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MICROENTERPRISE INNOVATION PROJECT

Assessment of the Nachala Foundation
Sofia, Bulgaria
March 26 - April 4, 1996

Final Report

U.S. Agency for International Development

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I. REPORT PURPOSE AND METHODOLOGY

The Microenterprise Innovation Project (MIP) is the main vehicle through which the USAID Office of Microenterprise Development supports the goals and principles of the Microenterprise Initiative, a program designed to increase the availability of financial services to micro- small- and medium-scale enterprises in the developing world. The Implementation Grant Program (IGP), an MIP component, provides grants to U.S. private voluntary organizations (PVOs), cooperatives, credit unions, and developing country organizations capable of working in more than one country to support the development of indigenous organizations involved in microenterprise promotion and service delivery. The goals of the IGP are: to increase the ability of local institutions to achieve increased outreach and scale of microenterprise services; to help them move toward higher levels of financial viability; and to improve the quality and efficiency of financial reporting and internal administration.

Field assessments of all IGP grant recipients are scheduled during the first year of program implementation to:

(i) Verify each local institution's capacity for reporting accurate/consistent data,
(ii) Review financial statements and other relevant documentation to verify baseline data presented in the IGP proposal, and
(iii) Assess the appropriateness/reasonableness of annual and end-of-project targets.

In September 1995, Opportunity International, a U.S.-based non-governmental organization (NGO), received a five-year IGP grant from USAID to help develop the Nachala Foundation, a Bulgarian NGO that supports private enterprise development by lending resources to small and medium-scale businesses. Opportunity International's goal for the program with Nachala is to increase the outreach and the benefits of the credit and training programs, while also increasing the scale and efficiency of its client services. These efforts are also expected to increase Nachala's capability to sustain itself from earned income, with a target of 102 percent financial self-sufficiency by year-end 2000. Specific objectives identified by Opportunity include:

- An increase in the number of loans outstanding from 174 in December 1994 to 1,500 in December 2000;
- An increase in the value of loans outstanding from $987,836 in December 1994 to $8,000,000 in December 2000 (five years);
- Maintenance of an arrears ratio of five percent or less throughout the life-of-project;
- Achievement of a long-run loss ratio of 2.5 percent or less;
- An increase in the return on operations from 53 percent in 1994 to 102 percent in 2000;
- An increase in borrowed funds to a total of $1.5 million in the last year of the project.

In March 1996, a two-person team from USAID/W visited the Nachala Foundation to complete the field assessment. The following report is based upon interviews with Nachala staff, conversations with the Regional Director of Opportunity International, visits with borrowers in Sofia and Plovdiv, and a review of financial and other reports.

II. BULGARIAN BANKING ENVIRONMENT

Bulgaria has a weak financial system that is undercapitalized, poorly structured and likely possessing high levels of non-performing assets. The government has been slow to privatize the banking system, and access to bank financing is very limited. Since 1990/91, attempts at bank reform have been made (e.g., approximately 70 state-owned banks were consolidated into 11 commercial banks and over $2.5 billion was used to recapitalize some institutions); however, most of the banks still have inadequate or negative capital, and loan portfolio problems are common, mainly the result of historical lending to state-owned enterprises. A recent article in the *Economist* indicated that "only a third of Bulgarian banks are solvent and, according to the IMF, the sector has a negative net worth of $1.5 billion. Banks made a collective loss of $1 billion in 1995." The Central Bank has indicated that loans extended by local commercial banks to state and private enterprises total approximately 360 billion levs (US$4.6 billion). Between 60 and 75 percent of these loans are considered to be uncollectible.

A recent article in a local business gazette noted that the Central Bank has been criticized for "allowing an unprecedented decapitalization of the banking system and has reportedly tightened bank supervision and restricted lending." New prudential regulations for deposit taking and lending were enacted, but bank supervision is still in an embryonic stage, and there is little compliance with safety and soundness criteria. State-owned banks continue to dominate Bulgarian financial markets, but there are many newly-established private commercial banks now operating as well. Most of these are very small and thinly capitalized, and they restrict lending to short-term loans in trade and commerce. Their financial condition is unknown, but several recently collapsed, and others have been placed under Central Bank administration in an attempt at rehabilitation.

The generally poor financial condition of the Bulgarian banks and their reputation for mismanagement and insider deal-making has further constrained the availability of credit to the private sector. A poor public image has dried-up local deposits and liquidity for lending. One banker told the *Economist* that about 70 percent of the banking system's deposits have been withdrawn and stuffed under mattresses. According to the article, the Central Bank has raised interest rates sharply in an attempt to curb bankers' excesses. This has caused the inter-bank market to dry up and has led most banks to stop lending to third parties. Many of the banks seem to prefer placing their funds with the Central Bank (as deposits) or investing in Bulgarian Government securities. The small amount of lending that occurs is highly concentrated in large loans to a small number of well-known clients. Furthermore, commercial banks only accept real estate such as houses and apartments as collateral. Loan interest rates are high, typically between 24 and 36 percent annually on U.S. dollar-denominated loans, and terms are limited to a one-year maximum. Farmers and small-scale businesspeople who do not own urban real estate have little if any access to commercial financing.

The development of open and competitive commercial loan markets also has been slowed by inadequate and confusing banking legislation. Although mortgages are the principal loan guarantee mechanism used by the banks, it is very difficult to foreclose on mortgages through the court system, should it become necessary. Expensive delays are commonplace, and the courts tend to shield borrowers by requiring lenders to auction foreclosed properties at artificially-established "replacement values." If, for example, a lender is unable sell a property at the court-established replacement value after two attempts, the security is declared invalid. The risk associated with mortgages is further compounded by the absence of legislation providing for contracts guaranteed by movable property (e.g., inventories, cattle, machinery, and vehicles), and the lack of a central registry for security interests in chattel mortgages. Lenders can register loan contracts and chattel mortgages with notaries (such contracts are enforceable), but there is no way to ascertain whether a prior pledge exists without contacting the thousands of notaries located in the country.

While bank reform has been moving slowly, Bulgaria's private sector has grown rapidly over the past four years. In late 1995, private enterprise was officially estimated to account for 27 percent of total economic activity, and an additional 18 to 20 percent of household incomes are thought to be derived from informal economic activities that escape official statistics. Private sector firms have been the main source of growth in output and employment, and most of these are concentrated in agriculture, related processing and sales, and services (e.g., retail and wholesale trade and construction). Over 90 percent of the private firms are small, with fewer than five employees, and most depend upon limited household savings and loans from friends and family to finance their operations. Owning and operating a small business in Bulgaria is difficult and complicated by a lack of experience, a scarcity of capital, complex tax structures, rules and regulations, and the absence of government support for private initiatives.

