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REVIEW OF
THE PRIVATE INVESTMENT CORPORATION
FINAL REPORT

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FINAL REPORT

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I. EXECUTIVE SUMMARY

A. Purpose

The purpose of this studv is to:

* review the portfolio and pipeline of projects of the Private Investment Corporation to evaluate the respective
  - additionality
  - risk profile
  - financial soundness
  - development impact

* review PIC's credit process for promotion, analysis, approval, administration, and supervision insofar as this relates to the fulfillment of the terms of the loan contract with AID

* review PIC's staffing and organizational structure to determine the extent to which it contributes to PIC's overall mission of development lending

* review PIC's financial position to determine its profitability and operational capability to sustain a market position within the private financial community

B. Methodology

The reviewer familiarized himself with background material and prior revisions of PIC. In the PIC revision, every every credit file was reviewed to assess the effectiveness of credit initiation, analysis, and loan administration, as well as the strength of each credit and its suitability as development lending. Meetings and interviews were sustained with all of the

PIC credit staffers, as well as other key management people within PIC.

The PIC staff cooperated fully with the review and facilitated all of the information requested in a timely and expeditious manner.

C. Findings and Conclusions

portfolio

The PIC loan portfolio in general is a developmental one, financing mostly start up projects, and reflecting a considerably higher than commercial risk profile. There are some lower risk loans on the books, but these are few and, in any event, for project loan purposes and for long tenors (as required by PIC's lending mandate). The recently approved but not yet booked loans, as well as others in the PIC pipeline of projects, preserve these characteristics.

In attempting to assess "additionality," we feel that this concept is present, i.e. that PIC loans, with two or three exceptions, would probably not have been made by a commercial bank, even had this bank had access to five year matched funding. Perhaps the primary element in this determination is how many start up projects, those with no established track records, are financed. On this score, the PIC portfolio, including the recently approved but undrawn credits, qualifies.

The PIC portfolio, especially considering the small amount of total loans, is also quite diversified, which contributes to the development impact. Reported PIC figures indicate that about US$

2.23 in foreign exchange generation has been achieved per dollar of AID loan.

The growth in this portfolio has been slower this year than it could have been as new management has appropriately come in with a priority to first get the house in order and clean up problem loan situations. It can thus be expected that volumes of loan bookings per year will tend to increase. However, given the nature of the projects to be financed. and the long lead time at PIC from project prospect to project analysis to loan disbursement, a rapid portfolio growth is not realistic. There are not that many projects in Costa Rica, and PIC cannot analyze them all at once. Based on a general feeling for PIC and its market, we anticipate a growth in the range of about US$ 4 million per year.

credit process

PIC has recently devoted more resources to marketing efforts by hiring a marketing executive. This is an appropriate area of focus for PIC, which would enable management to achieve a greater understanding of the development lending market in Costa Rica and the different risks and opportunities available. However, bank and financial services marketing has traditionally been handled by experienced credit executives who understand the business rationale and needs, as well as the "approvability," of specific projects. We therefore question the adviseability of hiring another person, without real lending experience, for this job.

The credit files at PIC reflect, in some cases, insufficient and superficial project analysis, although the more recent presentations have shown considerable improvement and project analysis skills. In particular, the more standardized credit approach followed in some of these more recent credits demonstrates a more appropriate and complete (though not yet strong) financial focus, i.e., on cash generation and loan coverage capabilities. Greater focus has also been seen in the qualitative area, with appropriate consideration of management capabilities and risks in the credit. This is good but improvement in some areas is still desireable.

However, the area of financial analysis (of balance sheets and income statements, not cash budgets) has, in general, been deficient. Analysis in this area has been superficial, not delving into the reasons behind the numbers, or what the numbers mean in terms of risks. One area in particular requiring greater focus is for a consolidated numbers and qualitative analysis of those situations where the Costa Rican company is highly or wholly dependent upon a related organization for product marketing. This is the case with several loans and others not yet taken down, and almost no analysis was perceived in this area. Yet for these loans, this overall, consolidated, analytical viewpoint is critical to understanding the risks in the credit.

organization and staffing

As is the case with other private sector financial institutions in Costa Rica, there is a lack of experienced credit staff at PIC. However, at PIC this situation manifests itself everywhere, from senior management to credit supervision to administrative assistants. Yet the present PIC organizational structure does not help to remedy this weakness in the risk asset management situation. Rather, perhaps it even hinders the situation.

