a competitive, viable business, given its employees' excellent work ethic and technical ability in middle management.

Page 15. "Among the more significant joint venture failures have been :"

Ameribif. "..owner never obtained operating license." Not true. The American owner obtained a one-year temporary operating license, but was unable to obtain a permanent license.

AgManagement. "The U.S. partner has been unable to produce markets as promised....". Not true. The problem has not been an inability by the U.S. partner to produce markets, since several specific opportunities have been identified, but rather start-up delays and herd disease which is delaying export to the Czech Republic and the European Union. The investment will create significant upgrading of beef cattle herds for Slovakia, and we expect to recover our investment.

Leader Gasket (Pages 15 & 26). Characterizing this investment as "a significant joint venture failure" is ludicrous and the judgment of the DAI evaluator must be questioned. The DAI report states that Leader is a success in revenue and employment terms. The Slovakia-based U.S. Managing Director has developed and trained a first class Slovak management team, the company is successfully penetrating the Western European markets, the company has just received ISO 9001 quality certification (less than 20 are so certified in Slovakia, and the secondary effect of training a world class team is incalculable).

Note 11 on page 26 is not correct. The U.S. partner management fee is a fixed amount and not "7% of revenues" as stated in the DAI report. It will be a lower percentage as revenues increase. It does not "effectively eliminate any profit for CSAEF and any other investor" as stated on page 26, note 11.

Page 17. Use of TA. The DAI report states that "CSAEF...has a philosophy that any company worthy of receiving an investment should not need technical assistance, so its approach is much more hands off." Not true. This is absolutely not our philosophy. We alerted DAI to this in our comments on their draft report, and of course anyone reading our Annual Reports over the past several years would know that we are a hands on investor utilizing our staff and TA resources to do whatever is possible to make our investees successful.

We are actively involved as advisors to our companies and consider this to be an integral part of investment activity. Our investment officers and staff members are active in company management and on supervisory boards. In addition, more than half of our investees have had the benefit of TA projects to help them, primarily in the areas of marketing and financial control.

Our emphasis on TA and hands-on approach highlights another serious error in DAI's overall methodology; namely, their assumption that whatever they found during their one-week site visits will remain static. These are dynamic environments. Companies that look promising today may have serious problems in the future. More important, with active involvement from the EF, companies looking troubled today may be the success stories of next year or the year after.

Page 27. "It is not clear just how one defines start-up....Most of the small loan clients have been in business for very short periods of time, and yet the loss rates on these investments appear to be within an acceptable range. Therefore, relative to other risk factors and options, investing in a 'start-up' company does not, by itself, appear to change the overall loss expectations".

DAI's statement regarding business in operation for a short period of time is contradicted by the facts. A June 1994 Ernst & Young study of French venture capital showed that from 1978-1992 venture investments in "early stage" companies had a negative internal rate of return (IRR) while investments in later stage companies were profitable. We cited this study in our Annual Report, but DAI ignored it.

Many of the CSAEF's start-up companies were pure start-ups that did not have any prior operating history, since the communists did not allow for private business to operate for even "very short periods of time." Such start-ups clearly do have higher risks than companies already in operation.

Start-up companies take the longest to mature, and even in the U.S. many successful start-ups get off to shaky starts. It will be a few more years before a verdict can be reached on many of the CSAEF's start-up investments.

Page 30. The data for CSAEF contains errors (to which we alerted DAI after seeing their first draft). It should conform to the 1994 Annual Report audited financials which were available to DAI. For example, the table shows Total Assets at $23,732,000 while the Annual Report shows $26,591,234. Cash is shown at $7,699,000 while the Annual Report shows cash at $2,823,534.

Page 31. "training of more than 200 host country professionals..." CSAEF alone trained more than 2000 bar ers, entrepreneurs and staff personnel.

Page 35. "CSAEF, the only multiple country program that was reviewed, has higher rather than lower costs." Not true. The EFs' Annual Reports for FY94 indicate the opposite, with the CSAEF having the lowest per country cost, at $1,242,000, or $2,484,000 for the two countries.

> DAI also states that the overall operating costs for small loan programs should be limited to about $1 million per year. Yet the PAEF's program, which DAI rightly praises throughout the report, cost $2 million in FY94.

DAI has even failed to correct simple numbers in many of its charts, after the CSAEF pointed out these errors from the earlier DAI draft. A few of the errors include:

> Page 8 (Table 1): The Direct Portfolio figures (amounts funded as of 9/30/94) for the CAEF are 20 investments with a total value of $7 million. For joint lending, the Czech Republic figure is $733,000 and the Slovak figure is $570,000 (DAI's chart seems to show the total funded, including the share funded by the local bank).

> Page 23 (Table 5): To arrive at administrative costs as a percentage of initial capitalization, DAI includes the cost to administer Technical Assistance (TA) Grants in the numerator. DAI leaves the TA funds out of the denominator, even though those monies were provided by the USG as part of the program "capitalization." The correct figure for CSAEF's Administrative Costs as a % of initial capitalization for FY94 is 3.8% rather than the 4.1% shown in the Table.

Some of these misstatements tend to put CSAEF in a bad light; we cannot understand why they were not corrected.

The mass of errors and misstatements embodied in the DAI Report is startling. The fact that so many of these mistakes were brought to DAI's (and AID's) attention prior to publication, but were left uncorrected, is even more disturbing.

It gives one pause in evaluating the validity of the more generic DAI findings and recommendations. Were these findings and recommendations based on accurate, validated information, or is their foundation similarly flawed and deserving of a skeptical review?

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May 4, 1995

Dr. Deborah Prindle
Chief, Program Assessment & Coordination Division
Program Coordination & Strategy Office
Europe and New Independent States Bureau
ENI/PCS/PAC, Room 3320A New State
U.S. Agency for International Development
Washington, DC 20523-0057

Dear Dr. Prindle:

The purpose of this letter is to respond to the Draft DAI Enterprise Fund Evaluation Report, dated April 1995.

The study covers a lot of ground. All things considered, it shows an understanding of the various Funds and captures many of the strategic and governance issues that have concerned all of us. Nevertheless, although the DAI team undoubtedly worked hard, it was a large group pressed by a constantly changing, often compromised whirlwind schedule. One consequence is that the report is more an assemblage of data and not integrated opinions than a reasoned evaluation and a roadmap for constructive change.

The single largest failing of the report is its ignoring of the different conditions of each country prior to 1989 and, indeed, of the unique circumstances faced by each Fund. Thus, the report fails to take into account the different Board directed strategies of each Fund. This static, "snapshot approach" does not capture the dynamic setting in each country. In fact, "freezing" the evaluation especially misleads in Bulgaria where we are the newest Fund operating in the toughest market. The report also omits one vital attribute of Fund governance and in our opinion, draws some erroneous conclusions. We welcome the opportunity to address these for the record.

We will elaborate on a number of these topics in the balance of this letter, specifically:

1. Bulgaria is uniquely different and difficult compared to its Northern neighbors. Regardless of whatever carefully crafted strategy might have been initially adopted in 1992, slower progress and surprises were to be expected. The comparatively slow rate of foreign investment in Bulgaria reflects these differences and explains much of the difficulty the BAEF encountered.

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Dr. Deborah Prindle
May 4, 1995 -- Page 2

2. The report concludes that the BAEF is overstaffed and expensive compared to U.S. venture capital norms (a "straw man" comparison, in our view) and cannot become financially self-sufficient (an erroneous conclusion), and implies that the BAEF Board of Directors (none of whom were interviewed by DAI) have been negligent in allowing this situation to develop.

In fact, the Fund's strategy with respect to investments, staffing and office configuration has been developed in conjunction with the Board. Management and the Board continually review this investment and organizational strategy in the most hands-on way and have not hesitated to make course changes that reflect the latest information. In the Board's judgment the present approach continues to be the best way to achieve long-term success and viability for the BAEF.

3. The DAI report does not give full credit for the Fund's recent improvement in investment activity and performance brought about by its new strategy or its prospects for achieving economic self-sufficiency. Our analysis suggests that the BAEF will achieve sustainability. However, we will accomplish this in the next few years by building the business, not by reducing expenses and drawing back in our market presence, as the DAI recommendations would imply.

THE INVESTMENT ENVIRONMENT/
FUND OPPORTUNITY IN BULGARIA

When the BAEF began operations in Sofia in the summer of 1992, the Fund encountered different conditions than in the more developed economies of Poland, Hungary and the Czech Republic. There was little tradition of private enterprise -- only about five percent of businesses were in private hands, mostly those of small merchants. The economy was dominated by large, state-owned enterprises, with near total collectivization of the agricultural sector. Meanwhile, BulgariaÕs major export markets, the former Soviet and COMECON countries, were collapsing and/or disappearing. The war in Yugoslavia and the Serbian embargo compounded the economic decline and blocked the emerging trade routes to Western Europe. In response, Bulgaria looked to the West for assistance but garnered little as most Western investors were preoccupied with the surer opportunities to the North. Later, political turmoil and institutional gridlock added to these difficulties.

Moreover, Bulgaria has a markedly different history from its Northern peers. These precedents had a profound impact on the political and economic environment encountered by the BAEF. In short, Bulgaria is not a Central European country with a long history prior to 1945 of integration into Western Europe. Rather, Bulgaria is a Balkan country that after 500 years under the Ottoman yoke enjoyed a

Dr. Deborah Prindle
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brief 65 years of quasi-independence before becoming what was often called the 16th Republic of the Soviet Union, an appellation reflecting the closed and eastward looking nature of the country. As a result there are important societal differences; free enterprise is half-hearted and the investment climate is rudimentary at best.