III. PROGRAM OVERVIEW

According to the April 1995 MIP grant proposal submitted by Opportunity International (OI), the Nachala Foundation has demonstrated its ability to operate a highly efficient lending program. The loan portfolio doubled in size between 1994 and 1995, loan delinquency was under control at 5 percent of outstanding loans in December 1994, and Nachala was covering 53 percent of operating costs from earned income during the same period. The USAID grant to OI was designed to ensure Nachala's long-term institutional sustainability by providing an injection of equity capital to finance increased lending and reduce the dependence on the external loan capital now provided exclusively by the Bulgarian American Enterprise Fund (BAEF).

Over the five-year life-of-project, USAID's Implementation Grant with Opportunity International will provide a total of $771,110 to support the development of Nachala, including $251,110 for operating costs and audits, and $520,000 to capitalize Nachala's loan fund. Contributions from Opportunity International will total approximately $328,126, including an additional $180,000 for the loan fund. Combined USAID and OI loan fund contributions ($700,000) are designed to:

i) allow Nachala to scale-up its program by leveraging borrowed funds;
ii) permit Nachala to become a more effective originator and manager of micro loans on its own and on behalf of other institutions such as the Bulgarian American Enterprise Fund (BAEF); and
iii) allow Nachala to reach a level of operations at which it is financially viable and can undertake a transition to commercial sources of funds.

IV. THE NACHALA FOUNDATION

A. Background and Organizational Structure

The Nachala Foundation was incorporated in Bulgaria in July 1993 as a private, non-profit foundation which promotes small business development. Nachala is an affiliate of Opportunity International, a U.S.-based private voluntary organization (PVO) whose goal is to create employment and income opportunities for the poor through small and microenterprise development. Opportunity's strategy is to build independent microenterprise development institutions (called "partners") which are managed by local, volunteer boards of directors. It was the first major international microenterprise PVO to begin operations in Eastern Europe and the CIS, and the program with the Nachala Foundation was its first such initiative.

Opportunity International identified a board of directors for Nachala in 1993, initially attracting four Bulgarian business men and women, and one university professor, who represented Sofia, Vellingrad and Plovdiv. The maximum size of the board was set at nine members, and there are currently six serving, including a new representative from the city of Pleven. Because Nachala has a policy to select new board members from regions where it would like to open branches, a search is underway to identify and select a representative from Varna, the next city targeted for a Nachala branch. Each board member is elected for a three-year term, with the option to renew for an additional three-year term if willing to serve. The board meets monthly to discuss policy and related matters affecting the overall operations of Nachala. Five members of the Nachala board are owners of small enterprises and ex-clients of the loan program. They understand the problems that small business start-ups in Bulgaria face and are anxious to expand Nachala's outreach.

B. Relationship with Bulgarian American Enterprise Fund

The Bulgarian American Enterprise Fund (BAEF) is a private U.S. corporation established by the U.S. Congress to promote the development of free enterprise and entrepreneurship in Bulgaria. Operating with capital totaling $55 million, the BAEF disburses financing denominated in U.S. dollars for investments in the private sector. The Fund has five different programs, each of which is designed to address different loan sizes and sectors of the economy. The "Micro Loan Program", with a current budget of $2.75 million, is the most active of the BAEF programs. It is managed by the Nachala Foundation and provides credit to small-scale businesses with a maximum loan size of $20,000.

Under current Bulgarian legislation, non-bank financial intermediaries such as Nachala are not permitted to engage in direct lending, nor are they allowed to mobilize savings from the public. The Micro Loan Program permits Nachala to circumvent these restrictions when lending to clients because the loan resources are actually owned by the Enterprise Fund, which has a waiver to operate in Bulgaria. The loan approval procedures required by the government are onerous, but compliance is the only way Nachala can operate at this time. Sometime during 1996, Nachala plans to launch a subsidiary to engage in lease financing as a complement to the BAEF-financed program. The subsidiary will be capitalized using IGP and other resources, but specific operating guidelines have yet to be developed. (See page 15, "Nachala Limited").

As of February 1996, Nachala had provided loans to 360 small- and medium-scale entrepreneurs, using approximately $2.26 million under the BAEF's Micro Loan Program. Nachala identifies prospective borrowers, evaluates the quality of their loan proposals, prepares loan documentation, approves (or disapproves) applications, monitors loan repayment, and reports to the Fund on a monthly basis. For these services, Nachala has earned a three percent origination fee from the borrower and a three percent asset management fee from the BAEF. Nachala has also received operating grants from the BAEF, as well as additional grant financing from private donors to Opportunity's General Fund and the British Know How Fund. During the period July 1993 through December 1995, operating grants from these sources totaled approximately $179,000.

Under the original agreement with the Enterprise Fund, Nachala was charged with loan administration and collection, but the BAEF assumed all risks associated with loan default. The agreement was modified in January 1996 to revise the management fee formula and to increase Nachala's responsibility for loan collection (see Attachment A). Under the terms of the new agreement, the BAEF committed to provide a total of $2.25 million to finance the Micro Loan Program through December 1998. This was increased to $2.75 million at the March 1996 BAEF board meeting. In addition, the BAEF will provide $150,000 to Nachala over three years to finance technical assistance and training programs for clients. Finally, Nachala will receive 50 percent of the fee and interest income generated by the loan portfolio; however, it will now be fully responsible for loan recovery. Principal and interest written-down by the BAEF on loans with balances greater than 120 days past-due will be deducted from Nachala's share of the earnings each quarter. The new contract increases Nachala's capability to generate greater earnings from the BAEF-owned loan portfolio, but it also increases the costs that will be incurred should delinquency become a problem. The BAEF will provide, on a case-by-case basis, a power of attorney to permit Nachala to represent the BAEF in court actions designed to collect loans that have been charged-off.

The BAEF has non-voting representation at Nachala's bi-weekly credit committee. It also reviews all loan documentation to ensure that Nachala loan officers are following the appropriate loan policies and procedures. The specific chain of events following the approval of a loan by Nachala's credit committee are described later in this report. Approved loans are secured by personal guarantees (for loans smaller than $3,000) or by mortgages on assets, and they are formalized by a contract between the BAEF and the borrower. Loan proceeds are either disbursed in cash or are deposited into an account of the borrower in U.S. dollars.

C. Loan Policies

The Micro Loan Program permits Nachala to extend loans, ranging in size from $1,000 to $20,000, "to entrepreneurs who are unable to borrow from formal financial institutions because they are either too small, too inexperienced or they do not have suitable collateral."[1] Loans are made in U.S. dollars at a fixed annual interest rate of 15 percent. The rate was established by the BAEF when the program began in 1994 and has remained unchanged since then. The maximum loan term is three years. Loan payments must be made monthly in U.S. dollars (or the equivalent in local currency on the date the payment is made), leaving the borrowers to bear any foreign exchange risk associated with converting Bulgarian leva to U.S. dollars for the monthly payment.[2] Nachala believes the 15 percent interest rate will generate sufficient earnings to defray its operating costs and is reasonable, given the requirement that borrowers repay in U.S. dollars. According to Nachala staff, "the economic uncertainty precludes using a higher rate of interest."