At PIC, functions and responsibilities of the credit staff are compartmentalized, resulting in a lack of accountability of credits. Once the analysts finish their job of project evaluation, their general responsibility over the credit terminates and once the operation is booked, the administrative staff takes over.

When the administrative people inherit the credit, they come in cold, without a feeling or sense of involvement for the credit and without, it appears, a proper understanding of the critical variables and risks in the credit. And the people who best understand these points, the analysts, are no longer responsible. This may result in loss of momentum, and management gaps in the credit. This also results in an inadequate anticipatory posture which hampers problem recognition, and, ultimately, problem resolution.

To achieve greater accountability and increased effectiveness in account management, we feel that implementation of an account officer/executive system would be appropriate. Under this system, responsibility can be shared with the administrative people, but with the account executive in charge of and responsible for overall management of the relationship, under the general supervision of the credit unit head. This would enable a pooling of experience and a sharing of the work load while permitting greater comprehension of the current credit situation.

Other financial directions being explored by the investment banking unit, involving various and imaginative deals, are promising and should be encouraged. Time should be permitted to consummate these deals, especially since this area could potentially provide an interesting, although probably limited, comparative advantage in the financial market.

financial situation

PIC's spread on its loan portfolio is a strong 9.08%. However, this generous margin is more than offset by the very high PIC operating expenses, which currently register (through 31 July) 9.28% of the average portfolio. These costs include those of the Finance Department, so that at present the 9.28% figure absorbs the added costs (now two people) of carrying this department.

PIC's posted earnings of 2.30% of assets is due entirely to interest income on short term money market investments, which could be managed by one person on his/her spare time. PIC is thus losing money on operations at 7-31-87, primarily due to the high cost structure from an overly dimensioned operation, as attested by the 9.28% figure, which includes high salary expenses. The figures for the Cofisa and Banex development unit operational costs / portfolio are in the range of 4% to 5%, for similarly sized development portfolios.

Nevertheless, the cost figures present an improvement over the past, both in real and relative terms (see the attached PIC comparative financial figures). And, as the portfolio grows the high PIC fixed cost structure will be better absorbed within the portfolio, thus reducing the percentage of operating expenses to the average portfolio. For the month of July alone, on an annualized basis, the figure is lower than the 9.28% figure above due to the growth in the portfolio as compared to the January 1 opening figure. Also, as the Finance Unit matures and produces income, its cost structure can be "spun off" to a separate profit center, thereby reducing the present subsidy by the Project Unit in terms of manpower costs.

For a financial institution, PIC is extremely under leveraged, currently registerining a liabilities to equity ratio of only 0.79. This situation renders an adequate return on equity extremely difficult (assuming profits on the portfolio could be achieved) since high earnings are needed to achieve sufficient returns in relation to this high equity. And such a high earnings profile is not wholly consistent with the developmental nature of the institution. For these reasons, a diffuse ownership structure with minority shareholders, as exists with PIC, is questionable in terms of practicality and desireability. This financial situation at PIC implies unclear objectives.

A financial institution could rely on other activities and sources of earnings to counterbalance and complement development banking objectives, but one of the clauses of the loan contract specifically precludes PIC from engaging in "traditional banking activities." Yet the diffusion of ownership, with no shareholder

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having greater than a 10% ownership, and with numerous minority shareholders, implies a focus on earnings so as to qualify as a viable investment opportunity in the market.

Investors buy stock for one of two reasons, or both: dividends and/or share price appreciation. In PIC's case, the shareholder, at least for the present, gets neither. Not only has the share value (measured in terms of book value per share) not increased, but there is no market in which it can be sold at the present time. It is the intention of PIC management to create a market for these shares eventually, and management anticipates that this process will take several years, after establishing profits and some dividend payouts.

We hope that the financial situation will not get worse before it gets better, as the present level of marketable securities, with its "subsidizing" earnings stream, is liquidated and converted into loans. It is the PIC management's intention not to add personnel as the portfolio grows, i.e. to manage the growing portfolio with the present staff. Whether this can be accomplished, within a reasonable context, remains to be seen. If achieved, "economies of scale" will permit greater fixed cost absorption within the portfolio.

The financial/investment situation could be complicated by PIC's attempts to obtain the additional US$ 2 million in capital to qualify for the incremental US$ 12 million from AID, since leverage will at that time tend to decrease even further. This will render achieving an adequate return on equity even more difficult.