The BAEF's first efforts were directed at finding the right strategy and building a staff capability for what obviously was going to be a difficult, long road. Two directors with prior experience in Bulgaria were very active and helpful in this regard and the entire Board has helped to reshape BAEF strategy as experience dictated. Thus, it is not surprising that it was difficult to make a lot of investments right away.

However, the DAI report concludes "Investment performance is much more a function of staff capabilities and strategic approaches adopted by each Fund, and much less a function of the country conditions and the stage of economic development." That confuses Bulgaria with Kansas. There was essentially no Western investment in Bulgaria and no staff with the requisite training. The BAEF had to define the strategy and build the staff. This took time in an extraordinarily difficult environment which in turn, retarded this process.

External data confirms that a comparatively slow pace in Bulgaria was inevitable and to be expected. Appendix D of the DAI report shows that between 1990 and 1993 foreign direct investment in Hungary exceeded $5 billion while in the same period Bulgaria attracted only $160 million -- a ratio of more than 33 times as much foreign investment in Hungary. Later in Appendix D it points out that from 1992 to 1994 Hungary received $171 million of disbursements from the EBRD, while Bulgaria received $2 million. During the same period, the IFC committed $61 million to Hungry and $0 to Bulgaria. Anecdotally, one of the most famous names in American business, a fast food franchiser with ubiquitous global operations, has described Bulgaria as the most difficult place to do business in the entire world.

The DAI report seems to further contradict itself (Chapter 4, Inquiry Area #13) when they acknowledge that new funds in "Romania, Albania, Ukraine, Russia, and Central Asia should expect conditions which resemble Bulgaria more than the Czech Republic or Hungary." This, we believe, is correct for it implicitly recognizes that certain countries in the Balkans or elsewhere are far more difficult than others. The report goes on to say that "these extra complications do argue for a cautious approach and for developing a staff of knowledgeable locals who can navigate the complex web of impediments." Stated otherwise, take the time to do it right. We agree, and have, we believe, done so.

Dr. Deborah Prindle
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THE BAEF'S
EVOLVING STRATEGY

The Fund's strategy with respect to investments, staffing and office configuration has been developed in conjunction with the Board. Management and the Board continuously review this investment and organizational strategy. The present approach, in the Board's judgment, is consistent with achieving long-term success and viability for the BAEF.

Investment Focus

The DAI report asserts that the BAEF's early investment efforts were misdirected and that with a better strategy would have found more deals and improved output. This is equivalent to saying that one should only buy stocks that treble in value. In an investment terrain with no landmarks we had to "find" the right strategy and then to develop and implement it. It takes time and mistakes can happen, particularly before a base of experience is built. And, as we will discuss, we pursued small loan programs virtually from the outset, and while that too was difficult, it is now bearing fruit.

We started out with the objective of creating expertise in three high potential areas of the Bulgarian economy: food/agri-business, tourism and electronics. We intended to invest across a wide spectrum of size, relying on the BAEF staff to handle larger deals and to create specialized vehicles for accomplishing the funding of smaller enterprises.

ShoreBank was contacted in October, 1991 before the BAEF was even officially formed and our first contacts with Opportunity International were in June 1992, the same month we opened the Sofia office. By September, 1992 we were negotiating agreements with both of them, approximately three months after commencing operations in Sofia. The Opportunity International Program began in January 1993, and the first attempt at a ShoreBank program through one Bulgarian bank was proposed at the same time but later discontinued in favor of the multi-bank program that we have today.

We gave this initial strategy about one year but found that our efforts at developing larger deals in Bulgaria did not materialize as we originally hoped. Therefore, in September of 1993 we shifted even more emphasis into our two small loan programs and created our Hotel and Tourism lending program. With the active assistance of our Board, we also stepped up our efforts to bring US investors to Bulgaria. This resulted in the Struma Foods project with Tri-Valley Growers and a backlog of five other high profile, "flagship" joint investees with whom we are working. Additionally, we also have a specialized program that lends in Dairy and one pending in Swine.

Today we have the broad-based program that we set out to establish three years ago. We have modified our approach through trial and error. It more closely matches the special Bulgarian environment and it is beginning to work. The BAEF is approving 25+ investments per month with a corresponding build in total commitments and disbursements. As a result we are headed toward reaching our investment goals.

Staffing/Expense Levels

Management and the Board are quite aware of the cost of running the BAEF. In fact, BAEF staffing which accounts for 56% of our budget and all other expenses are the result of a deliberate strategy and intense scrutiny by the Board. The Board takes a businessman's view of what makes sense and what doesn't.

Staffing and strategy are linked. We agree with DAI's conclusion that the "Funds can achieve their greatest impact when they work across a broad spectrum of the SME market and not limit themselves to either larger venture capital investments or micro-enterprise loans." What DAI failed to add is that it takes people to do this, which in turn translates into expense. This is because deals do not come to us in a bankable form and almost every proposal requires extensive rework.

Our longer term staffing strategy is to build a local Bulgarian staff. However, our first attempts at hiring locals simply did not turn up any experienced Bulgarian candidates that had the education, experience, outlook and motivation necessary to do the job. When one or two qualified Bulgarian candidates were identified, the BAEF salary paled by comparison to private sector alternatives in the west. As a result, we decided on a hybrid strategy whereby we would use a mix of MBA Corps candidates alongside younger Bulgarians who initially would act as Investment Analysts but who over time would step into Investment Manager roles. We chose MBA Corps candidates from top schools that had relevant prior experience. They have all extended giving additional continuity.

We did not pick this approach; it was dictated by local circumstances. Notwithstanding the difficulties, we are building a strong, increasingly Bulgarian staff and have found this approach to be cost effective. We like the way it is developing and so does our staff.

U.S. Office Presence

The DAI report states that "the largest single avoidable cost was the cost of U.S. investment staff." This is not supported by the facts in the report nor do we recall any serious inquiry on the subject by DAI. The BAEF does not have U.S. investment staff.

The BAEF operates principally out of Sofia. Today, we have 22 people in Sofia and four in Chicago, one of which spends about 40% of his time in Bulgaria.

The BAEF does operate a four person office in Chicago. In the case of the president, he spends about 25% of his time on U.S.-side investment opportunities for Bulgarian enterprises and the Director of the Chicago Office about 50% of her time similarly. This U.S. presence has resulted in one of our most visible deals (Tri-Valley Growers) and there is a possibility of several other high-profile deals within the next year. This has not been a source of problems as referred to in the DAI report. Additionally, we have been helpful to hundreds of American businesses evaluating investment possibilities in Bulgaria. Finally, our most likely early successes at raising money appear to be from U.S. investors. We could not access them as readily without a presence in the United States.

The rest of the office activities are spent on items that might in theory be done in Sofia but are much more easily handled in the United States where there are better communications and we are not separated by eight time zones. Included in these are financial reporting to AID, annual auditing, director relationships and participation and control of our undisbursed funds, which we keep in the United States. Our analysis of this issue, initiated last year by our Board, showed that there would be little if any savings from operating solely out of Sofia but that there would be a substantial negative impact on effectiveness, control, and possibly management continuity. DAI seems to confirm this indirectly by acknowledging that field reporting might necessitate a contractor relationship.

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In summary, strategy selection and development take time. It is hard to put out money in larger deals in Bulgaria but we feel that we have been timely and done well to discover several different niches where the BAEF can participate. At the same time, the Board is acutely aware of cost issues and endorses the current operating plan. The BAEF has maintained itself as the lowest cost Fund, recognizing not only that the moneys are tax payer dollars, but that it is easier to become self-sufficient at a low overhead level.

ACHIEVING ECONOMIC
SELF-SUFFICIENCY

DAI comments in the Summary of Findings and Conclusions regarding financial results that "For BAEF it is too early to tell. Early results are not positive, but if it can continue its more recent pace of investing while simultaneously reducing its costs, its future could be more positive."

The various ratios between expenses, income, and investment must be understood and eventually met. However, in the early years of a Fund, particularly if a difficult environment leads to a slow start, it is patently obvious that the ratios will be unfavorable. The real question is whether successful levels are reached over the life cycle of the Fund, which can be up to 15 years, or another 12 years for the BAEF.

The DAI report states "that current experience indicates that at best Funds can expect to realize a cash yield in the range of 3 percent to 5 percent per year." The range appears to be much higher as we examine each of our programs. At BAEF, loan income after providing for bad debts is estimated at 5 percent on Nachala to 10+ percent on some high grade mortgages. Equity deals should on average be better, though we acknowledge that our early experience has not been good. Consequently, a portfolio of performing assets in the area of $25 to $35 million would be sufficient to break even on a $2 million overhead. This is our present overhead level but it should decline once the portfolio is mature, allowing for even better performance.

The BAEF is committed to achieving economic self-sufficiency as soon as possible. The recent experience is quite positive and suggests that the BAEF will achieve self-sufficiency in about 18 months to two years. However, as discussed earlier, this will be arrived at by building the business, not by retreating to a diminished presence.

$thousand	Activity 1st Three Months following DAI Report		
	9/94	1/95	Change (%)
#Deals	160	244	+53
$Disbursed	$4174	$5963	+43

As can be seen from the change in activity in just the past three months, the static "snapshot" taken at September 30, 1994 does not capture the improving prospects

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for the Fund that are embodied in the strategy of management and the Board. Rather, we see a progressive improvement which already is partially reflected.