Nachala practices character-based lending for loans ranging in size from $1,000 to $3,000. Borrowers for these smaller loans are not required to pledge collateral, but they must secure their loans with third-party personal guarantees, i.e., co-signers who become legally liable for repayment if problems occur. Two co-signers are required for loans up to $2,000, and up to five co-signers are required for loan amounts between $2,000 and $3,000. Loans exceeding $3,000 must be secured by a mortgage on assets such as a home or equipment. In these cases, the value of mortgaged security must equal at least 150 percent of loan amounts, somewhat less than the 200 percent minimum collateral now required by most commercial banks.

D. Loan Application and Approval Process

Nachala does not advertise its services. Most prospective borrowers are recommended by former clients or by individuals who are familiar with Nachala, a procedure designed to improve the quality, and control the number, of clients who arrive at their offices. During the first visit, prospective clients are interviewed by the loan officers to assess the "seriousness" of the proposed activity, as well as their understanding of the conditions that must be met for loan

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1 Nachala Foundation Annual Report, 1995.

2 The leva lost 48 percent of its value against the U.S. dollar between 1994 and 1995, and has continued to erode during 1996.

approval. The interview process is very important, being designed to filter-out those individuals who do not possess the character or the business sense to embark on a debt-financed investment. Prospective borrowers complete a simple loan application that includes a detailed earnings and employment history, as well as a list of character references who can be contacted. Once informal contacts with references have been made, loan officers visit clients at their place of business to further discuss business plans, evaluate potential cash flow repayment capacity, and reach agreement on the loan amounts and the terms to be sought.

No formal cash flow or repayment capacity analysis is actually performed by Nachala, but loan officers do help potential borrowers prepare simple business plans to more accurately assess their credit needs (including grace periods and terms). One Nachala loan officer said "since almost everyone wants the maximum loan amount, we need to help them avoid becoming overly indebted." Nachala typically provides borrowers with grace periods on principal and interest payments ranging from one to six months. This policy has been particularly important for agricultural loans and new business start-ups, and borrowers consider it one of the most attractive aspects of the credit program.

Nachala has a five-member credit committee which meets bi-weekly to review the loan proposals brought forward by Nachala's loan officers. Members include two board members, the executive director, the finance manager, and one loan officer. The finance manager and the executive director are the only permanent committee members, and the other three positions are filled on a rotating basis. A non-voting representative of the BAEF also attends each credit committee meeting. Loan applications are presented by the loan officer who interviewed and provided follow-up assistance to the applicant, and each application is discussed by the committee before being approved or declined.

Once an application is approved by the credit committee, it is forwarded to the BAEF office in Sofia, where it is reviewed for completeness and then forwarded to BAEF's Chicago headquarters for final approval. Once the BAEF's endorsement has been obtained, the loan application is forwarded to the Bulgarian Ministry of Finance for an interim opinion (typically a month-long process) and then forwarded to the Central Bank for final approval. This procedure is required by the Bulgarian government because: i) the Enterprise Fund does not have a local banking license; and ii) as a foreign entity operating in Bulgaria, its operations must be reviewed to ensure that all investments are beneficial to the country. The entire loan approval process takes approximately 45 to 90 days to complete, but borrowers do not complain because it is considered relatively fast when compared with the loan processing time and costs incurred when trying to obtain a commercial bank loan. The chart below depicts the distribution of loans by Nachala offices to date:

	Plovdiv	Sofia	Vellingrad	Pleven	TOTALS
1994					
# of Loans	29	100	44	n/a	173
Value (US$)	104,620	679,110	285,435	n/a	1,069,165
Average	3,608	6,791	6,487	n/a	6,180
1995					
# of Loans	46	72	46	n/a	164
Value (US$)	266,707	457,127	280,433	n/a	1,004,267
Average	5,798	6,349	6,096	n/a	6,124
March 96					
# of Loans	13	13	6	3	35
Value (US$)	46,000	46,000	28,000	5,000	120,000
Average	3,538	3,538	4,667	1,667	3,429
TOTALS					
# of Loans	88	185	96	3	372
Value (US$)	417,327	1,182,237	593,868	5,000	2,198,432
Average	4,742	6,390	6,186	1,667	5,190

While there are some small differences among the Nachala offices (e.g., Plovdiv has about 50 percent of its portfolio invested in agriculture and related businesses, whereas Sofia has only 22 percent in similar activities), there is much homogeneity among clients. Most are middle-class, first-time borrowers who are embarking on small business development to supplement or replace government salaries. Many are well-educated, anxious to succeed, and worried about becoming indebted.

E. Loan Administration and Delinquency Control

Recipients of Nachala loans are required to make monthly payments of principal and interest, unless a grace period has been authorized. (Note: interest accrues during a grace period but is not actually paid until the first installment is due). Loan payments can be made directly into BAEF accounts located in the International Bank for Investment and Development (IBID), which only has offices in Sofia, or the First Private Bank, which has branches located around the country. Borrowers may also make their monthly payments at the local offices of Nachala, which deposits them into the previously-mentioned BAEF bank accounts.

In mid-1995, Nachala obtained a software program entitled "Loan Administrator" from Opportunity International that is used to monitor and report on the loan portfolio. The program has greatly improved Nachala's loan tracking capabilities, but is complex and its use is limited to the Sofia office, where one Nachala staffer is trained to use it and another is receiving orientation. Nachala loan officers manage their clients through monthly visits to their place of business or, if this is not possible, by telephone conversations. According to the loan officers, monthly visits are an effective way to identify potential problems, and the "personal touch" is greatly appreciated by borrowers, offering them an opportunity to talk about their business plans, problems and successes.

Nachala formally monitors loan repayments once a month, when it receives transaction reports from the participating banks. These bank reports are often delayed, and borrowers are now asked to provide Nachala with a copy of their payment receipt as soon as possible after the payment has been made. Receipts are kept in a client file at Nachala's Sofia office and/or in each of the branch locations, and later compared with the bank reports. This system has helped Nachala reconcile client accounts. However, since there is no borrower obligation to forward the receipts, payments of principal and interest cannot be monitored more frequently.

Loan delinquency rates have been increasing since Nachala began making loans in the last quarter of 1993. In December 1994, the delinquency rate on loans past-due for periods greater than 30 days was approximately five percent,[3] and no loans had been written-off by the Enterprise Fund. Fourteen months later (February 1996), loan delinquency was estimated at 15.7 percent of the outstanding portfolio, and $86,512 in loan principal (3.8 percent of total accumulated loans) had been written-off.[4] The increase in loan delinquency is a source of concern within Nachala, and the board has tightened loan approval criteria (particularly for the larger loans) as evidenced by a decline in the number of loans and the amounts approved in 1995 and 1996.

