Western NIS Enterprise Fund

# Unleashing Potential

Annual Report
2006

Western NIS Enterprise Fund (WNISEF) is a regional private equity fund, a pioneer in Ukraine and Moldova with more than a decade of successful experience investing in small and medium-sized companies. Since its inception, WNISEF has invested approximately $120 million in a range of industries with a concentration on fast-moving consumer goods, construction materials, packaging, retail, and financial services. WNISEF is managed by Horizon Capital Associates, LLC.

WNISEF was established by the U.S. Congress and funded by the U.S. government via the U.S. Agency for International Development (USAID).

USAID promotes peace and stability by fostering economic growth, protecting human health, providing emergency humanitarian assistance, and nurturing democracy in developing countries. USAID's work in transformational countries enables these nations to build the capacity to sustain their own progress. Since 1992, the USAID has provided USD 1.6 billion worth of technical and humanitarian assistance to Ukraine to further the processes of democratic development, economic restructuring and social sector reform in the region. (www.ukraine.usaid.gov)

## MISSION

Our mission is to build competitive market leaders that attract additional private capital to the region. We serve as a catalyst for growth in our portfolio companies by utilizing international best practices, corporate governance standards, and prudent environmental practices.

## STRATEGY

We have a strong growth strategy, successfully utilized and honed during the past decade in Ukraine and Moldova. Working with our partners, we strive to increase shareholder value by focusing on increasing company profitability and market share, which in turn ensures successful realization of investments. The amount typically invested in a single company ranges from US $1 million to US $10 million. WNISEF's stake varies, but always includes active participation in corporate governance via representation on a portfolio company's Board of Directors.

# TABLE OF CONTENTS

Both Moldova and Ukraine sustained economic growth in 2006 and demonstrated positive indicators for future prosperity. Strong development in the retail, export, and real estate sectors were driven by an increase in real wages and moderate inflation. A rise in the price of natural gas to near market levels is the main cause of inflation in the region. In turn, declining energy subsidies have forced governments and businesses to begin a process of structural reforms that seek diversification of energy supply and transport routes, as well as policies that encourage energy savings and efficiency.

Ukraine's democratic transition of power from the presidency to the parliament and coalition government was the main source of political instability last year. Despite this process, the country's economic growth continued for the sixth consecutive year, fueled by real wage increases and high consumer confidence levels that led to increased consumer spending. Retail sales in Ukraine grew by 25%. Revived metals and chemical sector exports contributed significantly to a rebound in GDP growth after 2005, estimated at 6.6% in 2006. Legislative changes last year cleared the last hurdles for Ukraine's admittance into the World Trade Organization (WTO), expected in 2007. This has also led to the commencement of negotiations over a new partnership agreement between Ukraine and the European Union, which is expected to further open European markets to Ukrainian goods and services.

Moldova saw a 28.5% growth in average salaries last year, a testament to the success of a continuing drive to increase the quality of life in this small country. Moldova's neighbor Romania became a member of the European Union, sending hundreds of thousands of Moldovan citizens in a rush to apply for Romanian passports. The importance of this cannot be underestimated; a sizable portion of Moldova's GDP is comprised of remittances sent home from citizens working abroad. With the EU now so accessible, Moldova hopes that 2007 will be a boom year for foreign direct investment, which last year was down to $200 million, from $260 million in 2005. The economy, however, revealed its vulnerability to external shock as a Russian ban on imports of Moldovan wine and rising energy costs had a negative effect on economic growth.

**Both Ukraine and Moldova present attractive risk-return potential and wide opportunities for WNISEF and our portfolio companies in a number of industry sectors. Sustained growth in consumer demand and purchasing power is changing buying habits in the region. Perhaps the strongest evidence of this is the meteoric rise of the banking sector, which has benefited from foreign investment and consolidation. WNISEF has devoted significant investment to meet the rising demand for home mortgages as well as business and consumer lending.**

Our portfolio company, ProCredit Bank Ukraine, is a full service bank that focuses on small and micro business development loans. In 2006, it met fast-growing demand in the region by introducing a competitively priced money transfer service that does not require individuals to open accounts. Customer deposits and the bank's loan portfolio nearly doubled, growing 97% and 87%, respectively. ProCredit Moldova also increased its loan potential and saw rapid growth in its portfolio. Another portfolio company, International Mortgage Bank Group, raised $31.5 million in a private placement, funds which were invested to expand the bank's equity base and meet rising demand for consumer and mortgage lending.

One common thread that can be seen in all of our portfolio companies during the past year is improving quality of management. As corporate governance and management standards in the region look to western benchmarks, a new generation of local professional managers has arisen that are helping transform companies and whole industries.

In the food processing and retail industries, our portfolio partner companies showed steady growth and continued to lead the market by aggressively focusing on sales and new management strategies.

Troyanda, a leader in the medium and premium price ice-cream market segments, welcomed a new Chief Executive Officer with vast experience in sales. This experience paid off with the company improving its share in the take home sales category. Troyanda also became a more socially responsible market leader by supporting children from boarding homes and children with physical disabilities. Management changes at Shvydko restaurant chain helped sustain an expansion to meet the high demand for quality Ukrainian cuisine for people on the go, opening a new unit in Kyiv. AVK, a top producer of branded and novelty confections in Ukraine, strengthened sales and marketing functions with new managers, refined distribution to better meet regional customer needs, and refocused its product line toward high-margin chocolate products. AVK expanded its business internationally, opening a wholly owned subsidiary in Russia.

WNISEF investments in manufacturing, agricultural and energy sectors have also continued to bring success and sustained market leadership. For the sixth consecutive year, notwithstanding the effect of the Russian ban on Moldovan wine exports, production was at full capacity at our portfolio company GCC, which maintains one of the highest efficiency rates in the glass bottle industry globally. GCC successfully diversified its customer base and expanded capacity in 2006 and continues to lead in the bottle export market.

As emerging markets with liberalizing economies, Ukraine and Moldova are attractive equity investment destinations for foreign investors. We are very proud of our team's ability to build upon their track record, reputation, and this market interest to establish Horizon Capital Associates, LLC. Horizon Capital Associates is a private equity manager, which will manage not only the outstanding WNISEF portfolio, but also has succeeded in raising $132 million for a second mid-market private equity fund for the region – Emerging Europe Growth Fund, LP (EEGF). Successfully leveraging the experience of WNISEF in these markets and attracting private capital from North America and Europe is a very meaningful part of WNISEF's legacy. Not only will WNISEF continue its lead role in the private equity market by investing to shape the direction of some of the regions' most active and successful businesses, but together with Horizon Capital Associates, WNISEF has forever strengthened and expanded the private equity market in Ukraine and Moldova.

The WNISEF team's expertise stems from our vast experience in the region during the past eleven years. For our continued success we are thankful to our Board of Directors and our team of investment professionals. Successful fundraising for EEGF and the rapid economic growth in 2006 speaks to a high potential for success in 2007, and we look forward to continuing cooperation with our partners, whose good management and business acumen have provided the stable base upon which these achievements became possible.

Dennis A. Johnson

**DENNIS A. JOHNSON**
Chairman of the Board

Natalie A. Jaresko

**NATALIE A. JARESKO**
President and Chief Executive Officer

# YEAR IN BRIEF: CALENDAR OF KEY EVENTS

2005

2006

11 12 01 02 03 04

November December January February March April

AVK, a leading confectionary group in Ukraine manufacturing branded and novelty confections, increased sales by 21-23% up from the same period in 2004. This substantial growth reflects an on-target business strategy focusing primarily on developing premium and medium segments of the business.

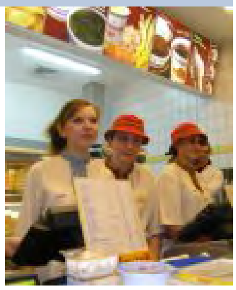

ProCredit Bank Ukraine, the country's leading micro- and small-business lending institution, introduced a new service of ProCash international money transfers, which are noticeably less expensive than similar money transfers between individuals and do not require opening of an account.

GCC, a leading Moldovan manufacturer of green glass packaging, diversified and reestablished its export markets, with exports accounting for 74% of sales. Foreign customers are located in Georgia, Armenia, Azerbaijan, Russia, Ukraine, Belarus, Romania, Kazakhstan, and Turkey.