ADDITIONAL COMMENTS

1. Inappropriate U.S. Venture Capital Comparisons. The report makes more of the "Venture Capital" model than was intended by the legislation or by the various Boards of Directors that are implementing the SEED Act. The U.S. Venture Capital industry, which began after World War II and came to its present maturity in the 1980's was at best a faint metaphor, not a predictive model for Enterprise Funds. To use them as a standard is to ignore the manifold difficulties presented by Eastern Europe's unpredictable and ever changing politics, fractured economies, primitive legal systems, entrenched communist bureaucracies and fictional accounting "standards". The Enterprise Funds cannot and should not be compared to the U.S. Venture Capital model which encounters none of these difficulties. The BAEF Chairman and two other directors, whose cumulative venture capital experience exceeds 90 years have serious reservations about this "straw man" comparison.

The Funds are venture capital in the sense of being in high risk environments and advancing moneys before normal bank financing is available, but they are also there before any true venture capital firms. The idea of duplicating venture capital is appropriate in the sense of bringing the insights and discipline of venture capitalists; however, ascribing expectations of venture capital returns and expense ratios based on Western models is inappropriate.

A much more realistic expectation is to make money over the life of the Fund despite the risks of collapsing economies, commercial anarchy and the other problems that are legion in Eastern and Central Europe.

2. Policy Impact. DAI asserts that the Funds have not been particularly effective at providing policy advice or influencing government actions. The Fund has had unparalleled access to senior government officials in Bulgaria, from the President on down. While the policy impact of the BAEF's interactions may have been "small" in a geo-political sense, they have been quite useful in advancing Western business practices, as envisaged by the SEED Act. For example, our numerous meetings with the President of the Bulgarian National Bank have succeeded in removing various burdensome and unnecessary hurdles that needlessly delayed BAEF disbursements, thereby denying BAEF funds to qualified, approved Bulgarian applicants. These efforts, undertaken by Sofia and U.S. staff and Board members is but one of many examples of small incremental policy changes.

Because of the disarray in Bulgarian politics, it is not clear that in Bulgaria anyone has been particularly successful at either giving or receiving constructive advice. However, the BAEF has and continues to act as an informal counselor to a number of high-ranking officials. In this and other ways, our operating model is having influence on business developments. Moreover, DAI should not dismiss some of the unheralded benefits of having real private sector people "on the ground" influencing Bulgaria's adoption of a modern market economy.

DAI then goes on to state if "USAID's development objectives are only at the policy and macro-economic level, Enterprise Funds are not a useful vehicle for achieving those objectives."

Unfortunately, policy makers in Bulgaria regardless of political party tend to be products of 40 years of history's most ill-conceived economic thinking. Few of them really understand the degree of freeing-up that the market economy requires. As a consequence, most embrace old ideas in new dress or remain stalled in indecision. The transformation in Bulgaria is happening anyway, but it is a "bottoms-up" transformation that is forcing the hands of policy makers. Thus, indirectly, Enterprise Fund activity increases the pressure to make the needed policy changes.

Another consideration is that advice on policy must be given over an extended period of time and it is helpful to know the territory. Enterprise Funds with their long-term commitment to the country have a significant advantage in knowledge, personal contacts and credibility over policy contractors who are less familiar, and come and go.

Finally, we can see no direct or indirect way that the BAEF's activity in influencing public policy has been harmful, an intimation made by DAI without specifying any particular Fund.

3. <u>Financial Institution Impass.</u> DAI states that "A class of strategic investments which are particularly supportive of the transition are investments in financial institutions." This sounds good but in practice has not been feasible in Bulgaria despite the BAEF's efforts. For example, as cited in the report, the three programs of the World Bank and the European Investment Bank are doing little or nothing. This is because the financial institutions are embroiled in their own problems, are often political, and seem to have little confidence in the small business sector. In many respects these institutions still epitomize the worst of what used to be, exactly what we are trying not to be.

4. Host Country Directors. The BAEF has not appointed host country directors for reasons related to the unpredictability of Bulgarian politics. It is an issue regularly considered by the BAEF Board which has decided to form a rotating advisory board of Bulgarians who will play a comparable role without some of the disadvantages of permanent board membership.

5. Role of the Board. The report pays scant attention to the critical role of the Board of Directors. In fact, DAI made no attempt to interview any of our non-management directors. Our bipartisan Board serves without pay, and is comprised of two U.S. Venture Capitalists, an international investor of considerable distinction, a CEO and a CFO of two NYSE manufacturing companies, a full-time commercial farmer and former U.S. Under Secretary of Agriculture, and a lawyer/environmentalist/Balkan expert who speaks and reads Bulgarian. Three carry the "Honorable" mantle. All give generously, without pay, of their time, talents, experiences and business networking capabilities for the BAEF. They set policy, approve budgets, scrutinize investments and promote Bulgaria to U.S. companies. Many visit Bulgaria frequently at their own expense between Board meetings to assist the staff and to meet with Bulgarian officials. That their contibutions, matched we believe by their counterparts in the other Enterprise Funds is omitted by DAI, does them a disservice and misses one of the most insightful contributions of the SEED Act to U.S. foreign assistance programs.

Various reasons attract each of them to service on our Board. But collectively their experience, insight, judgment and business contacts are invaluable in making day-to-day operating decisions as well as for planning the long-term strategy. They are well informed, demanding and are in the best position to evaluate how the Fund should operate.

CONCLUDING COMMENTS

In theory we have a rather straight forward mission. The Fund aims to promote the development of free enterprise and entrepreneurship in Bulgaria by investing long term in the Bulgarian private sector. The Fund attempts to use Western investment criteria and to earn a satisfactory rate of return. In practice it is not quite so simple but we are making progress.

The Fund is unique among U.S. government or other aid programs in that it places money for economic development directly into the hands of private Bulgarian citizens. It is similarly unique in that with reasonable luck the Fund will return all the moneys to the U.S. government with a small profit.

Dr. Deborah Prindle
May 4, 1995 -- Page 11

Today, the Fund is well down the learning curve. We are of sufficient size and appropriately targeted to have a significant impact on the development of the Bulgarian private sector. We still appear to be the only Fund of this sort in Bulgaria having a meaningful level of activity.

Finally, we continue to work with other elements of the American team in Bulgaria and welcome further discussion of these comments and how the Fund can better contribute to the overall mission.

Sincerely,

Stephen W. Fillo
Chairman

Frank L. Bauer
President

ANNEX C

THE BANKING SYSTEMS AND SMALL BUSINESS LENDING

THE BANKING SYSTEMS AND SMALL BUSINESS LENDING

The banking systems of Eastern Europe are undergoing their own transition from a command to a market economy. Historically in each country there had been one dominant commercial bank owned by the state, and other specialized state banks such as an agricultural bank, a foreign trade bank, and a state savings bank. Allocation of bank credit was as much a part of central planning as any other business activity: state-owned commercial banks were simply directed to make loans to state-owned businesses. They did not analyze financial results or projections, and simply relied on an implicit guarantee of repayment from the government. Since the governments no longer guarantee many of these transactions, the banks are left with portfolios of loans to troubled former state-owned enterprises.

When the economies opened up licenses for new private banks were granted, but most of these banks were poorly capitalized and managed. Many immediately made a series of badly underwritten, now problem loans. A number of these banks failed and had to be taken over by bank authorities. The banking authorities are now juggling the privatizing of state-owned banks, addressing the problem loan portfolios, and dealing with near-bankrupt private banks to stabilize the entire banking system.

In all of these countries, small business lending is still very limited, for a variety of reasons which are cited below:

- The banks have no history of lending to small businesses, and perceive them as very risky. They preferred to deal with much larger, "riskless" (i.e., state-owned) companies, thus are now looking to privatized large businesses and foreign joint ventures as their target market.
- Substantial loan losses have made the banks gun shy, and they are now not willing to take any risk at all.
- Top managements' attention is focused on workouts of the problem loan portfolio and/or privatization, and they have no interest in taking on new markets.
- The banks prefer to buy and hold government paper as assets, because no underwriting is needed and the interest rates are close to loan rates.
- Banking laws typically require banks to balance long term loans with deposits of similar terms. Virtually all of the commercial bank deposits are demand deposits, thus the banks have no funding to match with term loans.
- The small businesses themselves are generally new, thus do not have track records.
- If the banks lend they want great amounts of collateral (up to 200% of the loan amount), and/or only accept cash or real estate as collateral.
- Many businesses believe that bank officers only give loans if bribed. The variation on this is the perception that an inside contact is needed to get a loan. (One Hungarian bank keeps the composition of its credit committee secret, even to other people in the bank, to avoid accusations or implications of this type.)
- Bank officers have little or no training in credit assessment.
- Small business loans are regarded as too small to be profitable.

While all of these problems are being mitigated over time, they do point up the need for demonstration models and joint lending programs, and all of the Funds have instituted programs to deal with these circumstances.