The BAEF has a policy of writing-down any loan with a balance greater than 120 days delinquent, but Nachala continues collection efforts and has had some success rehabilitating loans in default. According to Nachala's loan administrator, 26 loans are delinquent for periods ranging from 31 to 120 days, but 20 of these borrowers have contacted Nachala, explained the reasons for their inability to repay, and are making reduced payments on their loans. All 20 are expected to repay the total balance due. According to Nachala's loan administrator, "these borrowers were unable to remain current in their loan payments due to circumstances beyond

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[3] IGP Grant Proposal from Opportunity International, May 1995.

[4] "Funding and Services Agreement" between the Bulgarian American Enterprise Fund, Opportunity International and the Nachala Foundation, amended in December 1995.

their control (e.g., crop failure, break-down of equipment, poor market conditions, etc.), but they have every intention of repaying their obligations." Nachala also has a penalty for late payments of 0.5 percent of the original principal, but this has not yet been applied in any of the existing cases. Only six loans are in default due to borrower fraud or simple unwillingness to repay, and in these cases, the borrowers (and the co-signers, where applicable) have been threatened with legal action. As yet, no cases have actually been brought before a court for action, and it is unclear when or if this will occur.

In Bulgaria, as in many other countries, it is very difficult to take court action against a delinquent borrower. Foreclosing a mortgage through the court system is a long and expensive process. The BAEF estimates the foreclosure process can easily consume one to two years, and there is always a risk that courts will rule against the lender for social reasons. For small loans ($3,000 to $5,000) such as those made by Nachala, it is simply not economical to attempt foreclosure. In contrast, repossession of assets financed through lease arrangements is apparently much easier than mortgage foreclosure, but the resale value of used assets is typically much less than outstanding obligations. In addition, it can be very difficult to recover property in the physical possession of a delinquent borrower. Nachala has had mixed experience recovering leased assets, with some borrowers voluntarily offering assets in lieu of payment and others hiding or selling them to avoid paying their obligations. Nachala has not tried to foreclose a mortgage using legal action, arguing that the "social stigma" attached to a threat of legal action will provide sufficient incentive for most delinquent borrowers to repay.

F. Staffing and Operating Costs

Nachala has its main office in Sofia, with branch offices in the cities of Plovdiv, Pleven and Vellingrad. The main office is staffed by three loan officers, a loan administrator, a finance manager, an office manager, and a driver/messenger. The branch offices are staffed with loan officers (two in Plovdiv, one in Pleven and two in Vellingrad). All Nachala staff are young, motivated, and very client-oriented. With the exception of the newly-opened Pleven office, Nachala's loan officers each manage an average of 50 active borrowers, and they believe they can double that number without great difficulty. Typically, loan officers help clients prepare loan applications, act as a client advocate at the bi-weekly credit committee meetings, and provide advice and support during their regular (monthly) contacts once loans have been approved and disbursed.

The position of executive director has been vacant since the resignation of Nachala's first executive director in June 1995; however, staff have operated very effectively with little outside (i.e., board) supervision. In March 1996, Nachala's Board selected one of the Sofia loan officers to become the new executive director, an important step that will strengthen internal management and Nachala's plans to expand into new regions of the country during 1996.

As of December 1995, Nachala's operating costs were equivalent to approximately six percent of the outstanding loan portfolio ($1,673,000), and earned income financed about 63 percent of those costs. Staff salaries and benefits represented 49 percent of total operating costs, somewhat below the 60 percent average cost ratio of other similar NGOs. Salaries are competitive with the commercial banks; however, bank employees also receive other benefits (e.g., clothing and transportation allowances, automobiles, etc.) not provided to Nachala personnel.

Over the near term, it is likely Nachala's operating costs will increase more quickly than income as new branches are opened, new staff are hired, and it becomes necessary to provision against loan loss, a new expense item. As noted earlier, under the terms of the October 1995 "Funding and Services Agreement" with the Enterprise Fund, Nachala is now fully responsible for loan collection, and all loan defaults will be deducted from quarterly earnings by the BAEF. The new agreement increases Nachala's fee income from 3 percent to 7.5 percent of the outstanding portfolio, but new loan volume is actually falling at a time when costs are expected to increase. In addition, delinquency rates are increasing. Nachala will need to pay close attention to income and expenditures as the expansion program moves forward, while also becoming more demanding in requiring on-time payment from all clients.

V. SUMMARY REMARKS

A. General Conclusions

The assessment of Opportunity International's program with the Nachala Foundation was completed in March/April 1996, approximately six months after the grant agreement with USAID was approved. The purpose was to verify baseline data and appraise Nachala's capacity for reporting accurate and consistent data, and to assess its ability to meet the annual and the end-of-project targets included in the grant agreement.

The USAID grant to OI is expected to permit Nachala to attain full financial self-sufficiency by the year 2000. Achieving this goal will require: 1) sound financial planning; 2) significant growth in lending; 3) good control of delinquency and operating costs; and 4) the mobilization of external capital to complement that provided by USAID and OI through the grant. This report has reviewed aspects of Nachala's financial and operational structure, and attempted to assess its progress in meeting the annual targets for Year 1 as outlined in the grant agreement:

Key Program Indicators

Indicator	Year 1 Target	Completed to Date	Difference
Number of Loans Outstanding	433	312	(121)
Value of Loans Outstanding	$2,600,000	$1,793,000	($807,000)
Delinquency Rate > 30 days	6.0%	15.7%	9.7%
Long Run Loss Rate	2.0%	3.2%	1.2%
Return on Operations	70%	63%	(7%)
Borrowed Funds	0	n/a	n/a

In March 1996, Nachala was making good progress toward achieving Year 1 targets for the number and the value of loans outstanding, as well as the annual return on operations; however, loan delinquency was well above the six percent target and was beginning to affect both loan size and the loan approval rate. Delinquency increased from 5 to 15.7 percent during the three month period ending in March, forcing Nachala's board of directors to reassess and tighten loan approval criteria. The Board has since instructed staff to promote smaller loans (e.g., $1,000 to $3,000). In addition, the credit committee is now requiring applicants for larger loans to provide several co-signers and to pledge tangible collateral.

These actions may help improve portfolio performance and the eventual recovery of delinquent accounts, but they are not sufficient to address the risks associated with the recent and very rapid devaluation of the leva. The leva lost 62 percent of its value (moving from 74 to 120 leva to the U.S. dollar) during the month of May 1996, and Bulgaria's economy is in a tailspin. Nachala loans are denominated in U.S. dollars, with the borrower assuming all exchange rate risks. As the exchange rate deteriorates, borrowers will need more and more local currency to purchase the dollars needed for their monthly payments. Since the typical Nachala client produces and sells for domestic consumption, many may be unable to raise prices sufficiently to compensate for devaluation without becoming non-competitive. In addition, small businesses that produce luxury items or provide non-essential services are likely to encounter a slowdown in sales as households reduce excess expenditures. This is not a favorable environment for any lending institution, and it could be a critical period for the Nachala Foundation.