At present, PIC is achieving its mandate of development lending, although at a slower pace than originally envisioned when PIC was created. But in terms of financial performance, PIC's only beneficiaries up to now have been its relatively high salaried employees (on average, salaries more than twice as high as at Cofisa and Banex). PIC management hopes to rectify this situation and only time will tell how successful the results will be.

compliance with terms of the loan contract

In general, PIC has complied with the spirit and terms of the loan agreement, building up a development portfolio and taking higher than commercial bank risks. However, the creation of this portfolio has taken much longer than originally envisioned, due in large measure to problems with prior management. The organization to manage it has not yet developed into the kind of financial institution originally intended, although some steps in the appropriate direction have been taken in the past year.

II. FINDINGS

A. Portfolio Characteristics

overview

At 6-30-87 PIC's long term credit/investment portfolio consisted of 13 relationships for a total of US$ 10.4 million in approvals and US$ 8.9 million in outstandings as depicted in the quarterly report sent by PIC to AID. Of these outstandings, US$ 2.4 million have not been eligible for AID funding for one reason or another, while the remaining US$ 6.2 million in loans have been AID funded.

Nine of these relationships were booked prior to the arrival of the present management about one year ago, and several restructurings of these prior loans have been consummated during the tenure of this new management. All of the relationships involve loans, and one of the relationships (Paco) involves equity participation as well (US$ 300,000).

Of the 13 relationships, about 6 of these, representing US$ 3.1 million, were for new projects, while US$ 5.8 million was for new or expansion projects of existing enterprises. Three of the relationships are agricultural, 3 are food processing, and 5 are industrial. These figures reflect a diversified portfolio.

The typical loan tenor of the term dollar portfolio is five years, although a couple of longer loans were found with tenors of 10 years (Desarrollo Lachner & Seanz and Liga de la Caña). Grace periods ranged from zero to five years, with one year being

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the most common figure.

Reflows from this portfolio have been minimal. Newer loans are still on grace periods and several of the older loans, that would have required some payment by now, have been rescheduled, granting additional grace. Only two loans have been repaying principal (Pegaso and Hules Tecnicos), with payments of only US$ 98,000 so far in reflows.

additionality

AID appropriately focuses on "additionality" in analyzing a development portfolio. The basic concept here is wether a commercial bank would grant the same credit, and under the same terms. Based on this viewpoint, the PIC AID funded long term portfolio essentially falls within these parameters, although some of the newer credits could be considered more commercial in nature (Talmana and Yanber).

The Talmana loan was made to an established fishing company (with a spotty earnings history) to finance the purchase of a Panamanian registered tanker ship to fuel the fishing fleet at sea, thereby taking advantage of cost advantages in dollars vs. local pricing for thew petroleum products. Because the original intention was to take a cost advantage, which has apparently been temporary, the developmental nature of this loan is questionable, as it appears to have been more profit driven. For this reason, the loan did not qualify for AID funding.

The Yanber loan was made to finance machinery acquisitions, under the concept that the borrower exports a non traditional product (plastic and cellophane), but in this case the borrower could have probably obtained the loan from a commercial bank given its solid financial position. Another loan, for the purchase of Spanish equipment (Gazapati), while demonstrating a "developmental profile", was structured with the partial guarantee of a major international bank. A local commercial bank could have done the loan with this support, at least for the portion backed by the clean letter of credit. None of these three loans were sourced from AID funds.

Another industrial client (Hules Tecnicos) which exports gaskets and rubber seals (non traditional exports) to the USA, and which presents strong earnings, could conceivably obtain commercial bank financing. But the size of the operation, and the relatively short existence of only 10 years, still reflecting high growth and "cash short" characteristics, probably still situates it within a "developmental" classification. In any event, this particular operation is precisely the type of project that falls within AID guidelines for promotion of alternative and non traditional industrial and export capabilities within the country, and is also being financed by Banex.

risk profile

Because of the portfolio's composition as a developmental one, with several loans to new projects and with longer than commercial loan tenors, the risk profile is inherently higher than with a strictly commercial portfolio. New projects do not bring the comfort of established track records, and longer

tenors, even on loans to established companies, mean higher risk. The risk is therefore significantly higher than in a strictly commercial loan portfolio.

The diversification within the PIC portfolio also contributes to the risk element in that less specialization and expertise build up has been achieved at PIC in analyzing varied sectors of the economy. For many projects, analysis must start from square one, rather than permit utilization of specialized expertise build up. On the other hand, the diversification existing within the portfolio serves to reduce the risk of dependency on one major subsector of the economy.