JOINT BANK LENDING PROGRAMS

The Funds have established small loan programs that generally fall into one of two types: a joint bank lending program and a smaller loan program. Frequently the Fund establishes a separate division, or even a separate legal subsidiary to handle these programs, and the Fund's role may be administered under contract by another organization. The primary characteristic of the joint bank lending programs is that they had two objectives: to get capital to small businesses, as well as to train and encourage commercial banks to make small business loans directly. Loan sizes typically range from $20,000 to $100,000, and the credit is analyzed and approved both by the bank and the Fund. The expectation is that the Banks will learn new techniques of analysis and loan management under the guidance of the Fund, and later take on that market without further assistance of the Fund. Shown below are the Fund programs that fit this category:

Hungary:

Small Loan Program — This program was set up jointly with two commercial banks, with total funding set at $5 million for loans in the $10,000 - $100,000 range. Loans are made by the banks, with all funding coming from the Fund. Risk of loss for the initial $5 million of loans was split evenly between the bank and the Fund; as loans have been repaid and Funds available for relending the bank has assumed all risk of losses. (The Fund does not track relending activity but this has occurred.) First loans were made in December, 1990. The Fund paid for bank staff training in cash flow lending, and offers training and technical assistance to borrowers on an as-needed basis.

Poland:

Windows — This was a joint lending program set up by a Fund subsidiary, Enterprise Credit Corporation, with ten banks for loans up to $75,000. (This has since been increased to $500,000 but there are only a handful of loans more than $100,000.) The program was designed by South Shore Bank on a consultant basis, and included the training of 75 loan officers and 30 local staff members. Through dedication of staff at each of the banks (funded in part by technical assistance money) a loan "window" was opened, and made term loans based on analysis of cash flow. First loans were granted in December 1990.

Banks have been withdrawing from the Windows program since early 1994, so ECC has continued to make loans by establishing loan production offices in various major cities. 3,400 loan commitments have been made through the Windows program and ECC since 1990, although only about 72% of committed Funds have actually been disbursed. The program currently has 1,525 active borrowers, and ECC will be affiliating with the first Polish American Bank of Krakow so that it can expand its range of loan products and services. The Fund has provided $28 million of capital and a $12 million loan, of which $3 million has been drawn. The average loan size is about $28,000, and at present there is no minimum loan size.

Slovakia:

American Loan Program — This is a joint lending program with a commercial bank. All funding, interest income, and losses are borne 50 - 50 by the bank and the Fund, thus the bank's $3 million commitment should produce $6 million of loans. The program called for all potential borrowers to take a two day seminar on business planning. Over 1,000 people have attended this training, but the loan program has been underutilized as only 18 loans have been made since July, 1993. The program also trained bank loan officers in cash flow lending.

Czech Republic:

Joint Bank Lending Program — This program is identical to the Slovakian program in design, with similar results. $5,000,000 was committed by the Fund for the program (producing a $10 million loan pool) but only 17 loans have been made starting in September, 1993. In addition to factors cited below the low usage levels can be attributed to the program structure: since all funding and losses are shared equally, the bank has little incentive to do extensive analysis and underwriting for a loan that will only be half-sized.

Bulgaria:

Kompass — This is a joint lending program set up with four banks. It was designed by South Shore Bank on a consultant basis, and will be substantially the same as the original Windows program in Poland. In addition to local staff there are two people from South Shore Bank in Sofia to implement the program. $5 million has been committed for loan funding, and the first loans were made in September, 1994.

SMALLER LOAN PROGRAMS

The smaller loan programs are directly administered by the Fund or its agent, and are usually for amounts of less than $20,000. These programs may have some of the characteristics of micro programs, but are targeted to businesses and the structurally unemployed, not to the poor per se. For the Funds, small loans are generally those that would be made by banks, under conventional western banking conditions that do not presently exist in eastern Europe. The smaller loan programs include loans that would not be bankable because of administrative costs. The businesses participating in the programs are very similar, save need for different amounts of capital. It is also important to note that none of the Fund programs is anything other than a credit vehicle, as extensive training is not required and there are no social outreach aspects to the programs. As will be noted later the Funds have used some of the micro credit program techniques to lower administrative costs and as substitutes for collateral. The smaller loan programs include:

Hungary:

Micro Lending Program — This $400,000 program was established jointly with four local agencies starting in July, 1993, and some relending has occurred. Loans for this program are in the $2,500 - $20,000 range. The Fund has arranged for training for both agency lenders and borrowers, with the most recent program presented jointly with AID.

Poland:

Fundusz Mikro — This is a microenterprise lending project that is still on the drawing board. The Fund has committed $2,000,000 of loan funding, to be increased to as much as $20,000,000 depending on demand and program performance. Maximum loan size will be about $7,500. Once this program is running it should permit the ECC program to increase its minimum loan size to a more cost-effective amount.

Bulgaria:

Nachala — Designed and run by Opportunity International, this small loan program has made 139 loans and leases since startup in July, 1993. $1,500,000 of funding for loans has been committed, in addition to a $100,000 annual contribution from Technical Assistance funds for overhead.

Hotel Loan Program — $750,000 has been earmarked for loans to small bed & breakfast type hotels in resort areas of Bulgaria. The program has funded 15 loans since November, 1993.

Dairy Program — This is a new program started in July 1994 for Milkway - supplier dairy farmers to finance herd additions and improve facilities on a term basis. Working capital loans are also available. $250,000 has been allocated by the Fund, and four loans to two borrowers have been funded thus far.

ENTERPRISE FUND CONCEPT AND SMALL LOAN PROGRAMS

There are particular advantages to having the small loan programs run as a part of the Funds, rather than being established separately. These include:

- The business-like, professional atmosphere of the Fund carries over to the small loan programs. Even though none are truly self-sustaining at present, they are not treated as entitlements, and the management and procedures are very high caliber.

- Including the small loan programs as a part of a family of investment programs gives the borrowers alternative financing sources to go to once they outgrow a particular program.

- A Fund spends a lot of time and effort developing country knowledge particularly relevant to business and to foreign programs, including issues such as taxation and banking law requirements. If programs were established independently this research would have to be duplicated be each project.

PROGRAM DESIGN AND DEVELOPMENT EFFECT

As noted above part of the dual purpose of the joint bank lending programs was to encourage local bankers to make small business loans. Much of each Fund's technical assistance money has been devoted to training bankers, but overall the results have not been as successful as the small loan programs themselves. This appears to be due to the very difficult conditions under which the banks are operating, with no prior experience in lending to small businesses, a fixed idea that bigger is better (even if bigger is a state-owned enterprise that never repaid loans), large portfolios of problem loans that consume attention, an aversion to granting new credits because of the bad loan experience, and finally, government bonds that can be held as assets that pay as much as loan interest and require no underwriting and monitoring work.

The Polish Fund's Windows program was the most ambitious program for loan training, and was successful in this respect really only when the bank was committed to the program. Some banks have left the program because their announced target market was large businesses, and they truly had no interest in developing small loan customers. Others have since established substantial small business loan portfolios of their own, and continue to pursue the market. The training received by the lenders appears to have benefitted all the banks, and one banker indicated that the personnel who had been trained by the program were regarded as the "pillars of the credit department." Further, there appears to be widespread use of the application form that was developed for the program, as well as the committee format and analysis techniques.

While these joint lending programs initially tried to make small business credit available country-wide, in practice the programs were more successful when the focus was more narrow, and only a few people at the bank were charged with implementing the program. The Windows program is a good example of this. The program selected fifteen offices at some ten banks, located all around the country, and trained the staff that had been assigned by the bank to work exclusively on the project. This meant that the Windows staff did not have to promote the program to all bank employees at all branches, but could concentrate their efforts. The program worked well when the staff assigned were the bank's "best", and when there was little turnover.

The Hungarian Fund's experience reflects these lessons as well: it worked through one branch each of two major banks, and loans from other parts of the country were channeled through the branch. The program has had some problems with collections because of bank manager turnover or worse, unfilled slots. In recent months it has worked with bank management to get a committed staff for the portfolio, and has been able to clean up many of the problem loans. In establishing its micro program it learned from these problems, and used smaller, more local institutions as the bank partner. In this way it was able to simultaneously capture the attention of both the local managers and the senior management of the institution.

By contrast, the joint lending programs set up in the Czech Republic and Slovakia took a very broad brush approach, and this appears to be partially responsible for the low level of use of these programs, as the programs have only made about eighteen loans each over a fifteen month period. (These programs were designed and established before the Czech-Slovak split, so they have the same characteristics and many of the same problems.) A partner bank was selected in each country, and a five day training session was provided to some 250 loan officers. Unfortunately the turnover rate for loan officers is extremely high, due to low salaries, and very few of these lenders are still on staff. In this case it appears that the program would have been more effective if only a few people had been given more in-depth training, perhaps after agreeing to committed service terms.

In general the Bulgarian Fund appears to be taking the focused approach as well: the Nachala program is offered in three cities, selected in part by resources that the Nachala board could bring to bear. The small hotel loans are not granted haphazardly, rather, the Fund has put in the research time to get to know the tourism markets in specific towns. The dairy lending program is the most concentrated program of all, dealing only with the dairy farmers who sell to Milkway. (This is one case where the Fund's ability to serve both the small loan market and make major investments comes into play, since plans are for it will be a major shareholder in Milkway when it is privatized.)

Related to this point is the question of choosing the right bank to participate in the program. In general, participating with the largest banks has not worked, because the programs have been lost amid the bank's other priorities and focus on problem loan workouts. The bank has to want to participate for the right reasons as well. For instance, Komercni Banka, the Czech bank participant, indicated that they considered it politic, because of the prestige of the Fund at the time, to accept the invitation when asked. They were also interested in the training offered, but that was all completed over a year ago. Their target market is, and was, only the largest businesses, and it seems clear that they would drop the program if they could do so gracefully. The original banks participating in the Windows program did so because they were required to do so by the government: at least one of the Kompass participants indicated that it was participating because they thought it was good for the country, not because they expected to make money from the program. It will be interesting to see how actively that program is used.