First, Nachala will not be able to meet the growth and income targets included in the grant agreement with USAID until the Bulgarian economic situation becomes more stable. Aggressive expansion of new lending under current conditions would be highly risky. Loan delinquency may increase over the short-term as more clients have difficulty generating the cash flow needed to repay their loans. Pressure techniques and/or the use of legal action to foreclose on collateral will not help Nachala grow and expand.

Most non-bank financial intermediaries that have survived bouts with hyper-inflation and long periods of severe economic adversity have done so by minimizing operating costs and controlling risk by cutting loan volumes, limiting loan size, and reducing loan terms. Only the most credit-worthy borrowers are financed and loan terms are made as short as possible. Borrower unhappiness over tight loan terms is often offset by offering relatively easy access to new financing once loans are repaid. Finally, applicants are required to demonstrate clearly how they plan to repay their obligations. This protects both the borrower and the lender by allowing a transparent assessment of risks. A common pitfall during this process is to overly emphasize collateral. Having sufficient collateral to guarantee a loan is very different from having repayment capacity, and it is important to avoid confusing the two.

Hopefully, Bulgaria's economic instability is a temporary condition, but it highlights the importance of regularly monitoring local financial markets and making adjustments to policies whenever necessary or prudent.

Opportunity International should also consider steps to improve and decentralize Nachala's management information systems. At present, Nachala's MIS and accounting system is not capable of supporting accelerated growth, nor does it generate the kind of information that is needed for timely decision-making by management and the board of directors. First, the simplified monthly income and expense reports now prepared by Nachala are not supported with balance sheets, making it impossible for management to analyze financial structure. In addition, the statements do not compare budgeted projections against actual results, nor do they measure central and branch office operating expenses against the income generated. These are key aspects to judging where costs are justified and where they are not. Nachala needs a new accounting system and a uniform reporting format that clearly reports on critical aspects of monthly operations (e.g., interest income, administrative costs, loan loss provisions, etc.).

Effective financial management during periods of high inflation demands an ability to closely monitor cash flow, income and expenditures. Each Nachala branch should be treated as a cost center where income and expenditures can be closely and regularly tracked. In addition, loan portfolio monitoring should be decentralized and accompanied by a more timely reporting system for loan payments. The current monitoring system of monthly bank reports is insufficient. Finally, responsibility for portfolio performance should be transferred to each of the branches.

Nachala has completed the start-up phase of a much longer-term institutional development effort that is now complicated by a high degree of currency instability and high rates of inflation. Operating successfully in this environment will require internal control and reporting systems that are accurate, timely and permit lending policies and operating procedures to be modified whenever necessary. Greater outreach is one of the keys to increased earnings and will eventually require expanding the client base in Sofia, Vellingrad, Plovdiv and Pleven, as well as the opening new outlets in other cities. Accelerated growth under current economic conditions, however, is not a realistic strategy at this time.

Over the short-term, Nachala's future is tied to: 1) the reestablishment of relative economic stability; and 2) the continued availability of BAEF and other external sources of loan capital. Access to these funds must be protected by maintaining an effective credit delivery and recovery record, and particularly, by encouraging clients with outstanding loans to maintain their repayment schedules. The adverse economic conditions will make this a challenge. Over the medium-term, Nachala must grow and become capable of financing all normal operating and financial costs (as well as providing for a reasonable growth of capital) from earnings. Nachala will only be able to leverage the external resources necessary to finance a growing portfolio if it can demonstrate profitable operations and low rates of loan default.

Finally, the long-term future of the Nachala program will be determined by the effectiveness of Nachala Limited, the leasing company that will provide the Nachala Foundation with a source of income independent from the loan capital now provided by the BAEF. To date, Nachala has been slow to market its leasing program because: it has had more problems with leases than with loans financed under the BAEF program; Nachala loan officers are inexperienced with leasing; and it took several months to obtain an operating license. The license was obtained in October/November 1995; however, since that time, the economic situation has deteriorated greatly. Prudence suggests that Nachala reinvestigate the potential and the risks of leasing in a volatile economic climate before launching the program. In addition, further investigation is necessary to clarify existing legal restrictions and/or requirements that surround lease financing in Bulgaria. During this investigation, Opportunity International can help Nachala: establish operating policies which may differ considerably from those in use under the BAEF-financed program; prepare simple but legally-binding lease documentation; train staff; and develop targeted marketing plans for use when the economic situation stabilizes.

B. Specific Areas for Improvement

1. Business Planning and Evaluation

Nachala's annual planning and evaluation process is not sufficiently well-developed to support the institutional goal of accelerated growth accompanied by low rates of loan delinquency and improved earnings. Most successful microenterprise programs possess annual operating plans and budgets that can be monitored and evaluated against measurable targets for growth, income and expenditures. In addition, staff work plans for such programs are often prepared in a format that assigns individual responsibility for key actions, thus permitting a periodic monitoring of progress and the early identification of problems before they become serious.

Nachala also needs a comprehensive management information system (MIS) that is accessible to all staff and capable of producing regular (at least monthly) reports. Currently, Excel spreadsheets are used to track some indicators, the "Loan Administrator" software is used to monitor the loan portfolio, and a Bulgarian accounting system is used to prepare monthly income and expenditure reports. Nachala does not prepare monthly balance sheets because "they are not required by Bulgarian legislation," nor is there evidence that Nachala compares projected annual operating budgets and financial statements with actual monthly income and expenditure reports. This must change if Nachala is to become an efficient, sustainable financial intermediary that can effectively extend financial services to thousands of business clients.

2. Nachala Limited

In April 1996, when the exchange rate was 75 leva to one U.S. dollar, the assessment team was prepared to recommend that Opportunity International accelerate the development of Nachala Limited. The creation of an independent, Nachala-managed credit program was a key component of the IGP grant with Opportunity International. It was designed to increase earnings and provide greater flexibility to the lending program, while also assuring Nachala's long-term sustainability. Six months had passed since the grant was signed. In May, the exchange rate reached 120 leva to the U.S. dollar, and all indications suggest a further deterioration of the economy. As noted earlier, it is very difficult for financial intermediaries to successfully weather adverse economic conditions such as high inflation rates and currency devaluation. Actions to reduce risk and control costs are typical responses of successful programs, and these (as well as others) should be considered before Nachala begins financing the purchase of equipment and machinery using lease contracts.