Collateral coverage seen in the project analyses has varied significantly. The range detected was from about 40 to 100%, with 70% a representative figure on the AID funded portion. This indicates flexibility in structuring of loans, and real development lending.

problem loans

The PIC portfolio has more than its share of problem loans. inherited from past management. These total six relationships, with 6-30-87 outstandings of US$ 4.5 million (including the US$ 300,000 in equity of Paco).

During the past year, considerable time and effort has been taken to reanalyze and reschedule some of these loans. This priority of the new management has resulted in less new business than could have otherwise been booked since precious staff time had to be devoted to this reanalysis process. Additional PIC resources have

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been channelled into some of these problem loans, contingent upon new shareholder investment.

The Paco equity investment of US$ 300,000 appears to be a total loss, but it also appears that a significant portion of the loan to Paco will be recuperated within the liquidation of the company. Other loans (Florex, Costa Flor, and Calzado Daisy) could in the future deteriorate to loss situations as well given the problems encountered so far, but for the present time, after restructuring of all three loans, no losses are anticipated.

Productos Congelados, a frozen food products producer, has recently ceased operations after sustained difficulties in marketing through its U.S. shareholder. The local shareholders are now exploring alternatives for reinitiation of operations, perhaps with different food products, but nothing has yet been defined. However, it appears that loan payments will continue to be made by the shareholders, so that losses on this loan are not yet anticipated.

development impact

PIC credit management periodically compiles for AID a listing of the development portfolio that provides a backdrop for determining the development impact of the loans. The information includes the total project investment amount, estimated future employment generation and foreign exchange generation to date. These figures are updated quarterly with the clients. We have reviewed the report with the person who prepares it and conclude that it is prepared in a conscientious manner and presents accurate figures, so far as accuracy is possible.

The 6-30-87 figures indicate that 1095 additional people will be employed in the future as the result of these projects, and that employment generation duruing the quarter was 200. The report also indicates that US$ 16.5 million in accumulated FX generation has been achieved to date from these projects. This computes to approximately US$ 2.23 in FX generation sourced from every AID dollar loaned by PIC.

It seems to us, however, that more meaningful information would be total employment generation to date, and an additional column for FX generation per year. In this latter case this would permit comparing FX generation from one year to the other.

pipeline

PIC has US$ 1.6 million in three new projects approved by the PIC board but not yet formalized. These are Fidesplant (production of seedlings for a Dutch flower operation) for US$ 580,000; Cera Tech (ceramic substrate production for use in computers) for US$ 600,000; and Florimax, a US$ 430,000 flower project. Other projects in the pipeline include another plant operation, for US$ 400,000 in loans and US$ 100,000 in equity participation, and a US$ 200,000 fresh water fishery project. If all of the first three are booked in their entirety during 1987, year end PIC outstandings would total US$ 12.0 million.

From the development perspective, these loans would probably reflect at least the same approximate characteristics of the

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existing portfolio. Hence these additional loans would be caracterized as developmental lending as well.

B. The Credit Process

target marketing

During the earlier part of this year PIC has implicitly refined its target market through culling of a significant amount of backlogged projects. More recently, PIC has hired an executive to direct marketing efforts. This executive has some experience in business promotion, but minimal lending experience.

Banks normally utilize experienced account officers for marketing since these people best understand what the bank can offer and the "approveability" of specific credits. This is important to avoid a situation where a marketing effort might bring in projects that later do not qualify for credit, resulting in a loss of credibility. We hope that PIC will not fall into this trap.

So far, the efforts of this new executive have focused on measuring the market potential (projects listed with CINDE, the Export Ministry, and CENPRO) and in making PIC's presence known within the corporate community. No new projects have yet been identified as a result of this effort.

In relation to this target market, the PIC senior management has talked about exploring the "safer" limits of developmental lending, looking for projects by established firms, thus reducing the overall developmental risk. The more recent bookings bear testimony to this (Gazapati, Talmana, Yanber). Implementation letter No. 11 signed in September 1987 has permitted financing of fixed asset investment projects for exports of non-traditional products if there is a measurable impact on new employment and exports, so that this lending to established firms may qualify within these new parameters.