On the other side it should be noted that the strength of the bank is a significant factor in the Fund's decision to seek bank partners. In 1991 in the Czech Republic, for instance, Komercni Banka was the only institution that was deemed strong enough to not fail: by contrast EC PHARE lost substantial small loan program monies when the Bank of Bohemia went under. Despite this, for the future it would be worth investigating the stability of smaller, more local institutions, since these are more likely to want the programs as an integral part of their operations.

Another significant characteristic of the small loan programs is that they are almost all pure credit programs, with no savings, training, or technical assistance components. Almost all of the businesses financed by the programs, including the Nachala clients, were existing businesses (albeit with short histories), and they themselves did not see the need for any training or other assistance.

Only the Czech-Slovak joint lending programs were designed to have an integral training component for borrowers. A two day training program was established and required for all would-be applicants, and over one thousand people attended these seminars in each country. Participants ranged from those who had vaguely considered going into business, to established small firms. The argument for having this requirement came from the fact that there were expected to be far more startup businesses because of a lack of entrepreneurial tradition in the country. In practice, however, the small loans granted under the program have been made to businesses with a track record or, at minimum, startups that had already done extensive planning. While several borrowers indicated that they had found the training useful, on the whole it appears that it was regarded mostly as a session on how to fill out the loan application forms. The Czech bank participant indicated that the applicants regarded the training as perfunctory, and that they further thought that they were automatically entitled to a loan once they had completed the program. While there may be some value to letting over two thousand people get an idea about business this should not be the main focus of effort, and the program should be designed to only pick up the serious participants.

Despite the fact that training and technical assistance was not a formal part of the small loan programs, Fund officers frequently did direct small loan participants to assistance sources. This was particularly evident in Hungary, where the program officer took the attitude that part of her function was to additionally assist businesses with their operations, not unlike the involvement that the Fund officers have with the direct investee companies. The Bulgarian Fund has arranged for technical advice for the small hotel operators, and paid for a brochure about the Bansko hotels, published in several languages, as well as the attendance of the Bansko hotel owners association at a tourism trade fair. Nachala has tried holding business training sessions for its loan recipients, but these have not been well attended. The Windows and Kompass programs have done very little outreach to clients.

One aspect of the loan programs which does not appear to have warranted much attention is the denomination of the loans, and this point should be considered when new loan programs are instituted. In general, loans are made in dollars and are repayable in dollars, primarily to preserve Fund capital, an element in the sustainability question. When the small businesses sell abroad, or use loan proceeds for equipment purchases abroad (which is common), they generate or need hard currency, but it seems unfair for a small, wholly domestic business to have to incur conversion costs on both ends of the transaction.

The Hungarian Fund created an unusual structure whereby it deposited dollars with the central bank and earned LIBOR, and the Hungarian bank participant then borrowed the same amount from the central bank in forints at the base rate for on-lending to small businesses. (A similar program was established in Slovakia to fund all crown-denominated loans, including those in the American Loan Program.) In this scheme the central bank essentially takes the foreign exchange risk, but the drawback is that the deposit and advance to the bank are for a set period of time, five years, thus all of the on-lending must be repaid by that date. While the loans originally granted under the program have been paid down or paid off, re-lending may be limited at the end of the five year period. The plan deserves attention as a solution to the needs of all parties, however, and the denomination question should be considered in setting the goals and plans of any new Fund.

SUSTAINABILITY

A final point for commentary on the small loan programs is their own sustainability. In establishing the joint lending programs all of the Funds seem to have held the view that if they could train the banks to make small loans, the banks would step into the role and the need for the Fund would disappear. This has not perfectly occurred, although some "normal" small business bank credit now appears to be available in the Czech Republic and in Poland. The Windows program has largely been dissolved, because virtually all of the banks have withdrawn from the program (reasons cited include lack of cost-effectiveness (including withdrawal of subsidies), no interest in the small loan market, creation of own small loan program, and direct competition from ECC). Except in the Czech Republic and Slovakia (and unsuccessfully in both places) the Funds have not attempted to leverage their Funds. The Enterprise Credit Corporation, however, established a far stronger, better staffed organization than expected, plus had closer ties to the borrowers than it originally anticipated. Rather than dissolve the organization it was permitted to continue a life of its own, and established loan production offices in the cities where it previously had bank Windows.

Whether the other small loan programs become permanent fixtures in their host countries remains to be seen. On the whole they are likely to be bridge programs, because the banks should eventually catch up. Further, a large amount of capital is needed to establish a sustainable operation (ECC is capitalized with $28 million, and has another $12 million line of credit available, yet is just now making a profit with virtually no cost of capital.) Other than ECC the Nachala program seems to be the most likely candidate to be a permanent scheme, in part because many of its loans are less than bankable size, but also because of the strong staff that has been developed.

Small Loan Program Statistics as of September 30, 1994
(Figures for Employment and Business Startups are for Life of Program)

Program Name	Loans Outstanding[1] as of 9/30/94	Number of Loans	Average Loan Commitment	New Jobs Created	Total Employment	Business Startups
Hungary						
Small Loan Program	$,2,567,120	120	$40,225	507	760	29
Micro Loan Program	$243,830	46	$6,262	100	201	1
Poland						
Windows/ECC	$28,125,119	1,525	$26,444	8,486[2]	(est) 50,000	none
Slovakia						
American Loan Program	$1,092,000	17	$79,000	Not Avail	217	11
Czech Republic						
Joint Bank Lending Program	$1,494,260	18	$91,724	188	411	4
Bulgaria						
Nachala	$618,031	112	$5,805	402	787	28
Kompass	$66,500	1	$64,100	Not Avail	Not Avail	none
Small Hotels	$318,166	15	$27,510	43	55	none
Dairy	$38,700	4	$9,675	5	5	none

[1] For SAEF and CAEF, includes both bank and SAEF or CAEF funding.

[2] Program estimates that 10,280 jobs would be created based on 3,376 loans committed. 2,787 loans have been funded program to date, and figure shown above assumes that employment creation is proportional to loans funded/committed.

ANNEX D

EVOLUTION OF THE PRIVATE ENTERPRISE MARKET AND SUMMARY ECONOMIC DATA ON THE REGION

EVOLUTION OF THE PRIVATE ENTERPRISE MARKET AND SUMMARY ECONOMIC DATA ON THE REGION

Enterprise Funds were created to help the transitioning economies of Eastern Europe. The success of an Enterprise Fund, both in financial and developmental terms, lies in its ability to implement a program which is relevant to a changing market.

The economies of Communist countries emphasized state ownership of enterprises, and relied on non-market forces to direct production and resource allocation decisions. Prices of inputs and outputs were set by the state to achieve social and political objectives. Enormous inefficiencies and stagnation resulted eventually bankrupting the system. Communism did not collapse from outside pressure. It collapsed under the weight of its own inefficiency.

But transformation does not occur instantly. Besides the thousands of inefficient and non-competitive enterprises, the system contained an array of supporting institutions and structures. Some of the institutions still retain great power and influence and are highly resistant to change. Activities considered normal and routine within an established market economy can be enormously difficult in these transitioning economies because of the carry-over of outmoded and inconsistent rules, policies, and personnel.

One of the most immediate effects of the collapse of Communism was a dramatic drop in national output. All five countries suffered GDP declines in the range of 20 percent to 30 percent between 1990 and 1993. It now appears that the declines have stopped, and in some countries growth is accelerating. In every case, faster growth is highly correlated with the emergence of an active private sector. Estimates are that by 1995 the private sector share of GDP will range from 65 percent in the Czech Republic to 40 percent in Bulgaria.

The Czech Republic has succeeded to a far greater extent than the others in establishing price and currency stability. Inflation measured by the CPI is projected at 10 percent for 1994, and the currency value has remained virtually unchanged for three years. By comparison, Bulgaria's inflation rate still exceeds 50 percent per year, and its currency was devalued about 60 percent against the dollar in 1994. Inflation rates in Slovakia, Poland, and Hungary all range from 15 percent to 30 percent and currency values have declined in similar amounts.

Hungary, Czech Republic, and to a lesser degree Poland are all attracting significant amounts of foreign direct investment. Foreign direct investment in Hungary exceeded $5 billion between 1990 and 1993. By comparison, Bulgaria has attracted only about $150 million during the same period. Hungary appears to be the only country with active private equity funds, but even those rely to a great extent on non-market sources such as EBRD. In every one of the countries, Enterprise Funds are recognized as one of the most significant sources of direct foreign investment.

While many types of businesses are emerging in these transitioning economies, there is considerable variation from country to country. In Poland and Hungary, for example, there were already many small private businesses. This independent entrepreneurial base represents a viable market for Enterprise Fund financing. In the other countries where there are far fewer experienced entrepreneurs, a Fund's market opportunities are far more limited.

The pace and form of privatization also varies quite considerably from country to country, and that difference affects the Fund's potential market. Czechoslovakia and Hungary privatized quickly. In Hungary many enterprises were privatized through share offerings, while in Czechoslovakia a system of vouchers was used. As a result, the HAEF invested in several initial public offerings of shares, while in Czechoslovakia the Fund was shut out of the first stage privatization. When Czechoslovakia split, the Czech Republic completed the voucher privatization while Slovakia delayed the process. In the Czech Republic there is now a potential for participation in second-stage financing of privatized and newly formed enterprises, while the opportunities in Slovakia continue to be more limited.