ProCredit Moldova, a key provider of financing to micro-enterprises in Moldova, received a $3 million loan from the U.S. Overseas Private Investment Corporation (OPIC). Funds will enable ProCredit Moldova to further expand its activities across the country.

05 06 07 08 09 10

May June July August September

WNISEF sold its stake in Moldova Agroindbank (MAIB) achieving a 3.6x cash-on-cash return and 36% IRR.

ProCredit Moldova negotiated a $3 million loan facility from Black Sea Trade Development Bank, which allowed the bank to implement its growth strategy.

WNISEF invested an additional $3 million for a 20% pro rata participation in a capital increase at ProCredit Bank Ukraine. The new issue of shares will help fuel the bank's outstanding growth and ambitious development plans.

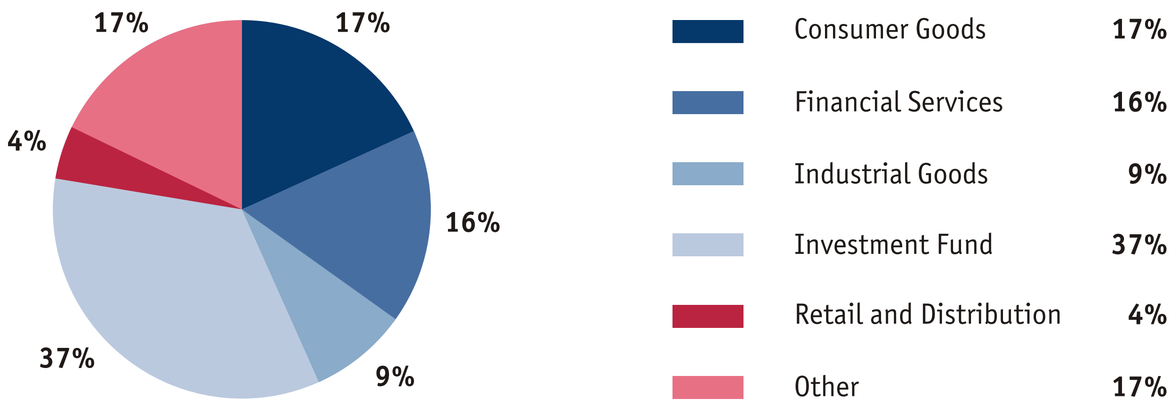
Fitch Ratings, the International Rating Agency, upgraded the outlook of ProCredit Bank from Stable to Positive for both local and foreign currency ratings and affirmed all its other ratings.

Shvydko, a leading chain of quick-service restaurants serving Ukrainian cuisine, opened its $11^{th}$ unit in Kyiv.

AVK opened a wholly owned subsidiary in Russia. AVK operates five confectioneries located across the country and exports its products to more than 15 countries.

# INVESTMENT PORTFOLIO COMMITMENTS BY SECTOR AND SECTOR HIGHLIGHTS

## WNISEF Outstanding Commitments by Sector




### Financial Services

In 2006, Ukraine's banking sector remained a growth leader in Central Eastern Europe, benefiting from strong lending growth on the back of continuing economic expansion and growing disposable incomes. In 2006, banks increased lending by 71% to USD 48.6 billion. The sector is set to continue expansion, particularly in the retail and mortgage segments where the level of saturation has yet to reach the CEE level.

In 2006, Moldova's banking sector continued on the path of growth and consolidation. The credit portfolio of commercial banks rose 22% in 2006 to nearly USD 1.1 billion. Commercial lending prevailed, however, the retail segment continued to expand and has immense potential for further growth, given the steady rise in the purchasing power of the local population.

### Consumer Goods

Ukraine's food and non-food consumer goods industries witnessed healthy growth in 2006 due to increased consumer demand. In 2006, spending on food increased by 6% in real terms. Spending on non-food items such as cars, consumer electronics and services grew by 30%. Some food industries have been hurt by bans on Ukrainian exports to Russia.

### Retail and Distribution

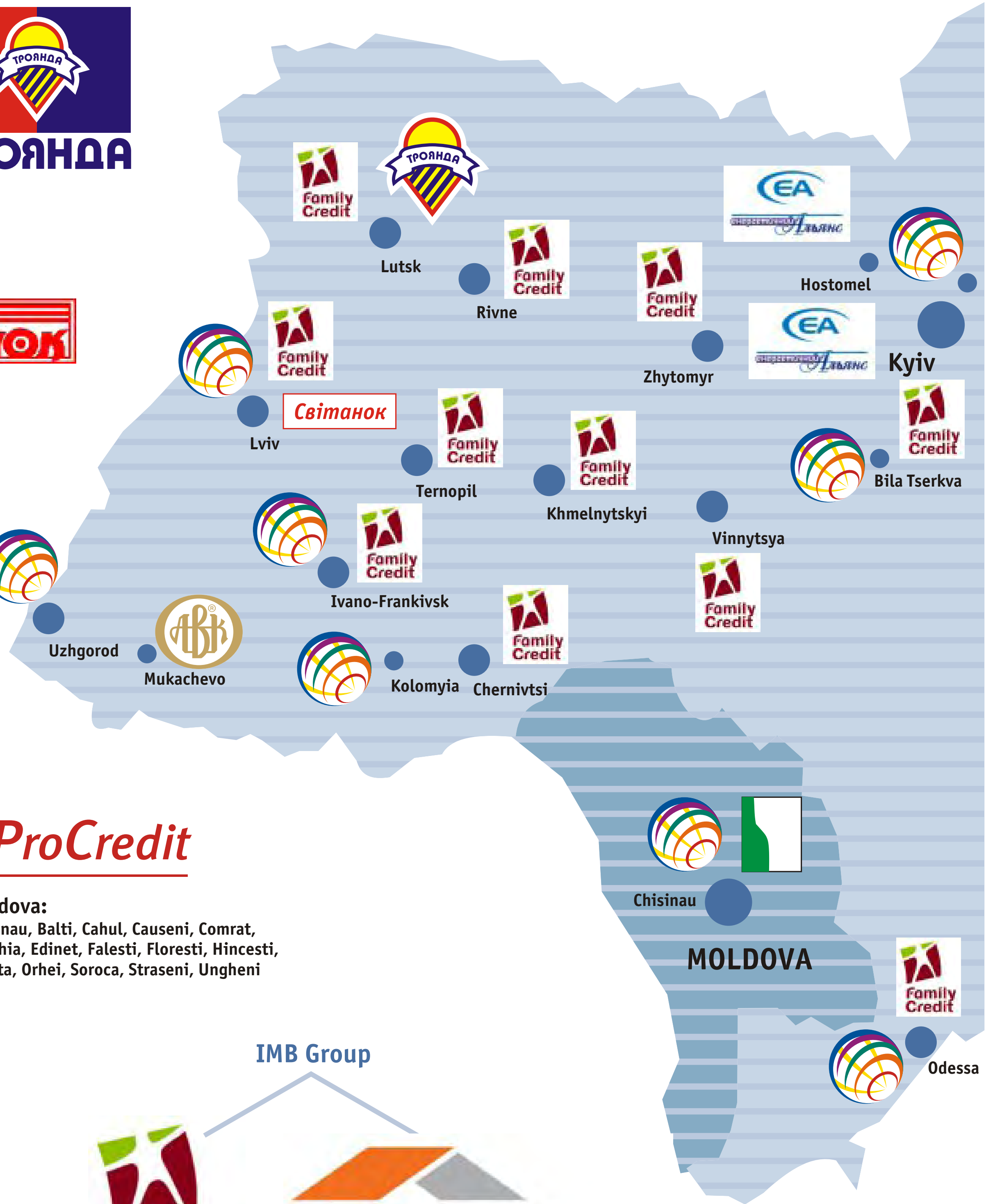
Ukraine is one of the most dynamic retail markets in Central and Eastern Europe, expanding at an average annual rate of 26% between 2002 and 2006. Total retail trade volume was up by 35%, reaching USD 42 billion in 2006, and is projected to grow to USD 49 billion in 2007. In 2006, AT Kearney ranked Ukraine fourth in emerging markets in terms of attractiveness for Western retailers (behind India, Russia, and Vietnam). Strong growth in consumer spending, negligible competition and significant market fragmentation offer plenty of opportunities for expansion and consolidation in the retail sector.