In any event, at PIC there is a general understanding by the general manager, the project analysis unit head, and the analysts, of their mandate for developmental lending. They also understand what type of project AID wishes to promote.

analysis

Analysis of a credit institution s portfolio and its credit process are inseparable exercises, since it is the credit process itself which will, over the long run, determine the quality and focus of the credit portfolio. Any deficiencies in the process will likely result in weak credits or inappropriate positioning vis a vis other creditors. This focus is equally valid in terms of a developmental portfolio, since to achieve this portfolio, there must be a system and people capable of analyzing, structuring, documenting, and administering in accordance with this mandate.

In general, we perceived a significant amount of number crunching within the various analyses, but in many instances, particularly the older presentations, the analysis itself was unfocused and superficial. In many cases, including more recent analyses and especially those involving financial analysis of existing companies, the numbers analysis pointed out that certain accounts went up or down but there was a very little attempt to get behind the numbers and explain WHY. This is indicative of inexperience. There were also some graphs and other enhancements within presentations, but the information presented often served only for cosmetic, and not substantive, effects.

Sensitivity numbers were done in most cases, but the pessimistic scenarios observed generally appeared to be too sanguine to represent a true downside potential, with the result that the risk was probably underestimated. Also, by not always enumerating the key assumptions, the credit approving authority could not get sufficient base information.

This observation could lead to the conclusion that several of the earlier credits were approved based on "pre selling" of the project to the board, or in "jawboning" within the board meeting, and not on the credit presentations themselves. In several cases (the older ones) there was not sufficient written qualitative and cuantitative credit information to justify approval.

However, these deficiencies have been limited in the more recent project presentations, which include improved numbers and qualitative factor analysis, emphasizing cash generation and loan coverage capabilities, ratio and trend analysis, and their sensitivity, as well as the capability of management to run the project. These more recent project analyses have also focused appropriately on risks and shortcomings within the project (all projects have them).

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The more recent project recommendations also appear to have followed recent recommendations and utilized a more standardized credit presentation approach, progressing in logical sequence from one issue to another. This makes the presentations more professional and understandable to the person who must decide on approval or not, and helps cover all the bases.

Nevertheless, there is still room for improvement, particularly in the ongoing analysis of projects that are totally dependent on the mother company for commercialization (Pegaso, Gazapati, Hules Tecnicos, and now Fidesplant and probably Cera Tech). No analysis can be complete without analyzing the consolidated position since the local operation is the manufacturing arm of a foreign marketing entity. If this foreign entity has problems, the local operation will have them too.

For example, Hules Tecnicos, which has not been identified as a problem credit, has ONE YEAR of receivables on its balance sheet. In an independent company, this would be disastrous, probably indicating considerable uncollectibles, and requiring massive working capital financing that could evaporate all earnings through high interest expenses. Yet little analysis has been focused on this issue. What is the collectibility of these recievables? Can the mother company sell all the inventory that backs Hultec's receivables, at normal prices? Are there problems with the quality of this inventory, or possible obsolete items? This point is the central financial issue for Hultec but little focus has been made here. The emphasis should therefore be on getting behind the numbers and understanding what they mean.

structuring and legal documentation

In general, structuring of tenor and grace periods has appeared appropriate. In any event, due to the five year minimum tenor for PIC loans, there is not a great deal of variety to be expected.

In general, collateral values have been inferior to loan amounts, sometimes by significant margins, which is indicative of developmental lending. This is to be expected in this type of loan, where the shareholder s contribution is often in expertise and seed capital, which does not translate into sufficient collateral, from a commercial banking standpoint. In most cases, the collateral deficit has been covered by personal or corporate guarantees, but in overall terms there is a significant coverage deficit.

Loans were structured with numerous clauses and covenants, as they should be. These clauses included pari passu provisions, limitations on dividends as appropriate, insurance on assets taken as support, payment in US dollars free of any taxes, provision for due publicity to AID indicating the source of funds, provision for possible prepayment, etc. Definition of appropriate instances of events of default were also evident in the loan documentation.

Most loan pricing was LIBOR + 3%, plus commissions. This standard pricing is used since it is the maximum amount that the Central Bank will register for dollar loans taken by Costa Rican borrowers. The spread is a commercial one and is appropriate so as to refrain from subsidizing otherwise uneconomical projects.

This pricing allows for a generous spread given PIC's cost of funds, and helps compensate for the costly loan analysis and administration process necessary with most of PIC's borrowers. This strong spread also helps build up earnings and capital to withstand potential higher writeoffs from PIC's inherently riskier portfolio.