In Czechoslovakia, two types of factors combined in a way that has greatly limited the effectiveness of CSAEF. As noted previously, local market factors and the privatization process restricted CSAFE's potential market. Then the CSAEF Board set policies which effectively excluded the CSAEF from investing in much of the new emerging private market.[1] As a result, many of CSAEF's early investments operated at the periphery of the economy. Unfortunately, CSAEF has yet to find an effective position in the market and as a result its activities continue to be marginal.

In Poland there has been no mass privatization, but the country does permit individual privatizations involving combinations of management and investor groups. PAEF has developed an effective strategy of supporting these privatizations using a model similar to management buy-outs common in the U.S. PAEF has also undertaken a series of strategic investments in the financial services market and other key sectors, and has created the most effective small loan program of all of the Funds. The fact that PAEF had substantially more resources than other Funds allowed it to consider types and forms of investments which were not really possible for other Funds.

In Bulgaria the combination of a stalled privatization program and the historical absence of private entrepreneurship contribute to BAEF's slower pace of investment activity. The initial strategy of BAEF was directed to larger scale investments. Finding few such opportunities in the market, the pace of its investment was very slow. BAEF has now reoriented its strategy toward more emphasis on smaller loans, and very selective larger investments in strategic industries. While this shift is quite recent, early results appear to indicate that BAEF is finding a more effective entry point into the market.

Since these markets are transitioning, the market configurations will not remain fixed. As transformation proceeds, a wider range of investment opportunities will become available. Funds must continually evaluate and modify their strategies, introducing new programs as market opportunities permit, while evolving existing programs to support the growth of the emerging private market segments. Enterprise Funds should not be confined to a particular form of investing or a particular market segment, but should be free to operate across a wide spectrum of the small and medium enterprise market.

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[1]These included an emphasis on manufacturing and lower priority for retail and services, a preference for investing outside of Prague, an emphasis on generating current income from investing, and a more explicit consideration of socio-economic impacts than in other funds.

	1989	1990	1991	1992	1993	1994	proj 1995	Source	
Real GDP Growth	**Percent**								
Hungary	0.7	-3.5	-11.9	-4.3	-2.3	1.0	3.0	EBRD, 1995 DB	
Poland	0.2	-11.6	-7.8	1.5	3.8	4.5	3.0	EBRD, 1995 DB	
Czech Republic	1.4	-0.4	-14.2	-7.1	-0.3	3.0	3.5	EBRD, 1995 DB	
Slovak Republic	1.4	-0.4	-14.5	-7.0	-4.1	1.0	0.0	EBRD, 1995 DB	
Bulgaria	0.5	-9.1	-11.7	-5.6	-4.2	0.0	-1.0	EBRD, 1995 DB	
GDP (Billion 1993 Dollars)									1992 gdp from WDR1994
Hungary	48.0	46.3	40.8	39.0	38.1	38.5	39.7	Calc from EBRD	30.6
Poland	99.4	87.9	81.2	82.4	85.5	89.4	92.1	Calc from EBRD	73.3
Czech Republic	39.9	39.8	34.1	31.7	31.6	32.6	33.7	Calc from EBRD	25.2
Slovak Republic	14.4	14.3	12.2	11.4	10.9	11.0	11.0	Calc from EBRD	10.2
Bulgaria	17.3	15.7	13.9	13.1	12.5	12.5	12.4	Calc from EBRD	11.3
Consumer Price Index	**(Annual Average)**								
Hungary	17.0%	28.9%	35.0%	23.0%	22.5%	18.5%		EBRD	
Poland	251.1%	585.8%	70.3%	43.0%	35.3%	30.0%		EBRD	
Czech Republic	2.3%	10.8%	56.6%	11.1%	20.8%	10.0%		EBRD	
Slovak Republic	2.3%	10.8%	61.1%	9.9%	23.2%	15.0%		EBRD	
Bulgaria	6.4%	23.9%	333.5%	82.0%	73.0%	56.0%		EBRD	
GDP Deflator									
Hungary	18.4%	25.8%	25.6%	31.0%	24.3%	16.1%		IIF	
Poland	288.1%	480.1%	50.8%	34.6%	31.1%	32.1%		IIF	
Czech Republic									
Slovak Republic									
Bulgaria	4.9%	22.6%	227.0%	75.2%	73.0%	56.0%		IIF	
Unemployment									
Hungary	0.3	2.5	8	12.3	12.1	11.0	9.0	EBRD;DB 95	
Poland	0.1	6.1	11.8	13.6	15.7	14.5	12.0	EBRD;DB 94-95	
Czech Republic	0	0.8	4.1	2.6	3.5	6.0	8.0	EBRD;DB 95	
Slovak Republic	0	1.5	11.8	10.4	14.4	17.5	18.5	EBRD;DB 94-95	
Bulgaria	na	1.5	11.1	15.3	16.4	16.0	20.0	EBRD;DB 95	
Foreign Equity Investment	**$ Mn**								
Hungary	187	314	1,459	1,471	2,328	1,800	1,500	IIF	
Poland	15	10	117	284	580	800	1,200	IIF	
Czech Republic									
Slovak Republic									
Bulgaria	0	4	56	42	62	100	140	IIF	

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	1989	1990	1991	1992	1993	1994	proj. 1995	Source
Foreign Direct Investment	**$ Mn, from national BOP data**							
Hungary		311	1,459	1,471	2,200			EBRD
Poland		88	117	284	350			EBRD
Czech Republic		188	592	983	606			EBRD
Slovak Republic				71	160			EBRD
Bulgaria		4	56	42	62			EBRD
Private Sector Share of GDP							EBRD 94	
Hungary	26	30	37	50			55	
Poland							55	
Czech Republic				20	50		65	
Slovak Republic			5.2	21	28	43	55	
Bulgaria							40	
Private Sector GDP ($ B)								
Hungary	12	14	16	20			22	Calculated
Poland							51	Calculated
Czech Republic				6	16		22	Calculated
Slovak Republic			1	2	3	5	6	Calculated
Bulgaria							5	Calculated
Exchange Rate	**Per $, Annual Average**							
Hungary	59.1	63.2	74.8	79	91.9			IMF
Poland	1,446	9,500	10,583	13,631	18,145			IMF
Czech Republic	15.1	18	29.5	28.3	29.2			IMF
Slovak Republic	15.1	18	29.5	28.3	30.8			IMF
Bulgaria	1.8	5.7	17.7	23.4	27.9			IMF
Exports to OECD								
Hungary	4.4	5.7	6.7	7.3	8.8			EBRD
Poland	6.0	8.9	9.9	11.1	10.9			EBRD
Czech Republic	4.1	4.9	6.6	9.2	9.8			EBRD
Slovak Republic	w/Czech	w/Czech	w/Czech	w/Czech	w/Czech			EBRD
Bulgaria	0.8	1.0	1.3	1.6	2.9			EBRD
Imports from OECD								
Hungary	4.6	5.4	6.6	7.8	8.5			E[illegible]D
Poland	6.1	7.7	12.6	13.7	15.0			E[illegible]D
Czech Republic	3.6	4.9	6.3	10.8	11.0			E[illegible]D
Slovak Republic	w/Czech	w/Czech	w/Czech	w/Czech	w/Czech			E[illegible]
Bulgaria	2.4	1.6	1.7	1.9	2.0			E[illegible]

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	1989	1990	1991	1992	1993	1994	proj. 1995	Source
Exports to World								
Hungary	10.1	9.7	10.2	10.7	8.9			IMF
Poland	13.5	13.6	14.9	13.3	14.1			IMF
Czech Republic	14.5	11.8	10.9	11.3	12.9			IMF
Slovak Republic	w/Czech	w/Czech	w/Czech	w/Czech				
Bulgaria								
OECD Export Share								
Hungary	44%	59%	66%	68%	74%			
Poland	44%	65%	66%	84%	77%			
Czech Republic	28%	41%	60%	81%				
Slovak Republic	w/Czech	w/Czech	w/Czech	w/Czech				
Bulgaria								
Imports from World								
Hungary	8.7	8.7	11.4	11.1	12.6			IMF
Poland	10.7	8.4	15.8	15.7	18.8			IMF
Czech Republic	15.0	13.7	11.1	12.6	12.8			IMF
Slovak Republic								
Bulgaria								
OECD Import Share								
Hungary	53%	62%	58%	70%	68%			
Poland	57%	92%	80%	87%	80%			
Czech Republic	24%	35%	56%	86%				
Slovak Republic								
Bulgaria								
EBRD Commitments Mn ECUs								
Hungary		0	98	154	387			EBRD
Poland		0	88	396	207			EBRD
Czech Republic		0	35	146	113			EBRD
Slovak Republic		0	0	0	246			EBRD
Bulgaria		0	0	108	12			EBRD
EBRD Disbursements Mn ECUs								
Hungary		0	0	65	106			EBRD
Poland		0	0	16	64			EBRD
Czech Republic		0	0	41	26			EBRD
Slovak Republic		0	0	0	8			EBRD
Bulgaria		0	0	0	2			EBRD

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	1989	1990	1991	1992	1993	1994	proj. 1995	Source
[redacted]								