### Industrial Goods

Favorable external conditions and a rise in investment activity sustained growth in machine building, metallurgy and industrial building construction. The largest contributors to industrial growth were metallurgy, food processing, and machine-building. Together they accounted for more than 80% of industrial output growth.

*Sources: International Center for Policy Studies (ICPS), National Bank of Ukraine (NBU), State Statistics Committee of Ukraine, National Bank of Moldova*

# Unleashing Potential




ProCredit

**Moldova:**
**Chisinau, Balti, Cahul, Causeni, Comrat, Drochia, Edinet, Falesti, Floresti, Hincesti, Ocnita, Orhei, Soroca, Straseni, Ungheni**

GLASS CONTAINER COMPANY

**IMB Group**

Family Credit

20 outlets;
391 points of sale
throughout Ukraine

International Mortgage Bank
Credit of trust. Forever.


ProCredit Bank
ПроКредит Банк
EA
енергетичний Альянс
Chernihiv
Sumy
Brovary
International Mortgage Bank
Kharkiv
Poltava
Троянда
Cherkassy
Kremenchuk
Severodonetsk
Slavyansk
Kramatorsk
Dniprodzerzhynsk
Dnipropetrovsk
Kirovohrad
Horlivka
Makiyivka
Luhansk
Donetsk
Kryvyi Rih
Zaporizhya
ЭКОПРОД А.Т.
Mariupol
Mykolaiv
Kherson
Simferopil
Sevastopil
Yalta
Family Credit
АБК
Швидко

## UKRAINE

Despite periods of political instability surrounding elections, Ukraine made good progress on structural reforms in 2006. The economy grew 6.6% in 2006, an improvement over the sluggish performance of the previous year, and benefited from robust domestic consumption and recovery of foreign demand for metals and chemicals. An attractive risk-return potential continued to draw international investors to Ukraine. Economists project the Ukrainian economy will continue to grow 5% annually for the next 5 years.

**Economic Achievements: Stable Growth Continues**

- Ukraine's GDP grew 6.6% in 2006, compared to 2.6% in 2005. The economy proved stable despite the shock of rising prices for imported gas at the start of the year.
- Inflation was at 12%.
- The US granted Ukraine market economy status.
- The US Senate revoked the Jackson-Vanik Amendment for Ukraine.
- All necessary bills for WTO accession were passed by the Parliament of Ukraine.
- National Bank's international reserves increased by 14.75%.
- The nominal salary of Ukrainian citizens increased by 29.2%.
- Consumer spending continued its increase, close to 33%, similar to 2005 levels.

**Socio-Political Situation**

- March 2006 Parliamentary elections were judged by international observers to be free and fair.
- Ukraine received a better ranking in Transparency International's Corruption Perception Index, moving up to 107th position out of 159 countries.
- Relations with Russia improved.
- Civil and political freedoms are developing.
- Independent press and no government censorship.

**FDI Increasing**

- FDI from the US, UK, Germany, the Netherlands and Russia increased.
- Since independence in 1991, Ukraine has attracted $19.4 billion in FDI.
- The financial services sector has been the biggest FDI magnet in 2006, while the consumer market has also attracted strong interest.
- Traditionally strong industry sectors include food processing, machine engineering, transport and telecoms.
- FDI per capita is $419.

| Indicators | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Real GDP Growth, % | 9.2 | 5.2 | 9.6 | 12.1 | 2.6 | 6.6 |
| Average Inflation, % | 6.1 | -0.6 | 8.2 | 12.3 | 10.3 | 11.6 |
| Exchange Rate, USD | 5.37 | 5.33 | 5.33 | 5.32 | 5.05 | 5.05 |
| Current Account Balance, % of GDP | 3.7 | 7.5 | 5.8 | 10.5 | 3.1 | -1.1 |
| Foreign Debt Stock (USD billions) | 20.4 | 21.6 | 23.8 | 30.6 | 38.8 | 44.9 |
| FDI (USD billions, net) | 0.7 | 0.7 | 1.4 | 1.7 | 7.3 | 4.5 |

*Sources: ICPS, NBU*

## MOLDOVA

Although Moldova's 2006 economic performance is not as impressive as recent years due to shocks from Russian trade bans and gas price hikes, the country continues to make progress toward developing a viable free-market economy. The government has liberalized most prices and has phased out subsidies on most basic consumer goods. High levels of worker remittances and fast regional growth were the main drivers of economic growth. In accordance with a 2005 Action Plan with the European Union, Moldova has begun to harmonize its laws with those of the EU. The progress achieved to date, coupled with societal consensus on European integration present a unique chance for Moldova to ultimately fulfill its European aspirations.

**Macroeconomic Performance**

- Real GDP grew by 43% between 2000-2005.
- Absolute poverty declined from 71% in 1999 to 29% in 2006.
- Industrial output is $1.69 billion, down 6.9% from 2005.
- The average monthly salary rose by 29%.
- Moldova ranked 81st among 157 countries in economic freedom as evaluated by the Heritage Foundation and Wall Street Journal.
- Moldovan Government earned $12.8 million in 2006 from privatization.
- Successful rescheduling of foreign debt through the Paris Club and conclusion of all bilateral agreements.

**European Integration Remains a Focus**

- Moldova signed the Central European Free Trade Agreement (CEFTA), which replaces the patchwork of 32 bilateral and free trade agreements among the South Eastern European countries.
- Moldova became eligible for Millennium Challenge Corporation (MCC) program. MCC approved a $24.7 million agreement for assistance with anti-corruption strategy under MCC's Threshold Program.
- European Union and the World Bank provided $1.2 billion for implementation of the EU-Moldova European Action Plan and the Moldova Economic Growth and Poverty Reduction Strategy Program.
- IMF approved $167 million for realization of the three-year Poverty Reduction and Growth Facility.

**Investment Climate**

- Since independence, $1.2 billion in FDI has been invested in Moldova.
- Banking, energy, transportation, retail, communications are among industry sectors attracting the highest foreign investments.
- Societe Generale de France Group became owner of 70.57% stake in commercial bank Mobiasbanka by paying $24 million. It is the largest transaction in the history of the Moldovan Stock Exchange.

| Indicators | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Real GDP Growth, % | 6.1 | 7.2 | 6.3 | 7.3 | 7.1 | 7.5 |
| Average Inflation, % | 9.6 | 5.2 | 15.7 | 12.5 | 10.0 | 14.1 |
| Exchange Rate, USD | 13.00 | 13.6 | 13.9 | 12.3 | 12.9 | 12.8 |
| Current Account Balance, % of GDP | -4.6 | -3.1 | -7.3 | -5.5 | -7.5 | -5.4 |
| Foreign Debt Stock (USD billions) | 0.99 | 1.231 | 1.441 | 1.39 | 1.4 | 1.6 |
| FDI (USD billions, net) | 147 | 117 | 48 | 88 | 260 | 200 |

*Sources: The World Bank, Economist Intelligence Unit (EIU)*

## Table of Contents

KPMG

## Independent Auditors' Report

***To the Board of Directors***
***Western NIS Enterprise Fund***

We have audited the accompanying consolidated statements of assets and liabilities of Western NIS Enterprise Fund (the Fund) and subsidiaries, including the consolidated condensed schedule of investments, as of September 30, 2006 and 2005, and the related consolidated statements of operations and changes in fund balance and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Western NIS Enterprise Fund and subsidiaries as of September 30, 2006 and 2005, and the results of their operations and changes in fund balance and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