According to Opportunity International's Regional Director, $40,000 was disbursed to Nachala in late 1995 as start-up capital for the leasing subsidiary (Nachala Limited), but, as of April 1996, no further action had been taken to begin operations. While it may be advisable to delay start-up, Opportunity International can effectively help Nachala reassess local market conditions and prepare well-defined operating strategies and policies. For example, Nachala needs to decide how it will price leases and what economic activities will receive priority attention. It also needs to decide what criteria will be used in determining whether a loan request will be financed using BAEF financing or Nachala's lease facility. One possible option could, for example, direct all short-term, working capital loan requests to the BAEF-financed credit facility and all medium-term financing requests for equipment purchase to Nachala Limited. This would simplify decision-making concerning the source of funding and possibly permit Nachala to adjust the multi-year loan terms now being used to finance working capital loans. To date, it appears as though most Nachala clients have relatively easy access to multi-year terms and a grace period, regardless of the activity financed. This practice is inappropriate and could fuel delinquency by encouraging borrowers to divert loan proceeds to non-authorized activities when they could be reducing their obligations. The experience of other small-scale business lenders suggests that it is far better to keep loan terms short and offer borrowers "automatic" access to new loans, or a revolving line-of-credit if they maintain an on-time repayment record.

Bulgaria's current economic problems do not change the fact that leasing offers an attractive and perhaps unique alternative to traditional bank financing for equipment purchases in Bulgaria. This is particularly true for borrowers without collateral or well-developed balance sheets, common characteristics of the small and newly-established firms that are Nachala's primary clients. Most small-scale entrepreneurs can access sufficient resources for working capital from savings, friends and family, but they have much greater difficulty financing the purchase of capital goods such as machinery, equipment and transport. In Western countries, leasing arrangements are usually relatively simple. The lessor typically provides close to 100 percent financing to the borrower, with repayment being secured by retaining title to the asset financed until the end of the lease, when it is transferred to the lessee for a pre-determined fee.

In Bulgaria, the risk of non-payment that typically accompanies lease financing is aggravated by the absence of a central title registry, a poorly functioning legal system, and more recently, economic instability. According to a recent World Bank report (January 1996), repossessing and selling movable property in Bulgaria can take from six months to two years, a period during which farm and industrial equipment will depreciate in value and livestock can die. In addition, a lender also faces a constant threat that the collateral will disappear, having been sold or otherwise hidden by a dishonest debtor. While the risks of loss to Nachala Limited are real, the leasing program is the only way Nachala can now become an independent, sustainable financial intermediary for the small business sector in Bulgaria.

3. Capital Formation

The IGP grant proposal submitted to USAID by Opportunity International included a self-sufficiency projection for Nachala that required reaching 1,500 active clients, with a loan portfolio totaling $8.0 million, by December 2000. At this point, it may be possible for Nachala to reach 1,500 borrowers with small loans (e.g., $1,000 to $3,000), but it will be very difficult to create an $8.0 million loan portfolio without an additional source of capital. In March 1996, Nachala had approximately 320 outstanding loans and a BAEF-financed portfolio valued at $2.2 million. The BAEF recently increased Nachala's loan fund to a maximum of $2.75 million, and an additional $700,000 will be available from the IGP grant (including both USAID and OI contributions). This leaves a projected shortfall totaling approximately $4.45 million in loan capital that, realistically, can only be filled by leveraging additional external resources. OI's grant proposal projected Nachala obtaining external resources totaling $500,000 in 1997, $500,000 in 1998, $1.0 million in 1999, and $1.5 million in 2000, but local Nachala staff were unaware of these targets. Bulgaria's banking system is nearing collapse and is not a likely source of external capital, and beyond the international donor community, there are few other financing options. This suggests the need to prepare a strategic marketing plan with a variety of options for attracting the external resources that will be required to finance Nachala's long-term institutional growth and sustainability.

As a complementary activity to the resource mobilization planning, Nachala should also move forward with plans to establish local "business clubs" among clients in each of the regional branches. Initially, these clubs will be used for networking among the small- and medium-scale businesspeople who use Nachala's services. Over the medium-term, both Nachala and OI have mentioned the possibility of establishing savings facilities within the clubs. The legality of a club-sponsored savings program should be investigated. It offers Nachala's clients a potentially attractive alternative to the unsafe and low-yield savings facilities of the commercial banks, and it could also become an alternative source of liquidity for increased Nachala lending. While the potential to develop a savings program among Nachala clients is a long-term, low-priority activity at this time, the business club concept is a good one and should be encouraged to flourish.

4. Loan Administration

Nachala has an informal mechanism of loan administration which places responsibility for loan repayment on the borrower, as well as the loan officer who helped develop and sought approval of the application. As noted earlier, loan officers help prospective clients analyze their credit needs, estimate repayment capacity and prepare loan applications. Once loans are approved, they visit their clients at their place of business and develop a personal relationship during the loan cycle. The personal approach to loan follow-up is appreciated by Nachala borrowers, and it is an effective technique for monitoring small business loans; however, it should be accompanied by more formal tracking procedures to address the need for accelerated but controlled portfolio growth.

As the loan portfolio grows, loan officers will find it more difficult to visit clients on a regular basis, weakening their ability to monitor borrowers and identify potential problem loans quickly and effectively. For this reason, Nachala should consider the preparation and circulation of regular portfolio reports for the Sofia office and each of the branches. At a minimum, these reports should identify all pertinent borrower information such as: address and phone number; type of business; loan amount and terms; outstanding balance of principal and interest; payment date; and current status (e.g., on time, days delinquent, etc.). Such information can help loan officers determine who needs to be visited and who does not. In addition, they will permit the central office to monitor branch office operations, assign responsibility for borrower follow-up, and evaluate the effectiveness of collection efforts.

5. Loan Delinquency

To date, loan delinquency has been fairly well-controlled by the Nachala loan officers, but late payments are common and delinquency rates are increasing. The Bulgarian American Enterprise Fund has written-down approximately $86,000 in delinquent loan principal and, according to the new BAEF agreement with Nachala, such losses must now be absorbed by Nachala. Given the new financial risks to Nachala in cases of loan default, it should consider introducing a combination of sanctions and incentives to encourage more timely loan repayment. As noted earlier, Nachala has yet to apply monetary or legal sanctions against delinquent borrowers, citing both the high costs and the uncertainty of loan recovery through the legal system. Nachala also believes the threat of legal action is sufficient incentive for most recalcitrant borrowers.

While Nachala's willingness to renegotiate loan terms with delinquent borrowers illustrates a good understanding of the external problems often faced by small entrepreneurs in Bulgaria, delinquent borrowers always have "good" reasons for non-payment. Nachala should be very cautious when renegotiating loans to avoid becoming perceived by borrowers as "an easy target."

Loan delinquency has an immediate impact on earnings and cash flow, and it tends to lessen the productivity of staff. If left unattended, it can misdirect and weaken the entire program. For example, as default and slow payment rates increase, Nachala loan officers are forced to spend more time cajoling, convincing and pressuring clients to pay. Less time is then available to promote the program, attract new borrowers and support new growth opportunities.