Selected Statistics
Enterprise Fund Countries

Country	Population	Purch. Power GDP	Wages 1993
	1992	1992	US$/Mo.
[redacted]			
Poland	38.4	4,880	194
[redacted]			
Slovak Republic	5.3	5,620	201
[redacted]			

ANNEX E

DETAILED FINANCIAL AND PORTFOLIO DATA ON THE FUNDS

Czech and Slovak American Enterprise Fund $000 Omitted

	FYE 30-Sep-92	FYE 30-Sep-93	FYE 30-Sep-94
Average Cash	3,094	5,099	9,094
Average Investments, Net	3,689	11,132	14,779
Average Performing Assets	6,784	16,231	23,874
Investment Income	193	580	1,037
Other Interest Income	112	228	605
Gross Investment Income	305	808	1,642
Less: Financing Cost	0	41	508
Net Investment Income	305	767	1,133
Administrative Costs	1,738	2,302	2,484
Less: Loan Loss Provision	200	1,400	2,750
Total Operating Expense	1,938	3,702	5,234
Net Operating Margin	(1,633)	(2,935)	(4,101)
Income/Avg Perform Assets	4.5%	4.7%	4.7%
Admin Costs/Avg Perform Assets	25.6%	14.2%	10.4%
Total Oper Costs/Avg Perf Assets	28.6%	22.8%	21.9%
Net Oper Margin/Avg Perf Assets	-24.1%	-18.1%	-17.2%
Venture Capital Measure:			
Administrative Costs	1,738	2,302	2,484
Initial Fund Capital	60,000	60,000	60,000
Admin Costs/Fund Capital	2.9%	3.8%	4.1%
Expense Covered by Investment Income:			
Investment Income	193	580	1,037
Other Interest Income	112	228	605
Gross Investment Income	305	808	1,642
Less: Financing Cost	0	41	508
Net Investment Income	305	767	1,133
Administrative Costs	1,738	2,302	2,484
Invest Income/Admin Expenses	17.6%	33.3%	45.6%
Total Operating Costs	1,938	3,702	5,234
Invest Income/Total Expenses	15.7%	20.7%	21.7%

Hungarian American Enterprise Fund $000 Omitted

	FYE 30-Sep-91	FYE 30-Sep-92	FYE 30-Sep-93	FYE 30-Sep-94
Average Cash	9,462	11,451	5,905	5,213
Average Direct Investments	3,528	15,475	27,248	28,747
Average Small Loans, Net	1,250	3,500	4,670	4,851
Average Performing Assets	14,240	30,426	37,822	38,811
Investment Income	0	435	954	848
Interest Income	640	416	143	256
Realized Capital Gains	0	166	212	1,249
Gross Investment Income	640	1,017	1,309	2,353
Administrative Costs	2127	2,761	3,701	2,901
Valuation Reserve	0	500	2,520	0
Minus: Unrealized Capital Gains	0	292	0	2,653
Total Operating Expenses	2,127	2,969	6,221	248
Net Operating Margin	(1,487)	(1,952)	(4,912)	2,105
Income/Avg Perform Assets	4.5%	3.3%	3.5%	6.1%
Admin Costs/Avg Perform Assets	14.9%	9.1%	9.8%	7.5%
Total Oper Costs/Avg Perf Assets	14.9%	9.8%	16.4%	0.6%
Net Oper Margin/Avg Perf Assets	-10.4%	-6.4%	-13.0%	5.4%
Venture Capital Measure:				
Administrative Costs	2,127	2,761	3,701	2,901
Initial Fund Capital	60,000	60,000	60,000	60,000
Admin Costs/Fund Capital	3.5%	4.6%	6.2%	4.8%
Expense Covered by Investment Income:				
Investment Income	0	435	954	848
Interest Income	640	416	143	256
Realized Capital Gains	0	166	212	1,249
Total Investment Income	640	1,017	1,309	2,353
Administrative Costs	2,127	2,761	3,701	2,901
Invest Income /Admin Expenses	30.1%	36.8%	35.4%	81.1%
Total Operating Costs	2,127	2,969	6,221	248
Invest Income /Total Expenses	30.1%	34.3%	21.0%	948.8%

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Polish American Enterprise Fund	Consolidated FYE 30-Sep-91	FYE 30-Sep-92	$000 Omitted FYE 30-Sep-93	FYE 30-Sep-94
Average Cash	30,845	32,855	25,199	8,070
Average Direct Investments	39,979	70,668	73,372	92,779
Average Small Loans, Net	0	7,261	18,473	25,120
Average Performing Assets	70,824	110,783	117,043	125,968
Investment Income	225	2,749	4,545	4,638
Interest Income	2,126	1,201	801	273
Gross Investment Income	2,351	3,950	5,346	4,911
Administrative Costs	3063	4,939	4,160	4,443
Valuation Reserve	25	4,298	4,620	2,551
Total Operating Expenses	3,088	9,237	8,780	6,994
Net Operating Margin	(737)	(5,287)	(3,434)	(2,083)
Foreign Exchange Loss	0	859	1,779	233
Net Oper Margin (Inflation Adjusted)	(737)	(6,146)	(5,213)	(2,316)
Income/Avg Perform Assets	3.3%	3.6%	4.6%	3.9%
Admin Costs/Avg Perform Assets	4.3%	4.5%	3.6%	3.5%
Total Oper Costs/Avg Perf Assets	4.4%	8.3%	7.5%	5.6%
Net Oper Margin/Avg Perf Assets	-1.0%	-4.8%	-2.9%	-1.7%
Net Oper Marg, Adj/Avg Perf Assets	-1.0%	-5.5%	-4.5%	-1.8%
Venture Capital Measure:				
Administrative Costs	3,063	4,939	4,160	4,443
Initial Fund Capital	240,000	240,000	240,000	240,000
Admin Costs/Fund Capital	1.3%	2.1%	1.7%	1.9%
Expense Covered by Investment Income:				
Investment Income	225	2,749	4,545	4,638
Interest Income	2,126	1,201	801	273
Gross Investment Income	2,351	3,950	5,346	4,911
Administrative Costs	3063	4,939	4,160	4,443
Invest Income/ Admin Expenses	76.8%	80.0%	128.5%	110.5%
Total Operating Expenses	3,088	9,237	8,780	6,994
Invest Income/Total Expenses	76.1%	42.8%	60.9%	70.2%

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Bulgarian American Enterprise Fund	$000 Omitted	
	FYE 30-Sep-93	FYE 30-Sep-94
Average Cash	1,702	3,407
Average Investments, Net	348	1,149
Average Performing Assets	2,051	4,557
Investment Income	154	150
Other Interest Income	0	0
Gross Investment Income	154	150
Administrative Costs	1,665	1,869
Valuation Reserve	1,869	140
Total Operating Expenses	3,534	2,009
Net Operating Margin	(3,380)	(1,858)
Income/Avg Perform Assets	7.5%	3.3%
Admin Costs/Avg Perform Assets	81.2%	41.0%
Total Oper Costs/Avg Perf Assets	172.4%	44.1%
Net Oper Margin/Avg Perf Assets	-164.8%	-40.8%
Venture Capital Measure:		
Administrative Costs	1,665	1,869
Initial Fund Capital	50,000	50,000
Admin Costs/Fund Capital	3.3%	3.7%
Expense Covered By Investment Income:		
Investment Income	154	150
Administrative Costs	1,665	1,869
Invest Income/Admin Expenses	9.3%	8.1%
Total Operating Costs	3,534	2,009
Invest Income/Total Expenses	4.4%	7.5%

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ANNEX F

PROFILES OF INVESTEE COMPANIES

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PROFILES OF INVESTEE COMPANIES

As part of the evaluation, the team visited approximately 140 of the companies that have received money from the enterprise funds. The team visited approximately half of the companies in which the funds had direct investments that are still active in the portfolios (about 40 companies), and almost 100 companies from the micro and small loan portfolios. Although the principal purpose of these visits was to observe the investing processes used by the funds, the visits also provided a unique window on the emerging private enterprise market in the five countries.

The companies were not selected randomly. There was an effort to select companies from the direct portfolios that generally mirrored the overall portfolios. The companies were chosen to provide a reasonable distribution of size, geography, business sector, and, company health. The team provided each fund with a proposed list of visits, and, with only minor exceptions, the funds arranged visits from the proposed list. With regard to the small loan recipients, the funds (or participating banks) selected the companies since the team had no prior knowledge of the company names or characteristics. Based on these 140 visits, the team has concluded that private enterprise is developing rapidly and competently throughout the region. Entrepreneurs are emerging from all sectors of the economy, from fully independent individual situations and from privatizations of state enterprises.

The enterprise funds have organized their portfolio around three types of transactions:

- **Direct Investments** — equity or debt/equity combinations in larger amounts to privatized enterprises or joint ventures;

- **Joint Bank Lending Programs** — dual purpose schemes to direct credit in the $20,000 - $200,000 range to small businesses as well as to encourage bank lending of that type; and

- **Small Loan Programs** — for less than bankable size small business loans, as well as lending programs to a specific industry.

Despite these different portfolio structures, the individual investee companies often cannot be categorized so easily. Some of the companies in the direct portfolios are actually smaller than those in the small loan programs. Similarly, the distinction between a "micro" and "small" loan often has more to do with the nature of the company and its financing needs and less to do with the basic character of the company or its entrepreneur. Unlike microenterprise programs in the Third World, in Eastern Europe there is rarely a cultural or class differentiation between microenterprises and other small businesses. The principal distinction is often simply that the microenterprise borrowers, who require less capital to start and operate their businesses, may have as much earnings potential as the larger small businesses.