CJSC KPMG Audit

**CJSC KPMG Audit**
**December 14, 2006**

## Consolidated Statements of Assets and Liabilities

September 30, 2006 and 2005

*Expressed in US Dollars*

| | 2006 | 2005 |
|---|---|---|
| **Assets** | | |
| Investments, at fair value: | | |
| Equity and debt securities (cost $42,205,134 and $65,839,675 as of September 30, 2006 and 2005, respectively) | $ 61,955,692 | $ 57,902,198 |
| Emerging Europe Growth Fund, LP interest | 13,343,305 | - |
| Cash and cash equivalents *(note 6)* | 26,773,984 | 6,970,014 |
| Receivables: | | |
| Equity securities sold *(note 5)* | 874,679 | 1,721,362 |
| Interest, dividends and other income | 326,201 | 203,671 |
| Fixed assets sold *(note 12)* | 379,178 | - |
| Prepaid expenses: | | |
| Investment management fees *(note 12)* | 787,671 | - |
| Other | 30,463 | 162,575 |
| Fixed assets, net of accumulated depreciation and amortization *(note 7)* | 140,359 | 417,157 |
| Other assets | 100,462 | 185,050 |
| **Total assets** | **$ 104,711,994** | **$ 67,562,027** |
| **Liabilities and fund balance** | | |
| Accounts payable and other accrued expenses | $ 215,189 | $ 473,574 |
| Exit-based incentive payable *(note 9)* | 185,103 | 939,146 |
| Other liabilities | 26,258 | 2,069,792 |
| **Total liabilities** | **426,550** | **3,482,512** |
| Commitments and contingencies *(notes 10 and 13)* | - | - |
| Fund balance | 104,285,444 | 64,079,515 |
| **Total liabilities and fund balance** | **$ 104,711,994** | **$ 67,562,027** |

*See accompanying notes to consolidated financial statements.*

## Consolidated Statements of Operations and Changes in Fund Balance

Years ended September 30, 2006 and 2005

*Expressed in US Dollars*

| | 2006 | 2005 |
|---|---|---|
| **Investment income** | | |
| Interest income | $ 1,439,013 | $ 725,033 |
| Dividend income | 99,345 | 481,714 |
| Other income | 181,990 | 127,097 |
| **Total investment income** | **1,720,348** | **1,333,844** |
| | | |
| **Expenses** | | |
| Investment management fees *(note 12)* | 1,832,192 | - |
| Exit-based incentive expense equity incentive plan *(note 9)* | 1,218,551 | 856,550 |
| Professional fees | 1,748,741 | 1,959,197 |
| Employee compensation and benefits | 1,171,556 | 2,380,815 |
| Business travel | 386,181 | 470,600 |
| Occupancy | 136,855 | 274,601 |
| Depreciation and amortization | 58,168 | 100,839 |
| Other operating | 491,845 | 531,510 |
| **Total expenses** | **7,044,089** | **6,574,112** |
| **Net investment loss** | **(5,323,741)** | **(5,240,268)** |
| | | |
| **Net realized and change in unrealized gain on investments** | | |
| Net realized gain (loss) on investments *(note 5)* | 3,180,070 | (48,416) |
| Net change in unrealized gains and losses on investments *(note 5)* | 28,636,577 | 3,000,000 |
| **Net realized and change in unrealized gain on investments** | **31,816,647** | **2,951,584** |
| **Net increase (decrease) in fund balance from operations** | **26,492,906** | **(2,288,684)** |
| | | |
| U.S. Government grants *(note 4)* | 13,744,125 | 20,100,000 |
| Deferred exit-based incentive | (31,102) | 872,173 |
| **Net increase in fund balance** | **40,205,929** | **18,683,489** |
| Fund balance, beginning of year | 64,079,515 | 45,396,026 |
| **Fund balance, end of year** | **$ 104,285,444** | **$ 64,079,515** |

*See accompanying notes to consolidated financial statements.*

## Consolidated Statements of Cash Flows

Years ended September 30, 2006 and 2005

*Expressed in US Dollars*

| | 2006 | 2005 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net increase (decrease) in fund balance from operations | $ 26,492,906 | $ (2,288,684) |
| **Adjustments to reconcile net increase in fund balance to net cash provided by (used in) operating activities:** | | |
| Disbursements for: | | |
| EEGF Limited Partnership interest | (10,788,781) | - |
| Equity securities | (3,070,355) | (16,108,858) |
| Debt securities | (8,850,000) | (1,100,000) |
| Fixed assets | (272,267) | (90,375) |
| Proceeds from: | | |
| Equity securities sale to EEGF | 26,883,253 | - |
| Equity securities sale to third parties | 5,931,102 | 442,420 |
| Debt securities | 2,360,000 | 3,640,796 |
| Fixed assets | 84,221 | 749 |
| Net realized (gain) loss from sale of investments | (3,180,070) | 48,416 |
| Net change in unrealized gains and losses on investments | (28,636,577) | (3,000,000) |
| Loss on disposal of fixed assets | 27,497 | 3,667 |
| Deferred exit-based incentive | (31,102) | 872,173 |
| Depreciation and amortization | 58,168 | 100,839 |
| Decrease (increase) in receivables for investment securities sold | 846,683 | (1,721,362) |
| Increase in prepaid investment management fees | (787,671) | - |
| Decrease (increase) in prepaid rent and other prepaid expenses | 132,112 | (4,989) |
| (Increase) decrease in interest, dividends and other receivables | (122,530) | 128,461 |
| Decrease in other assets | 84,588 | 2,708,885 |
| (Decrease) increase in accounts payable and other accrued expenses | (258,385) | 81,376 |
| Decrease in exit-based incentive payable | (754,043) | (933,403) |
| (Decrease) increase in other liabilities | (88,904) | 2,001,482 |
| **Net cash provided by (used in) operating activities** | **6,059,845** | **(15,218,407)** |
| | | |
| **Cash flows from financing activities** | | |
| Cash received from U.S. Government grants | 13,744,125 | 20,100,000 |
| **Net cash provided by financing activities** | **13,744,125** | **20,100,000** |
| | | |
| **Net increase in cash and cash equivalents** | **19,803,970** | **4,881,593** |
| Cash and cash equivalents, beginning of year | 6,970,014 | 2,088,421 |
| **Cash and cash equivalents, end of year** | **$ 26,773,984** | **$ 6,970,014** |
| | | |
| **Non cash transactions** | | |
| Offset of investments with other liabilities | 2,000,000 | - |

*See accompanying notes to consolidated financial statements.*

## Consolidated Condensed Schedule of Investments

September 30, 2006

*Expressed in US Dollars*

| Investments (72.2%)[1] | Principal/Shares/Interest | Cost | Fair Value |
|---|---|---|---|
| **Limited Partnership Interest (12.8%)** | | | |
| Emerging Europe Growth Fund, LP | | | $ 13,343,305 |
| **Total Limited Partnership Interest** | | $ 10,788,781 | 13,343,305 |
| **Equity (51.5%)** | | | |
| **Ukraine (51.3%)** | | | |
| ***Food processing (32.0%)*** | | | |
| CJSC AVK | 9,867,477 | | 30,495,329 |
| Other | | | 2,873,372 |
| ***Financial services (14.3%)*** | | | |
| CJSC ProCredit Bank Ukraine | 62,922 | | 12,890,277 |
| CJSC Energy Alliance *(note 9)* | 934,270,627[2] | | 2,000,000 |
| | 132,085,215[3] | | |
| ***Agribusiness (4.7%)*** | | | |
| CJSC Ecoprod A.T. | 114 | | 4,901,785 |
| ***Manufacturing (0.3%)*** | | | 304,929 |
| **Moldova (0.2%)** | | | |
| ***Financial services (0.2%)*** | | | 200,000 |
| **Total Equity** | | 33,915,134 | 53,665,692 |
| **Debt (7.9%)** | | | |
| **Ukraine (7.9%)** | | | |
| ***Financial services (7.8%)*** | | | |
| CJSC International Mortgage Bank | $ 3,000,000 | | 3,000,000 |
| CJSC Energy Alliance | $ 3,000,000 | | 3,000,000 |
| CJSC ProCredit Bank Ukraine | $ 2,190,000 | | 2,190,000 |
| ***Food processing (0.1%)*** | | | 100,000 |
| **Total Debt** | | 8,290,000 | 8,290,000 |
| **TOTAL INVESTMENTS** | | $ 52,993,915 | $ 75,298,997 |

[1] Percentages indicated are based on fund balance as of September 30, 2006. The Fund's investments are closed-end investments with no periodic liquidity.
[2] Common shares.
[3] Preferred shares.