Loan documentation is prepared by an in house lawyer in accordance with legal requirements to maintain executive status (conferring special privileges in court in case of default) for loan agreements. These escrituras publicas are also necessary to provide for the various conditions negotiated in the loans since pagares (promissory notes) cannot be legally conditioned.

In general, the legal documentation aspect of the credits appeared comprehensive and satisfactory. PIC management explained that their lawyer now prepares loan documents in accordance with instructions from the project analysis department (it used to be, inappropriately, the other way around).

administration and follow up

Since all loans are term loans with numerous covenants and clauses, there is a considerable amount of follow up work that has to be done for each credit. Two administrative people, with some help from the operations head, perform these chores, following up on obtaining financial and other information, maintenance of insurance coverage on assets pledged to PIC, performance of periodic inspection of assets pledged to PIC, etc.

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This administrative effort appears to be done in a fairly complete and conscientious manner.

The operations area also provides accounting and other information to provide senior management with pertinent data on the status of outstandings and other portfolio matters. This information process is handled satisfactorily, as it should be in view of the small size of the portfolio in terms of number of bookings. Since few payments have yet fallen due within the portfolio (most loans are still on grace periods) it has not yet been necessary to introduce systems for flagging past due obligations and cash basis outstandings. This is simply done on a case by case basis and is sufficient for the present.

However, the follow up needs of credit management go beyond mere administrative effort, and encompass continued analysis. This is especially so in a development portfolio which includes many start up projects. In many (if not most) cases, the follow up aspects and analysis are crucial to maintaining asset quality, and are just as important as the initial analysis.

The initial analysis is a best guess of where things will go, and attempts to quantify with numbers the basic assumptions on which a project is based. But as the project takes shape and the numbers become real, the situation is often markedly different from what was analyzed initially. For this reason, the follow up effort is crucial to understand what the situation is and if there has been any change in the risk from what was originally approved. The follow up effort is therefore important to maintain control and to anticipate where any deterioration in risk may occur. This, in turn, will permit PIC management to maintain options open and be able to explore alternatives while they still exist in cases wheres some deterioration occurs.

At present, this control and anticipatory function (problem recognition) does not function properly at PIC. The reason has more to do with how PIC is organized (see the Organization and Staffing section below for more comments), rather than in systems utilized. After all, the follow up people "do their job" in visiting clients, chasing down the information, and complying with reporting requirements. There are systems in place, but there is really little sense of anticipation or accountability. As a result, the credit staff can be surprised when new problems occur.

Perhaps a case in point is Productos Congelados. This client's difficulties were identified as long ago as last November (1986) in a fairly comprehensive memo written by one of the analysts. But because of priorities elsewhere, and perhaps a lack of more aggressive follow up and senior involvement (the client did not send the financial statements) there was a gap in management of the credit. In a May 1987 memo, the USA marketing partner was mentioned as a strenghth of the credit, as was apparently initially analyzed. Yet the problems leading to the recent closing of the plant (August 1987) were related to the lack of reliability of this partner.

remedial management

In terms of remedial management for problem loans, the project analysis unit head manages the situation with each of the respective problem credits on a case by case basis. An analyst and the administrative assistants provide considerable support in these efforts.

Initial priority was given to these efforts when the new management arrived, and significant senior management time has been devoted during this year to restructure three of the most critical problem credits (Florex, Costa Flor, and Calzado Daisy). Time, and intensive follow up, will tell if the situations can be turned around.

C. Organization and Staffing

organization

PIC is currently organized with three operational areas reporting to the general manager. The three operational areas are Project Analysis (project analysis, formalization, and follow up administration), Operations (accounting, financial control, and premises management), and Finance (treasury, bolsa, and investment banking). We spoke with all of these executives, but have dealt primarily with the project analysis department.

The project analysis department has two project analysts and two administrative assistants. The analysts are professional people with good educational backgrounds. When a project analysis is completed (a process that can take from two to three weeks to several months, on and off) and a loan booking is completed, the

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administrative assistants are then in charge of policing and follow up.

We do not regard this as the optimal solution. At present after loan approval and formalization, the analyst is "off the hook" and the credit becomes the responsibility of the administration people. However, at this "hand off" there is a loss of control as the analyst, who is the one person in PIC who best understands the numbers, dynamics, and critical variables of each particular client, goes out of the picture. The analyst is replaced by someone coming in cold, without an understanding of the client or his business, and this person has the responsibility for anticipating and detecting any deterioration in the relationship.