The following are short profiles of companies visited during the evaluation. The purpose of this annex is to provide a bit more of a personal flavor to the report.

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PAEF's Investments in the Financial Sector

Through three separate investments, PAEF is having a significant influence on the financial sector in Poland. In 1991 PAEF purchased a 47 percent interest in a private bank in Kraków, which then came to be known as First Polish-American Bank (FPA Bank). Shortly after making the investment, PAEF realized that the FPA loan portfolio was more troubled than originally expected and that management was not capable of resolving the problem. Using its technical assistance funds, PAEF recruited a new chief executive and supplemented his salary for 18 months. PAEF also provided assistance to clean up the problem loans, install new management information systems, and initiate Western-style bank marketing programs at FPA. PAEF has converted a troubled bank into an efficient and profitable institution that was recently listed on the Warsaw Stock Exchange. Other banks in the market are now beginning to imitate FPA's marketing program and are also undertaking upgrades of their operations.

Polish-American Mortgage Bank (PAMBank) is a start-up institution in which PAEF owns 49 percent. PAMBank is the only institution in Poland currently offering term mortgages for home purchasing. It provides financing for home purchases and for construction. It has also spawned the formation of a housing development corporation to stimulate the development of new private housing. The PAMBank is not yet profitable and may well be several years ahead of the market, but it represents a willingness on the part of PAEF to invest in an activity whose development impact could be substantial once some macroeconomic and legal factors become more hospitable.

PAEF has a 20 percent ownership stake in the Agriculture Bank, and institution is being privatized. This institution invests in agroenterprise and rural development projects, making extensive use of government financing programs for small-scale rural enterprise and community infrastructure. Although PAEF's ownership stake in this institution is smaller than in FPA and PAMBank, PAEF has influenced the introduction of modern management practices into this former state enterprise.

The Loranger Joint Venture — Two Beneficial Outcomes from One Investment

The Loranger Company began as a family business in Warren, Pennsylvania, supplying components to Ford Motor Company. When Ford decided to open a facility in Hungary, Loranger was asked to establish a plant there, also. Although initially hesitant, financing from HAEF made Loranger more comfortable making such an investment in Hungary. Loranger and HAEF each invested $1.25 million, and each owns 50 percent of the Hungary operation. The plant has been operating for about one year and is a model of clean and efficient manufacturing practice. It currently employs about 100 Hungarians and 5 Americans.

While searching for a suitable site, Loranger came to an abandoned Russian military base. As part of the investment transaction, Loranger agreed to assist the local municipality market the additional industrial land to other users in return for allowing Loranger to occupy an existing building on the property. Loranger created a separate real estate joint venture with the local government, and has assisted in bringing three other companies onto the property. Currently these companies employ 125 people, but one company (Phillips Electronics) has the potential of bring as many as 5,000 employees into the community.

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Petofi — A Successful Privatization and Transformation

The Petofi Packaging Company was built on the remains of a bankrupt state-owned box company. HAEF invested about $2.5 million as part of a privatization transaction for which it received 10.1 percent of the company. In addition to its ownership, HAEF maintains a seat on the supervisory board. HAEF's presence, along with that of an Italian investor group, provided credibility and leadership to attract additional investment to transform and expand the company. The plant was completely rebuilt with modern equipment and processes, improving productivity by 166 percent and establishing Petofi as the leading packaging plant in Eastern Europe. Its 1993 sales were $53 million, with profits of $4.6 million. HAEF's investment has increased in value by 80 percent over the past three years.

Petofi is now being merged into a larger packaging conglomerate that will operate similar facilities in Poland and Czech Republic. HAEF's investment will be converted into shares in the new company. Over the next three years, it is expected that this larger enterprise will produce revenues of $110 million with a profit of $8-$9 million.

Struma Fruit — A Unique Agribusiness Joint Venture

Tri-Valley Growers of California and the BAEF have established a unique joint venture for the privatization of an agricultural area in Bulgaria. Because of uncertainties in ownership and marketing, the cherry orchards in a region of Bulgaria had been neglected. BAEF first hired Tri-Valley Growers to conduct a feasibility study on privatization of the orchards and then entered into a management and marketing agreement with the privatized company. BAEF's investment of $800,000 has allowed Struma Fruit to upgrade its production capability, while Tri-Valley Growers' management assistance has improved efficiency and marketing capability. Struma Fruit now processes the cherry production from private farms and markets the output throughout Europe.

PAEF's Investments in the Printing Sector

The largest investments have been made by PAEF in two related companies in the printing industry. As part of a privatization of Poland's state-owned print media, PAEF purchased 86 percent of a newspaper publishing company for approximately $16 million through its Polish-American Printing Association (PAPA). One year later, PAEF invested another $10 million in PAPA, which then established a joint venture with the R.H. Donneley Company, a large U.S.-owned multinational printing company. Through these investments, PAEF expects to provide high-quality printing services for newspapers, magazines, and other publications. This $26 million total investment is not yet profitable, but, because of marketing links to the Donneley Company, it is expected that the company will be profitable once it reaches full production levels.

NZ Foundry — A Troubled Privatization Investment

The NZ Foundry in the Slovak Republic is typical of the outmoded heavy industry of the old Soviet production system. NZ Foundry is a gray iron foundry that has existed under various owners and structures for almost 100 years. During the latter stages of communism, it was attempting to upgrade to higher quality precision castings, but could never obtain the resources from the state. Under the Czechoslovakian voucher privatization, NZ Foundry's ownership was transferred to a group of voucher

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funds, but little was done to change the operation. CSAEF has attempted to invest in the company in a way that would allow a precision casting unit to function within the company but be somewhat autonomous from the larger foundry operation. Unfortunately, it appears that some problems in the company are beginning to overwhelm the transformation. At least two members of the Slovakian management team were involved in fraudulent dealings that resulted in a loss of some of the CSAEF investment. In addition, losses and inefficiencies in the old foundry continue to drain capital from the company. CSAEF may yet be able to salvage its investment, but for now it continues to be a troubled situation with no clear turn-around in sight.

At least two important lessons emerge from the NZ Foundry case. First, a privatization that simply replaces the owners of a company without upgrading and modernizing operations is of little help to the company or the economic transformation. Second, when investing in a privatizing company, it is necessary to be in control of the operation in order to effect the necessary changes.

A Sampling of Smaller Loan Transactions

Almost 3,200 small businesses have received financing through the various micro and small loan programs of the funds. Most of these are family businesses or partnerships and corporations formed by friends or relatives. Some draw on earlier professional experiences of their founders, and others have been established by individuals with no prior experience either in business or in the particular technical activity.

In a small town outside of Budapest, two women started a clothing shop with a loan from HAEF's small loan program. They expanded by purchasing automated knitting machines to produce ladies hosiery. Operating from a tiny three-room facility, the company employs 12 people in three shifts. The loan was repaid early. The owners are now seeking financing to purchase a larger building and additional equipment.

In Kraków, a husband, wife, and daughter operate a bakery financed by PAEF's small loan program. Starting with one old oven, they have added two more automated ovens along with high-capacity mixing equipment. Using their own delivery vehicles, they now supply thousands of loaves of fresh bread to stores throughout the city and employ more than 40 workers in the bakery.

BAEF's small hotel program has financed 15 bed-and-breakfast hotels. Primarily located in the mountain ski resort or along the Black Sea coast, these are private homes that have added several sleeping rooms to rent out to guests. In the ski area of Bansko, the financing program is linked to a tourist bureau that markets the guest houses and brings in vacationers. The Russian national soccer team stays at one of the Black Sea hotels during practice sessions. These added guest rooms provide a supplemental source of income to the households.

When a state-owned sewing company in Bulgaria closed in 1991, one of the unemployed workers began sewing hems on bedsheets in her home on a contract with the Bulgarian army. As the work expanded, she leased machines from her former employer. Using a $25,000 loan from the Nachala program, she started a full-time business in the plant making clothing on contract with Greek and Italian companies. After three years, she succeeded in buying the company through an individual privatization, and now employs more than 50 workers.

A company near Katovice, Poland, makes fiberglass forms, and the company was originally started to make blades for the exhaust fans for the coal mines nearby. A major customer now is a German glider company, for which the Polish company originally made just component parts. It is now manufacturing the complete exterior shell.

A Slovakian firm handles disposal of hazardous organic waste and produces filters for biodegradation. The principals previously worked for a state-owned firm in the same business, and much of the new company's technology comes from a Canadian firm. Its equipment now meets European Union standards.

A Czech company laminates particle board for countertops, primarily for kitchen counters and cabinets. It is working with an Italian company that supplies it laminate to do subcontracted manufacturing for them. The Czech company is working hard to establish quality control standards, as well as standardized hours for employees.

A Czech company does machine embroidery, both for government agencies such as the fire department and for commercial clients. It also has a sister company that manufactures children's clothing, and 20 percent of its sales are work for this firm. It recently moved its facility out of Prague to a small village to reduce rents. It is opening a sales office in Moravia for both companies so that they will be better positioned to sell to the Austrian market.

In Bulgaria, an innovative firm makes remote controls for lighting systems. With technical assistance support from BAEF, the firm attended a trade show and, as a result, has greatly increased its orders.