*See accompanying notes to consolidated financial statements.*

## Consolidated Condensed Schedule of Investments

September 30, 2005

*Expressed in US Dollars*

| Investments (90.3%)[1] | Principal/Shares/Interest | Cost | Fair Value |
|---|---|---|---|
| **Equity (83.0%)** | | | |
| **Ukraine (69.4%)** | | | |
| ***Food processing (37.4%)*** | | | |
| CJSC AVK | 9,867,477 | | $ 8,712,951 |
| CJSC Shostka City Milk Factory | 1,070,059 | | 6,999,997 |
| CJSC Shvydko Ukraine | 8,053,810 | | 3,000,000 |
| CJSC Sonola | 802,254,766 | | 3,000,000 |
| Other | | | 2,251,030 |
| ***Financial services (23.1%)*** | | | |
| CJSC International Mortgage Bank | 37,167,201 | | 8,331,483 |
| CJSC ProCredit Bank Ukraine | 31,461 | | 2,758,657 |
| CJSC Energy Alliance *(note 9)* | 934,270,627[2]<br>132,085,215[3] | | 2,000,000 |
| Other | | | 1,701,773 |
| ***Agribusiness (7.6%)*** | | | |
| CJSC Ecoprod A.T. | 114 | | 4,901,785 |
| ***Manufacturing (1.3%)*** | | | 843,491 |
| **Moldova (13.6%)** | | | |
| ***Food processing (10.9%)*** | | | |
| Natur Bravo S.A. | 82,970,016 | | 7,000,000 |
| ***Financial services (2.7%)*** | | | 1,751,031 |
| **Total Equity** | | **$ 60,788,147** | **53,252,198** |
| **Debt (7.3%)** | | | |
| **Ukraine (5.7%)** | | | |
| ***Financial services (5.7%)*** | | | |
| CJSC ProCredit Bank Ukraine | $ 3,650,000 | | 3,650,000 |
| **Moldova (1.6%)** | | | |
| ***Financial services (1.6%)*** | | | 1,000,000 |
| **Total Debt** | | **5,051,528** | **4,650,000** |
| **TOTAL INVESTMENTS** | | **$ 65,839,675** | **$57,902,198** |

[1] Percentages indicated are based on fund balance as of September 30, 2006. The Fund's investments are closed-end investments with no periodic liquidity.
[2] Common shares.
[3] Preferred shares.

*See accompanying notes to consolidated financial statements.*

September 30, 2006 and 2005

## 1. Background

### (a) Organization and Description of Business

Western NIS Enterprise Fund (the Fund) is a not-for-profit corporation for tax purposes formed pursuant to the Support for East European Democracy Act of 1989 (the SEED Act) and the 1992 Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act (the FREEDOM Support Act). The Fund promotes the development of the private sector in the Western NIS region (the Region), which consists of Ukraine, Moldova and Belarus. The United States Government (USG) authorized appropriations of $150 million, of which $147.4 million has been committed by the United States Agency for International Development (USAID) for Fund program purposes and administrative expenditures (the Grant). Grants received from USAID are conditioned upon the Fund's compliance with the requirements of the Grant agreement with USAID and the SEED and FREEDOM Support Acts, which impose certain U.S. policy objectives and reporting obligations. Under the terms of this Grant agreement, the Fund may hold funds in interest bearing accounts and may retain investment and realized gain income for program purposes. According to the Grant agreement, USAID may establish the date (the Termination Commencement Date) after which the Fund shall not make any new commitments or investments, and shall commence the winding up of its affairs and sale of its assets. The Termination Commencement Date will not occur earlier than ten years after the date of incorporation or later than fifteen years from such date of incorporation, except as may otherwise be agreed to by USAID and the Fund. The Fund was incorporated on August 26, 1994 and as of September 30, 2006, no Termination Commencement Date has been set.

The Fund is engaged in a broad private investment program in the Region, which through equity, debt investments, technical assistance and other measures, emphasizes a commitment to small and medium sized private businesses. Through its direct role in investments in the Region's private sector, the Fund seeks to generate profits that will further support its activities and attract investment by others.

Following the precedent of USAID financed Enterprise Funds in Central and Eastern Europe, the Fund actively pursued its mission of attracting significant private capital to the Region by supporting the establishment of a private management company, Horizon Capital Associates, LLC (HCA) and the launch of a private successor fund, Emerging Europe Growth Fund, L.P. (EEGF). Based on USAID and Congressional approval, in 2006, the Board of Directors of the Fund committed $25 million to EEGF and approved the warehousing of certain recent Fund investments for sale to EEGF in anticipation of its initial closing. EEGF organizational costs incurred by the Fund are anticipated to be reimbursed by EEGF, to a maximum of $1 million, after EEGF's final closing date.

In February 2006, EEGF held an initial closing of $45 million in aggregate commitments, whereby both the Fund and EEGF entered into investment management agreements with HCA on the basis of pari passu terms. Subsequent closings raised an additional $87 million in aggregate commitments, resulting in EEGF aggregate commitments of $132 million as of September 30, 2006. As of the initial closing date of EEGF, sales-purchase agreements were signed between the Fund and EEGF for the sale of four investments, including OJSC Shostka City Milk Plant (“Shostka”), Natur Bravo S.A. (“Natur Bravo”), CJSC International Mortgage Bank (“IMB”) and Favorit Capital, LLC (“Favorit Capital”) as well as the sale of a Fund subsidiary, Western NIS Enterprise Limited (WNISEL) that held minority shares of Shostka and IMB as part of the sale of these entities. The sales price for these investments was based on valuations prepared by an independent audit firm that was not the auditor of either party. One remaining investment, Ergopack LLC (“Ergopack”), was sold to EEGF by the Fund in May 2006. Finally, effective March 1, 2006, following the initial closing of EEGF, all Fund employees, excluding the sole employee based in the Fund's U.S. office, became employees of HCA's wholly-owned subsidiary, Horizon Capital Advisors, LLC (HCAD), resulting in the transfer of employee compensation, operating and other expenses from the Fund to HCA and HCAD.

The Fund's activities are conducted directly as well as through various subsidiaries. WNISEF Holding Company #1 (the Holding Company #1), a Delaware corporation, is a 100%-owned subsidiary of the Fund. Holding Company #1 was incorporated October 26, 1995 for the purpose of establishing the Western NIS Enterprise Fund Finance Company, Ltd. (“FINCO”). FINCO is a 99% owned subsidiary of the Fund, while the remaining 1% is owned by Holding Company #1. FINCO was established as a Ukrainian Limited Liability Company on April 8, 1996 for the sole purpose of conducting small business lending on behalf of the Fund. FINCO does not engage in new lending, its operations are limited to collecting outstanding loans. Both FINCO and Holding Company #1 are considered dormant.

Western NIS Enterprise Limited (WNISEL) is a former 99.9% owned subsidiary of the Fund sold to EEGF in February 2006. WNISEL was established in Cyprus on December 12, 1996 solely to make investments on behalf of the Fund where a second shareholder is required by Ukrainian legislation. Prior to its sale to EEGF, WNISEL held a nominal position in IMB valued at $846 and a nominal position in Shostka valued at $363.

**(b) Business environment**

The Region is experiencing political and economic change which has affected, and may continue to affect, the activities of entities operating in this environment. Consequently, operations in the Region involve risks that do not typically exist in other markets. These financial statements reflect management's assessment of the impact of the business environment in the Region on the operations and the financial position of the Fund. The future business environment may differ from management's assessment. The impact of such differences on the operations and the financial position of the Fund may be significant. The ability to assess the valuation of Fund's investments is also significantly influenced by the transition process and current economic conditions.

## 2. Basis of Presentation

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) and include the accounts of the Fund and its wholly-owned and majority-owned subsidiaries, which include Holding Company #1, FINCO and WNISEL, prior to its sale to EEGF. All significant intercompany transactions are eliminated in the consolidation.

The Fund is an investment company and follows accounting policies contained in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, *Investment Companies* (the Investment Company Guide), which requires investment companies to account for their investments at fair value, as opposed to consolidation or using the equity method, as such provides more useful information to users of the financial statements regarding performance of an investment company. The American Institute of Certified Public Accountants and the Financial Accounting Standards Board are currently developing a Statement of Position on the clarification of the scope of the Investment Company Guide that could redefine the criteria applied to determine whether an entity is an investment company under the Investment Company Guide.

If the Fund were determined not to be an investment company under the revised Investment Company Guide then it would be required to consolidate its subsidiaries and account for its associates using the equity method of accounting, under US GAAP standards currently in effect. However a new US GAAP standard currently under development, entitled “The Fair Value Option for Assets and Liabilities”, may allow the Fund to elect to continue to account for associates at fair value, instead of applying the equity method of accounting to these investments. This standard however has not been issued in its final form as of September 30, 2006.