But this person does not have the background or understanding to achieve a meaningful management of the credit, a hands on management that goes beyond superficial analysis and follow up checklists. It is the belief of this writer that the follow up people at PIC do not really understand the relationships from a business and credit perspective, and hence cannot be effective in preventing deterioration of credits. Yet this is extremely important in a develpment portfolio such as PIC's.

The analyst is the person best situated to follow the progress of a project and anticipate when and where risk deterioration may take place in a credit, i.e., to manage the credit. The analyst should therefore bear more responsibility in management of the relationship once booked. The analyst should also be concerned, from the very beginning, not only with project feasibility, but with optimal structuring to satisfy the parallel needs of loan management, account administration, and collectibility.

We perceive a lack of accountability within the credit process at PIC, exacerbated by a lack of credit experience at all levels. To achieve accountability and greater control over portfolio management, we recommend implementation of an account officer (or account executive) system. Under such a system, responsibility could be shared with the administrative people, but with the analyst/account executive accountable for the management of the relationship. This would enable a pooling of experience, and a division of the work load, while permiting a greater comprehension of the current credit situation.

The difficulty in finding experienced credit people is a fact of life for Costa Rican financial institutions. Much of the development of the private financial sector in Costa Rica has therefore been achieved the hard way, empirically. One way of getting this experience faster is by managing loans, not just doing the analysis, which often deviates considerably from actual project situations once the project gets underway and registers financial results.

In this way, the account executive learns by dealing with the client and seeing what happens, not by supposing how things will be, as in the project analysis phase. If analysts are relieved of management responsibility after project analysis they are deprived of experiencing the credit. The problem of lack of experience is then reinforced as the maturation process is

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retarded.

staffing

As the system is organized now at PIC, analysts may become bored with the job after a couple of years, just when they are most productive. If they leave, another person must be trained on the job, resulting in a lack of productivity throughout the credit department. While a credit officer system will not prevent this from occurring, it does offer more opportunities within the organization, and also would provide more accountability within PIC, permiting more decentralization of the credit function, and offering greater continuity with the client.

While it cannot be expected that PIC will provide limitless career opportunities, it is worth noting that recently there has been considerable turnover within the PIC analyst ranks. The two current PIC analysts have only about six months experience combined at PIC (both were sourced from Cofisa); one is quite young and inexperienced, the other more of a veteran. The previous, experienced, PIC analysts have left or, in one case, moved on to another position within PIC. This latter executive has done a good job as an analyst and will be missed in the project analysis department.

PIC management has mentioned that the company was earlier organized along account executive lines, but that this structure has been discarded in favor of the present organizational mode. Without here going into the reasons for the earlier failure of the system, we note that for an account officer system to work

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properly there must be a firm, experienced, hands on, supervisory credit role since analysts/account officers tend to be young, inexperienced, and not sufficiently disciplined in terms of credit skills. Also, the unit head must overcome the natural tendency of an account officer to be overly vigorous in being the client's advocate, thus maintaining objectivity within the system.

It is the writers' estimate that an account executive corps, supported by administrative assistants, should be able to manage about 8 to 10 normal (i.e., not remedial) ongoing relationships each while performing project analysis duties. At this level, the PIC project analysis unit appears to be appropriately staffed, but inappropriately organized.

Training courses can also contribute to accelerating the learning curve, especially for a staff short on experience. It is highly recommended that a formalized training program be devised and/or followed for the staff, allocating at least one week per person per year (more for less experienced people). In particular, the present administrative staff needs financial statement analysis help now.

<u>other financial services</u>

PIC has embarked, via the establishment of an entirelv new department, on an active program to promote its investment banking activity. We believe this to be one of the most promising activities for PIC. While the market is small and the avenues are limited, the very absence of any parallel

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organization in Costa Rica and its very unique nature of a venture capital supplier gives PIC a niche it should definitely try to exploit.

While they are at different stages of completion, following are examples of some of the most interesting deals:

* A leverage lease buy out of a local electrical component making subsidiary of a U.S. company by local investors who believe that the company could be even more profitable than it is now. This requires term financing in colones. PIC, via its Costa Rican subsidiary, is considering the possibility of raising the funds in the market through an imaginative guarantee scheme. Against this loan it would have the full value of the company, the loan to the buyers, and it will also earn 10% of the stock of the company as a commission.