For these reasons, Nachala should consider applying fee or interest rate sanctions against all borrowers with loan balances greater than 30 days past-due. While it is important to maintain the client-focus of the credit program, there are always "special circumstances" that arise when dealing with delinquent borrowers. Renegotiation of loan terms is a privilege that should be used very judiciously. Nachala needs the interest income and the loan principal to finance increased growth, and loan officers do not need the distractions that accompany a non-performing portfolio.

Nachala should also begin taking legal action against any borrower who has refused to repay a loan, particularly when it is clear that a borrower possesses the resources to do so. The reliability of Bulgaria's court system must be tested to identify the need for additional or different loan guarantee mechanisms to support the credit program. Legal action may be a slow, expensive and ineffective mechanism for loan recovery, but it is equally time-consuming and costly for the recalcitrant borrower. Nachala's willingness to use all possible means to recover a delinquent loan should never be in doubt.

Finally, Nachala should consider an incentive program for "good" borrowers. Many successful micro and small business credit programs offer clients easy access to subsequent loans, special lines-of-credit, and larger loans if they repay on time. Nachala's leasing company could, for example, adopt a modified interest rate policy that differs from the BAEF program by including a pre-paid fee (e.g., 0.5 to 1 percent) that can later be rebated back to those borrowers who demonstrate on-time payments for periods such as six months or more. Since most small and medium-scale businesses have recurrent credit needs, most will work hard to maintain a good credit record. A potential rebate encourages greater effort from borrowers.

To summarize, Nachala's small business lending program is off to a good start, but additional steps are now needed to establish a firm foundation for expansion and growth. Annual business plans should permit a logical, area by area analysis of Nachala's current and projected operations. Important elements include the growth and quality of key indicators such as total assets, retained earnings, external borrowing, loans to clients, delinquency rates, provisions for loan loss, and operating expenses as compared to income. Pre-determined and measurable targets for specific periods (e.g., quarterly) should be prepared, and MIS systems should track progress and permit easy evaluation of progress. All staff should have access to key data and be encouraged to buy-in to the planning and monitoring process. Nachala's leasing program is important to long-term growth and should be launched as soon as the current economic situation becomes more stable. The program should be used to experiment with new lending policies and methodologies that reduce loan loss risk while contributing to organizational expansion and growth. Nachala will only become a sustainable and reliable source of financing for the small-scale Bulgarian entrepreneur if a disciplined, step-by-step program of planning, monitoring and problem resolution is maintained during its formative years. The ultimate goal remains that of attaining full financial self-sufficiency by the year 2000.

ANNEX

FUNDING AND SERVICES AGREEMENT
Amended December 1995

THIS FUNDING AND SERVICES AGREEMENT ("the Agreement") is made and entered into this ___ day of December, 1995 by and between the **BULGARIAN-AMERICAN ENTERPRISE FUND** (hereinafter referred to as "BAEF"), having its principal place of business at 333 West Wacker Drive, Suite 2080, Chicago, Illinois and **OPPORTUNITY INTERNATIONAL, INC.** (hereinafter referred to as "OI"), having its principal place of business at 360 West Butterfield, Suite 110, Oak Brook, Illinois, and **NACHALA LTD**. (hereinafter referred to as "NACHALA"), having its principal place of business at Vitosha Boulevard, Sofia, Bulgaria. This agreement is effective as of October 1, 1995.

WITNESSETH:

WHEREAS, OI has experience in designing and overseeing programs in developing countries that support the development of a private sector and market economy by encouraging and promoting entrepreneurship;

WHEREAS, BAEF desires to encourage the development of Bulgaria's private sector and to earn an acceptable rate of return by providing loan funds to individual and family entrepreneurs through a Small Enterprise Development Fund (the "SEDF");

WHEREAS, BAEF desires that the SEDF will be managed and operated by NACHALA, an independent Bulgarian not for profit agency;

WHEREAS, both parties desire that OI will provide technical assistance and advisory services to the BAEF and NACHALA with respect to NACHALA's operation and management of the SEDF;

NOW THEREFORE, in consideration of the mutual covenants herein contained, the parties agree as follows:

1. Purpose.

This Agreement is intended to amend the understanding of the parties as expressed in the initial agreement signed by both parties on February 25, 1994. To the extent that there is a conflict between this Agreement and the February 25, 1994 agreement, or any verbal agreement that occurred prior to this Agreement, the provisions of this Agreement will prevail.

2. SEDF Objectives.

The SEDF will be used to make small loans to individual and family entrepreneurs in a way that supports the development of the private sector and the market economy in Bulgaria. Furthermore, the SEDF will be established and operated with the intention of being self-sustaining and allowing for the return of the BAEF's loan funds, as well as payment of profits, on the timetable agreed to by the BAEF and OI.

3. BAEF, OI, and NACHALA Principal Roles.

The principal role of the BAEF will be to provide loan funds and technical assistance funds to the SEDF. The principal role of OI will be to design, establish, and oversee the operation of the SEDF. The principal role of NACHALA will be to operate and manage the SEDF.

NACHALA's role also will include administering borrower training and technical assistance programs and providing credit extension, monitoring and collection services. BAEF and OI will not in any way be responsible for the acts, omissions, debts, or obligations of NACHALA or its officers, directors, employees or agents.

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4. BAEF Name Promotion.

OI and NACHALA will establish and NACHALA will operate and manage the SEDF in the name and ownership of the BAEF. NACHALA will include appropriate signage at SEDF offices. The BAEF's involvement will be acknowledged in publicly distributed materials.

5. Loan Funds.

The BAEF will make available up to $2,250,000 of loan funds to approved SEDF borrowers from January 1993 through December 1998 on an "as approved" basis. The BAEF and OI will jointly determine the best method, legally and operationally, for disbursing these loan funds. Loan funds contributed by the BAEF will, at all times, be owned by the BAEF.

6. Technical Assistance Funds.

For planning purposes, the BAEF at this time is intending to provide technical assistance funds to OI for NACHALA in the total amount of $150,000 disbursed over three years. However, such funding is dependent upon NACHALA's performance. Each January 15, April 15, July 15 and October 15, the BAEF will pay the following amounts:

1996: $18,750
1997: $12,500
1998: $ 6,250

OI and NACHALA will provide the BAEF with reports on the use of the technical assistance funds on the first day of each January, April, July, and October, and at other times as requested by the BAEF. These reports will include a brief summary of operations, progress-to-date, use of technical assistance funds, and such other information as the BAEF may reasonably request. Subsequent quarterly technical assistance payments will not be transferred to OI or NACHALA until reports on the use of all previous installments have been received by the BAEF.

7. Additional Funds.

OI and NACHALA will attempt to raise additional concessionary and grant funds to be managed by NACHALA. The terms for obtaining such additional funds must be consistent with the financial objectives of the BAEF.

8. Loan Portfolio Parameters.

The BAEF and OI will develop jointly specific loan portfolio parameters to be followed by NACHALA in operating and managing the SEDF by the end of 1995. Parameters may be changed with the concurrence of both the BAEF and OI.