## 3. Summary of Significant Accounting Policies

**Management Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Investments in Equity and Debt Securities**

The Fund's investments, which includes both debt and equity components, are not readily marketable and are typically not listed on an exchange or quoted in an open market. These investments are stated at fair value by applying the guidance contained in the International Private Equity and Venture Capital Valuation Guidelines, which is consistent with the requirements of the Investment Company Guide, as determined in good faith by management and approved by the Board of Directors.

Equity investments may be made in cash or with in-kind equipment contributions and are initially reflected at cost. Subsequent valuation is determined by considering relevant available qualitative and quantitative information. This information may include the financial condition and operating results of each investee, current economic conditions affecting operations, recent purchase or sale of securities of the investee, any subsequent events or financing transactions that may indicate a change in fair value and available market comparables. These factors are subject to change over time and are reviewed periodically. As adjustments become necessary, they are reported in the period in which they become known. For debt securities, fair values are based upon management's continuing review and evaluation of these investments with consideration of current interest rates for similar loans, past experience, sovereign and currency risk, the financial condition of the borrowers, current economic conditions in the Region, and other relevant factors such as the non-collection of principal and interest when due in accordance with the contractual terms of the agreement.

The carrying values assigned to the investments are based on available information and do not necessarily represent amounts that might ultimately be realized, since such amounts depend on future circumstances and cannot be determined with certainty until the individual positions are liquidated, and such differences could be material.

Investment transactions are recorded on a trade date basis with the resulting realized and unrealized gains and losses recorded in the consolidated statements of operations and changes in fund balance. For purposes of determining gains or losses on sales of investments, the cost of investments sold is determined on the specific identification basis.

**Cash and Cash Equivalents**

Cash and cash equivalents include cash held in bank accounts as well as any highly liquid financial instruments purchased with original maturities of three months or less.

**Grant Funds Recognition**

USAID grant funds received, when draw-downs are made against the USAID letter of credit commitment, are recognized in the consolidated statement of operations and changes in Fund balance. The Fund drew down $13,744,125 and $20,100,000 of the USAID letter of credit commitment for the years ended September 30, 2006 and 2005, respectively.

**Dividend Income**

Due to the irregular nature of dividends on the Fund's investments, dividend income is recorded on the ex-dividend date, when possible, and on a cash basis when dividends that were not previously known are received.

**Interest Income**

Interest on debt securities is accrued at the contractual rate based upon the principal amount outstanding and credited to income as earned.

**Depreciation and Amortization**

Apartments are depreciated on a straight-line basis over 31 years. Automobiles, computer equipment and software, furniture and other office equipment are depreciated on a straight-line basis over their estimated useful lives, principally 5-7 years. Leasehold improvements are amortized on a straight-line basis over the lesser of their useful lives or the term of the lease.

**Translation of Foreign Currency**

The Fund's functional currency is the U.S. dollar. Generally, the Fund's operating transactions are denominated in U.S. dollars; however, on occasion transactions are contracted in foreign currencies.

Investments, which are denominated in foreign currencies, are initially recorded at the U.S. dollar equivalent on the date of the transaction and valued at September 30, 2006 and 2005 in accordance with the Fund's valuation policies. Liabilities related to the funding of investments, which are denominated in foreign currencies, are initially recorded at the U.S. dollar equivalent on the date of the transaction and translated into U.S. dollars at the prevailing exchange rates at September 30, 2006 and 2005, with the resulting gain or loss included in the accompanying consolidated statements of operations and changes in fund balance. Items of income or expense that are denominated in foreign currency are translated at the average rate for the month in which the transaction occurred.

**Technical Assistance**

The Fund provides technical assistance to certain of its portfolio companies that may include, but is not limited to, transfer of used fixed assets, payment of expenses for portfolio company systems implementations, consulting, training and other costs. Such amounts are expensed as incurred and included in professional fees in the accompanying consolidated statements of operations and changes in fund balance.

**Financial Participation Rights**

Historically Financial Participation Rights agreements have been established with management of a number of the Fund's portfolio companies. Generally, such rights entitle certain employees of portfolio company management to receive a percentage of the proceeds received by the Fund for dividends paid by the portfolio company or proceeds received from the sale of the portfolio company. No Financial Participation Rights expense was recognized for the years ended September 30, 2006 and 2005 as there were no such agreements in place.

**Long-Term Equity Incentive Plan**

The Board of Directors established a Long-Term Equity Incentive Plan (the LTEI Plan) with an effective date of October 1, 2002 for certain employees. This LTEI Plan, as approved by Congress and USAID, awards an interest in the net realized gain upon sale of the Fund's equity interest in a portfolio company. Interests are granted by the Board of Directors generally at the time of purchase of an investment. For LTEI Plan purposes, the calculation of net realized gain includes proceeds from sale, as well as cumulative dividends and preferred returns received from the portfolio company, net of any applicable Financial Participation Rights. Interests are subject to a three-year vesting period and vest in one-third increments on each anniversary of the date of grant. Under the terms of the LTEI Plan, the Board of Directors may, in its sole discretion, accelerate vesting, extend the term or period of exercisability, modify the exercise price or waive any terms of conditions applicable to any interests. Accordingly, no liability is recognized and no LTEI Plan expenses are recorded in the consolidated financial statements until a sale of an investment is realized.

In February 2006, the Board of Directors amended the LTEI Plan to enable continuation of LTEI Plan rights for eligible participants for so long as the LTEI Plan participant remains an officer and/or key employee of the Fund or of HCA, or its affiliate, and HCA is retained as investment manager to the Fund.

**Comparative amounts**

Certain prior period amounts have been reclassified to conform with current period presentation.

## 4. U.S. Government Grants

For the years ended September 30, 2006 and 2005, USAID committed, in a letter of credit, additional grant monies of $2,475,000 and $1,000,000, respectively, to the Fund for program purposes, including administrative expenditures. Under the terms of the Grant, the Fund may hold funds in interest-bearing accounts and may retain investment and realized gain income for program purposes. As of September 30, 2006 and 2005, the status of the Grant was as follows:

| | 2006 | 2005 |
|---|---|---|
| Planned grant funding | $ 150,000,000 | $ 150,000,000 |
| Total letter of credit commitment | $ 147,444,125 | $ 144,969,125 |
| Less amounts received | (147,444,125) | (133,700,000) |
| Balance available under letter of credit | $ - | $ 11,269,125 |

## 5. Investments

In the accompanying consolidated statements of assets and liabilities, investments are stated at fair value. During the year ended September 30, 2006, investments were written up from cost to fair value by $31,498,167. This amount was partially offset by reductions in the fair value of certain investments of $2,861,590, resulting in a net change in unrealized gains and losses on investments in the accompanying consolidated statement of operations and changes in fund balance for the year ended September 30, 2006 of $28,636,577. During the year ended September 30, 2005, an increase in fair value of $3,000,000 was recognized. During 2006, two equity investments were sold resulting in a net realized gain of $3,180,070 in the accompanying consolidated statement of operations and changes in fund balance.

In July 2005, a sale-purchase agreement was entered into with Prettl Kabelkonfektion GmbH to sell the shares of Prettl Kabel Ukraine for $2,238,856, comprised of five installment payments to June 30, 2007 totaling $2,212,200, and interest at a rate of 2% per annum of amounts outstanding subsequent to December 31, 2005, totaling $26,656. The Fund received proceeds to September 30, 2006 of $1,345,080, less bank charges, resulting in an outstanding receivable balance of $893,776. As of September 30, 2006 and 2005, the receivable balance included in the accompanying consolidated statements of assets and liabilities is $874,679 and $1,721,362, respectively, calculated by discounting future cash flows at a LIBOR interest rate to amortized cost. The discount rate represents a market interest rate the Fund would expect to receive commensurate with the credit, interest rate and prepayments risks involved, which is the rate at which the same loans would be made under current conditions. During the year ended September 30, 2006, the interest income totals $55,977 and included in interest income in the accompanying consolidated statement of operations and changes in fund balance. A loss on initial recognition of the receivable of $48,416 was included in net realized loss on investments in the accompanying consolidated statement of operations and changes in fund balance for the year ended September 30, 2005.

## 6. Concentration of Credit Risk

By statute, all of the Fund's investments are in business activities conducted in the Region. As such, these investments and cash balances held in the Region's local banks are subject to the political and economic uncertainties associated with doing business in the Region. At September 30, 2006 and 2005, the Fund held cash and cash equivalents of $14,208,296 and $6,699,068, respectively, with one large United States commercial banking institution and a deposit of $12,208,410 (including $208,410 of interest earned), and $0, respectively, with a Ukrainian consumer lending institution, IMB, a portfolio company of both the Enterprise Fund (debt) and of EEGF (equity). As of September 30, 2006, the Fund held foreign currency balances valued at $316,824.

## 7. Fixed Assets

As of September 30, 2006 and 2005, fixed assets consisted of:

| | 2006 | 2005 |
|---|---|---|
| Computer equipment and software | $ 230,198 | $ 513,836 |
| Apartments | 129,164 | 262,117 |
| Automobiles | 109,909 | 194,790 |
| Furniture, fixtures and equipment | 72,958 | 303,333 |
| Telephone equipment | 46,848 | 69,520 |
| Leasehold improvements | 8,411 | 105,370 |
| | 597,488 | 1,448,966 |
| Accumulated depreciation and amortization | (457,129) | (1,031,809) |
| Fixed assets, net | $ 140,359 | $ 417,157 |

## 8. Retirement Plan

The Fund established a defined contribution retirement plan (the Plan) designed to be qualified under Section 403(b) of the Internal Revenue Code. All eligible employees meeting certain age and service requirements may participate. Eligible employees may contribute amounts no more than $15,000 in calendar year 2006 and $14,000 in calendar year 2005. In addition, the Fund makes monthly contributions to each eligible employee's account equal to 25% of the employee's base monthly salary, as defined, plus 5.7% of the amount of salary in excess of the Social Security Taxable Wage Base ($94,200 as of January 1, 2006 and $90,000 as of January 1, 2005). Employees are eligible to participate in the Plan immediately and are fully vested in the employer's portion after two years of service. As of March 1, 2006, the Fund ceased contributing funds to the Plan on behalf of officers and employees transitioned to HCAD.

Employer contributions to the Plan totaled approximately $108,800 and $242,900 for the years ended September 30, 2006 and 2005, respectively, and the related expense is included in employee compensation and benefits in the accompanying consolidated statements of operations and changes in fund balance.

## 9. Long-Term Equity Incentive Plan

Since inception of the LTEI Plan as of October 1, 2002, the Fund has realized successful exits on four portfolio companies resulting in a liability for distributions to LTEI participants, including Moldova Agroindbank and Sonola in fiscal 2006, Slobozhanska Budivelna Keramika in 2004 and Intravest Finance and Investment Company Limited in fiscal 2003. As of September 30, 2006 and 2005 and for the years then ended, $1,218,551 and $856,550, respectively, are recorded as exit-based incentive expense, and $185,103 and $939,146, respectively, as exit-based incentive payable. As at September 30, 2006 and 2005, $185,103 and $154,001, respectively, are recorded as deferred exit-based incentive and will be recognized as a liability over the remaining vesting period. Deferred exit-based incentive is shown as a reduction of fund balance in the accompanying consolidated financial statements. The exit-based incentive expense, exit-based incentive payable and deferred exit-based incentive amounts include the Fund's portion of related payroll taxes. The deferred exit-based incentive amount is charged to expense over the remaining vesting period.

## 10. Commitments

**Operating Leases**

Rent expense for the years ended September 30, 2006 and 2005 is $136,855 and $274,601, respectively. The Fund's Schaumburg, Illinois office lease is in effect until December 31, 2007. Monthly rental payments are required under the lease and, as the Grant Agreement with USAID mandates that the Fund maintain a U.S. office, continue to be an obligation of the Fund. In addition, as of March 1, 2006, the lease obligations in Kyiv, Ukraine and Chisinau, Moldova were transferred to HCAD, except for a nominal portion of these office leases in order to maintain the Fund's status in the Region. These nominal rental payments are paid by the Fund and reimbursed by HCAD, in accordance with the investment management agreement between the Fund and HCA. Future lease payments under the Schaumburg, Illinois operating lease agreement as of September 30, 2006 are as follows:

| | |
|---|---|
| 2007 | $ 32,632 |
| 2008 | 8,185 |
| Total operating lease commitments | $ 40,817 |

**Investments**

As of September 30, 2006 and 2005, the Fund has outstanding investment commitments totaling $16,200,000 and $0, respectively, including $14,200,000 and $0, respectively, committed to EEGF. The Fund also guaranteed a $2,000,000 loan received by a portfolio company during 2006.

In accordance with the Share Pledge Agreement (the Pledge Agreement) between the Fund and the European Bank for Reconstruction and Development (EBRD) executed in September 2004, the Fund pledged 934,270,627 of common shares and 132,085,215 of preferred shares in Energy Alliance to the EBRD as security for a $10,000,000 Loan (the Loan) to this portfolio company. All loan obligations were fully discharged by Energy Alliance in 2006 and the pledge released against the Fund's shares in Energy Alliance by the EBRD.

In addition, in 2004, the Fund signed a Commitment Letter with the Overseas Private Investment Corporation (OPIC) for OPIC to provide a credit facility to IMB of up to $30,000,000, subject to the Fund assuming joint and several liability for certain agreed-upon obligations. Upon execution of the Loan Agreement between OPIC and IMB in 2005, the Fund was released by OPIC from any further obligations per the Commitment Letter.

## 11. Tax Status

**United States**

The Fund is exempt from Federal income taxes under Section 501(c)(3) of the U.S. Internal Revenue Code (the Code), and has been classified as an organization that is not a private foundation as defined in Section 509(a)(1) of the Code. In addition, the Fund is exempt from payment of state and local income taxes.

**Western NIS Region**

The registration of the Fund's accredited representative offices in Ukraine and Moldova occurred on March 31 and July 28, 1995, respectively. Under a bilateral agreement between the Government of the United States of America and the Governments of Ukraine and Moldova regarding cooperation to facilitate the provision of assistance, the Fund is exempt from taxation on income received in connection with implementation of the United States assistance programs. During fiscal 2003, the Fund ceased activities of its representative office in Ukraine, electing to conduct its operations as an international technical assistance project, as defined by the Governments of the United States and Ukraine.

## 12. Related Party Transactions

As disclosed in note 1, in February 2006, the Fund entered into an investment management agreement with HCA, approved by the Board of Directors, to manage the Fund's investments on the same terms as the investment management agreement between EEGF and HCA. Pursuant to both agreements, each entity pays HCA a fee of 2.5% of committed capital to manage its portfolio during the commitment period, payable semi-annually in advance on January 2 and July 1. The management fee expense from March 1 through September 30, 2006, totaled $1,832,192 and a prepaid balance of $787,671 is included in the consolidated statements of assets and liabilities as of September 30, 2006.

In addition, as disclosed in note 1, in 2006, the Fund sold investments, including Shostka, IMB, Natur Bravo, Favorit Capital and Ergopack, as well as a Cyprus holding company, WNISEL, to EEGF. Proceeds from the sale of these entities totaling $26,883,253 were received in full by the Fund from EEGF in 2006. In 2005, in relation to IMB, the Fund capitalized certain expenditures totaling $1,365,790 as part of its investment. These expenditures were fully recouped by the Fund upon receipt of the proceeds for the sale of IMB from EEGF.

As disclosed in note 1, subsequent to the initial closing of EEGF, a majority of the Fund's personnel, administrative and operating expenses were transferred to HCAD. During the period from March 1 through September 30, 2006, the Fund made payments to vendors on behalf of HCAD totaling $170,443 and HCAD made payments to vendors on behalf of the Fund totaling $10,591. The outstanding balance due to the Fund from HCAD and included in accounts receivable in the accompanying consolidated statement of assets and liabilities as of September 30, 2006 is $3,404. This balance was reimbursed in full in November 2006.

In addition, based on approval of the Board of Directors, the Fund sold fixed assets located in the Ukraine and Moldova offices, to HCAD on the basis of an Asset Purchase Agreement executed by both parties as of March 1, 2006. The purchase price of these fixed assets is $379,178, their net book value as of February 28, 2006. HCAD issued a promissory note to the Fund obligating payment of this amount plus interest at 5% per annum, in ten equal installments beginning January 1, 2007 and concluding July 1, 2011. Effective March 1, 2006, based on approval by the Board of Directors, the Fund entered into a five-year lease agreement with HCAD to lease certain vehicles and assets under temporary import status.