9. Loan Portfolio Performance Measures.

The BAEF and OI will jointly develop specific loan portfolio performance measures by the end of 1995 by which BAEF will judge NACHALA's portfolio management and OI's advisory and technical assistance services.

10. Loan Portfolio Management Fees.

This section represents a revision of the previously agreed upon formula for determining the fee to be paid to Nachala for the management of BAEF's micro-loan portfolio. The BAEF will continue to pay NACHALA a quarterly management fee which will now be calculated according to the following formula based on the loans managed by NACHALA in the SEDF portfolio.

In order to begin the new calculation from an equitable starting point, it is agreed that the September 30, 1995 calculation will be as follows:

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	Interest received since inception to September 30, 1995:	$ 137,091.49
less	One half of all interest earned since inception:	- 68,545.75
less	Cumulative principal write-offs since inception:	- 86,512.33
		$- 17,966.59
less	Guaranteed payment to NACHALA	- 5,000.00
	TOTAL DUE FROM NACHALA TO BAEF................................	$ 22,966.59

NACHALA will repay this debt of $22,966.59 to the BAEF based on its quarterly earnings. All fees earned in excess of $5,000 per quarter will be applied to reducing NACHALA debt to BAEF.

The BAEF agrees to waive repayment on the fees paid to NACHALA since inception in the amount of $23,040.00.

The following formula will become effective October 1, 1995:

(1) Interest income deposited during the quarter into the BAEF's bank accounts from the active portfolio
(2) less 1.875% of the average outstanding principal balance of the portfolio during the quarter (See Note A)
(3) less principal and interest charge-offs during the quarter (See Note B)
(4) plus previously written off principal that becomes fully current during the quarter (See Note E)
(5) plus principal and interest recoveries deposited during the quarter into the BAEF's bank accounts (See Note C and Note D)
(6) less taxes due (if any)

Note A: Average outstanding principal balance for the quarter is calculated by taking the sum of the beginning and ending principal balances for each month and dividing by six.

Note B: Principal and interest charge-offs occur when any amount due under the loan agreement becomes 120 days past due in the current quarter. The amount of the charge-off equals the full principal and interest amount due under the loan agreement.

Note C: Collection of the charged-off loans is at the expense of NACHALA.

Note D: BAEF agrees to provide, on a case-by-case basis, a power of attorney to allow NACHALA to represent BAEF in court to collect loans which have been charged off. BAEF reserves the right to decline to give such a power of attorney. In such an event, the loan amount charged off will not be deducted from line (3) principal and interest charge-offs during the quarter.

Note E: Previously written-off loans that become fully current, defined as all principal and interest and late fees, if any, paid in full, the principal portion can be added back to the portfolio <u>at the end of the quarter</u> in which they become current. For the purpose of the calculation, the remaining principal balance will be added back into line (2) the outstanding principal balance.

Conditions:

1) Should NACHALA not receive a minimum of $5,000 per quarter in fees, the BAEF agrees to pay a minimum fee of $5,000 to NACHALA for this quarter. In such an event, the difference shall be subtracted from the fee calculation for the following quarter.

2) In the event the calculated management fee is negative, that balance will be carried forward and applied against future management fee payments.

3) Upon termination of this agreement, any amounts due to BAEF will be payable in thirty days.

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Payment by the BAEF will be made within thirty (30) days of the quarter end provided that the BAEF has received adequate documentation upon which to confirm the fee due.

11. Access and Reporting.

Each of OI and NACHALA will provide the BAEF with reasonable access to its offices, personnel, financial records, and information that, in BAEF's sole discretion, is required to properly monitor and evaluate OI and NACHALA's establishment and NACHALA's operation and management of the SEDF. The BAEF and OI will jointly develop procedures for reporting by OI and NACHALA to the BAEF. This reporting will include, but not be limited to, regular submission of historical and projected operating budgets, periodic financial statements, monthly loan portfolio performance reports including 30, 60, 90, and 120 day delinquency reports, general activity reports, a quarterly accounting of the use of the quarterly technical assistance payments, and such other reports as the BAEF may reasonably request. Each of OI and NACHALA agree to provide such information in such detail and with such frequency as the BAEF may reasonably request. Additionally, OI will closely advise and consult with the BAEF from time to time on matters of material interest regarding the management and operation of NACHALA.

12. USAID Compliance.

The BAEF, OI, and NACHALA, will comply to the extent applicable with all United States Agency for International Development ("USAID") requirements for use of BAEF loan and technical assistance funds.

13. Term and Termination of this Agreement.

Each of the BAEF and OI reserves the right to terminate this Agreement and its commitments if there are any substantial changes in the funding agreement between the BAEF and the United States Congress and/or USAID or if NACHALA is unable to operate and manage the SEDF to the reasonable satisfaction of the BAEF or OI, as outlined in this Agreement. Unless otherwise terminated, the agreement shall expire on December 31, 1998.

14. BAEF Prior Consent.

The BAEF requires OI and NACHALA to receive the prior approval of the BAEF on the following matters:

a. Loan application, documentation, and approval policies and procedures;
b. Borrower training and technical assistance programs;
c. Location of loan offices,
d. Loan portfolio parameters;
e. Loan portfolio performance measures; and
f. Loan interest rates and other fees charged to borrowers for SEDF or other credits managed by NACHALA.

15. Governing Law.

This Agreement will be governed by and construed in accordance with the laws of the State of Illinois.

16. Indemnification.

The BAEF and OI agree to defend, indemnify and hold harmless each party and its officers, partners, employees, and agents against any and all claims, damages or liabilities, joint or several, to which such indemnified party becomes subject, at common law or otherwise, insofar as such claims, damages or liabilities or actions in respect thereof arise out of or are based upon the actions of such indemnifying party under this Agreement or the transactions contemplated hereby; provided, however, that no party will be indemnified under this Agreement for its or his own simple negligence or willful misconduct. The provisions of this Section will survive the expiration or termination of this Agreement.

17. Severability.

In the event that any provision of this Agreement will be declared void or unenforceable by any authorized body or becomes unlawful in its operation, such provision will not affect the enforceability of the rights and duties of the parties with regard to, or the validity of, the remaining provisions of this Agreement, which will continue as binding. This Agreement will be construed and interpreted as if such invalid or illegal provision were not a part of this Agreement.

18. Entire Agreement and Modifications.

This Agreement (including all of the Appendices attached hereto) constitutes the entire agreement between the parties with respect to the subject matter herein and supersedes all prior agreements between the parties, whether written or oral, relating to the same subject matter. No modifications, amendments, or supplements to this Agreement will be effective for any purpose unless made in writing and signed by each party. Approvals or consents hereunder of a party will also be in writing.

IN WITNESS WHEREOF, the parties hereto hereby agree to be bound by this Agreement as of the date first written above.

Bulgarian-American Enterprise Fund	OPPORTUNITY International

Nachala Ltd.

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