The rental rate is $46.88 per day, the daily depreciation rate of these assets, payable on a quarterly basis. All expenses, including but not limited to insurance, repairs and maintenance, taxes and operating costs, are paid initially by the Fund as legal owner and reimbursed by HCAD. During the period from March 1 through September 30, 2006, HCAD made lease payments to the Fund totaling $14,345, with $10,032 recorded as other income during the fiscal year and $4,313 included as deferred income in the consolidated statement of assets and liabilities as of September 30, 2006. As of September 30, 2006, no outstanding lease payments related to leased assets are due to the Fund from HCAD.

During the year ended September 30, 2006, the Fund sold a property, including certain furniture and fixtures, to an officer of the Fund. The purchase price of $80,000 was based on the average appraisal value of the property at $102,000 less $22,000 for reimbursement of leasehold improvements borne directly by the buyer. In addition, furnitures and fixtures valued at $844 were sold at their net book value as of the sales date. The sale of this property and purchase price were approved by the Board of Directors. The Fund recognized a realized loss of $12,932 on this transaction due to the non-inclusion of leasehold improvements incurred by the buyer in the gross book value of the property. This realized loss is included in other operating expenses in the accompanying consolidated statement of operations and changes in fund balance.

The Fund pays certain costs on behalf of its portfolio companies for which the Fund seeks reimbursement. Amounts not ultimately reimbursed to the Fund are written off and expensed in the accompanying consolidated statements of operations and changes in fund balance.

During the years ended September 30, 2006 and 2005, the Fund earned $108,867 and $126,944, respectively, of director's fees from its portfolio investments. In addition, fully-depreciated computer and office equipment was transferred to portfolio companies in fiscal 2006 and two automobiles and computer equipment, all fully depreciated, were transferred to portfolio companies in fiscal 2005.

## 13. Contingencies

In 2000, the Fund commenced arbitration proceedings before the International Centre of the American Arbitration Association in New York to recover a loan receivable from one of its portfolio companies, CJSC Sonola (Sonola). The Fund won a $3,769,839 arbitration award in 2001 but was subsequently unable to enforce it in Ukraine. Having exhausted all legal remedies in Ukraine, the Fund applied to the International Centre for Settlement of Investment Disputes (ICSID) in 2004 with a claim against the Government of Ukraine for failing to protect the Fund's Bilateral Investment Treaty rights in relation to Sonola. In June 2005, the Fund negotiated a $3,000,000 out-of-court settlement to divest of its shares in Sonola. During the year ended September 30, 2005, proceeds of $2,000,000 were received with the remaining balance of $1,000,000 paid during the year ended September 30, 2006.

In the ordinary course of business, the Fund is involved in various other claims and legal actions and may bear material legal costs relating to such matters. In the opinion of management, no provision is included in the accompanying consolidated financial statements as the ultimate disposition of the various claims and legal actions, based on information currently available, may not be determined at this time and the loss, if any, will not have a material adverse effect on the consolidated financial position or changes in fund balance.

## 14. Guarantees

In the normal course of business, the Fund enters into contracts that contain a variety of representations and warranties and which provide general indemnifications. The Fund's maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against the Fund that have not yet occurred. based on experience, management expects the risk of loss to be remote.

As disclosed in note 10, the Fund guaranteed a loan received by a portfolio company in the amount of $2,000,000.

## 15. Financial Highlights

The following presents the financial highlights for the years ended September 30, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| **Ratios to average Fund balance** | | |
| Net investment loss | (6.3)% | (9.6)% |
| Net realized gain on investments | 3.8% | 0.0% |
| Expenses, including exit-based incentive expense – current | 8.4% | 12.0% |
| Less exit-based incentive expense – current | (1.5)% | (1.6)% |
| Expenses, excluding exit-based incentive expense – current | 6.9% | 10.4% |
| **Total return, including exit based incentive expense – current and deferred** | 41.2% | (3.1)% |
| Less exit-based incentive expense – current and deferred | 1.5% | 0.0% |
| **Total return, excluding exit based incentive expense – current and deferred** | 42.7% | (3.1)% |
| **Ratios to Committed Capital** | | |
| Net investment loss | (3.6)% | (3.6)% |
| Net realized gain on investments | 2.2% | 0.0% |
| Expenses, including exit-based incentive expense – current | 4.8% | 4.5% |
| Less exit-based incentive expense – current | (0.8)% | (0.6)% |
| Expenses, excluding exit based incentive expense – current | 4.0% | 3.9% |

Ratios to average Fund balance are computed as year-end net investment loss (total investment income less total expenses), net realized gain on investments (excluding realized losses from the write-off of investments) and expenses divided by the average Fund balance for the year. Total return represents a change in the value of an investment, measured by comparing the aggregate ending value of the Fund balance to the aggregate beginning value of the Fund balance, adjusted for grant contributions during the year.

The total return and ratios have been presented before and after the effects of exit-based incentive expense, which includes expenses related to Financial Participation Rights and the LTEI Plan.

Ratios to Committed Capital are computed as year-end net investment loss (total investment income less total expenses), net realized gain on investments (excluding realized losses from the write-off of investments) and expenses divided by committed capital. Committed capital is the total letter of credit commitment from USAID. As of September 30, 2006 and 2005, these amounts were $147,444,125 and $144,969,125, respectively.

## 16. Subsequent Events

Subsequent to September 30, 2006, the Fund received a distribution of contributions made to date of $3,608,236 from EEGF from new investors admitted as of the third closing of EEGF held September 29, 2006 and an additional contribution was made to EEGF of $94,697. As such, the Fund's limited partnership interest in EEGF decreased to $7,275,242 subsequent to September 30, 2006. In addition, notional interest of $164,548 was received from new investors admitted as of the third closing of EEGF subsequent to year-end.

In November 2006, the Fund received $54,903 from ICSID which is the unused portion of the $75,000 deposit towards expenses relating to the Sonola case.

## BOARD OF DIRECTORS

**DENNIS. A. JOHNSON, CHAIRMAN OF THE BOARD**
Executive Vice President
Cooperative Housing Resources, LLC

**PATRICK H. ARBOR**
Shatkin Arbor, Inc.

**RICHARD I. ARTHUR**
Former Chairman of the Board
Sippican, Inc.

**ROBERT M. COTTEN**
Los Angeles, California

**NATALIE A. JARESKO**
President and Chief Executive Officer
Western NIS Enterprise Fund

**JAROSLAWA ZELINSKY JOHNSON**
Managing Partner
Chadbourne & Parke LLP

**WHITNEY MACMILLAN**
Chairman Emeritus
Cargill, Inc.

**JEFFREY C. NEAL**
Former Chairman
Global Investment Banking Group
Merrill Lynch & Co., Inc.

## WNISEF OFFICERS

**NATALIE A. JARESKO**
President and Chief Executive Officer

**LENNA KOSZARNY**
Chief Financial Officer

**MARK A. IWASHKO**
Executive Vice-President and
Chief Investment Officer

## ACKNOWLEDGEMENTS

WNISEF's Board of Directors and Senior Management would like to express its appreciation to the following individuals who made invaluable contributions to the professional development of our employees and portfolio companies during this past year.

**RONALD MENHENNET**
International Executive Service Corps (IESC)
Fremont, CA, USA

**DONATAS TIJUNELIS**
International Executive Service Corps (IESC)
Lemont, IL, USA

**UKRAINE**

4 Muzeyny Provulok
Third Floor
Kyiv, 01001, Ukraine
Tel.: +380 (44) 490-5580
Fax: +380 (44) 490-5589

**MOLDOVA**

27 Sfatul Tarii
Fourth Floor
Chisinau, 2012, Moldova
Tel.: +373 (22) 23-7141
Fax: +373 (22) 23-7136

**USA**

175 W. Jackson Boulevard
Suite 2225
Chicago, IL 60604
Tel.: +1 (312) 939-7003
Fax: +1 (312) 939-7004

Contact e-mail: info@wnisefk.com
Web-site: www.wnisef.org