* A colones package for individual investors to participate in the Free Zone. Via this method individual investors can buy a hedge against possible future devaluations of the Colon. The income to be derived from their investment in the free zone, while coming to them in Colones, will be the equivalent of a dollar amount at any given date since the revenues to the free trade zone are payable in dollars. This is an innovative scheme that, if it does take hold, should have interesting possibilities to local investors, even relatively small ones.

* A Trust Fund for the Compañia Bananera to raise long term funds in the local market. Using its financial strength, PIC can assist this borrower to fund a good portion of its short

term debt.

* Underwriting the stock of a local steel company for more widespread stock ownership. Companies whose stock is widely traded are still relatively few, most of them being family controlled. This company already has 15 shareholders and is willing to have more in its effort to raise more capital. The company is profitable and the prospective new partners are good credit risks.

* A company asked PIC to make a "financial diagnosis" upon which PIC determined that its expansion prospects are favorable and that it appears to be an interesting credit taker that will give PIC an option to invest in its capital at a fixed price.

These new activities should be encouraged. After all, these directions are consistent with the original intent of establishing PIC as a local investment bank. It is important that sufficient time should be allowed for these and similar deals to be explored, since the most difficult deal will be the first. After an initial deal that establishes a precedent, other deals should follow.

D. Financial Analysis

earnings and expense structure

PIC's earnings streams have come from two sources: interest income on marketable securities and on the loan portfolio. Due to the small size of the portfolio, PIC had more interest earned on short term money market investments than on the portfolio last

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year. But so far this year, interest on loans has been nearly double the interest earned on marketable securities as loans rise in size while short term investments are reduced commensurately.

Through 31 July of this year, income from the portfolio has not been sufficient to pay the cost of AID funds (2% p.a.) and operating expenses, thus indicating an inefficient level of operations vis a vis the size of the loan portfolio. Annualized operating expenses to the average portfolio have been a high 9.28%, which has wiped out the generous (annualized) 9.08% spread on the portfolio. Despite this situation, the figures are a considerable improvement over last year's numbers, which apparently have been impacted by high severance payments to prior management. Also, last year's figures for operating costs were measured against a smaller portfolio so that relatively, the 1986 figures were much worse.

Up to a point, high operating costs are to be expected given the type of loans PIC makes, which require significant analysis and follow up costs. Also, PIC does not have other operating departments which can contribute to cover costs of the accounting, auditing, general services, premises, etc., and earnings on the portfolio have up to July 1987 been subsidizing the Finance Department (one executive, two as of very recently), which drives up costs.

But even taking these factors into consideration, the present level of operating costs appears too high for the 7-31-87 size of the portfolio, reflecting cost ineffectiveness and a high "break

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even" level. The project analysis unit operating expenses for Cofisa and Banex are estimated in the range of 4% to 5% for similarly sized portfolios, about half the PIC 9.28% figure.

PIC's annualized salary expenses are nearly US$ 500,000, for a 25 person organization (US$ 20,000 per person). Cofisa, in contrast, registers an annualized salary expense of about US$ 670,000 for an organization of 80 people (US$ 8,375 per person), which includes a project analysis unit. Banex, also with a project analysis unit, presently employs 107 people on a consolidated basis. Its annualized salary expense is just under US$ 900,000 (US$ 8,410 per person). The obvious conclusion here is cost ineffectiveness at PIC in relation to manpower expenses, although PIC's organization has a higher level of executive personnel (about 40%) than Cofisa or Banex.

While a more detailed analysis might be appropriate to determine this issue, on the surface it appears that the PIC organization is overdimensioned. With 6 people in the Project Analysis unit, 2 in Finance, 3 in the Gerencia, and 14 in Operations (several of which are general purpose employees), PIC has a heavy infrastructure for the small level of operations it currently maintains.

We do not wish to be unfair to the PIC management, especially since we spent little time delving into operations, but it is difficult to imagine what all the operations people do at PIC. For the size and complexity of the PIC financial statements, they should be able to manage with fewer people.

FINDINGS

The original project paper anticipated a staff of 17 people in the third year of operation. This project paper also anticipated very high staff costs, but these were based on high salaries for two experienced expatriates, which included transfer costs and moving expenses, housing, etc.

Because of this situation with heavy payroll and infrastructure costs we see little evidence of cost control at PIC, and we get the impression that the board has not exerted much pressure in the areas of staff size and the payroll attached to it, which seem to be considerably out of line. This is curious because some of the people on the board represent their own financial institutions where this overdimensioning does not occur. And it is doubtful that this overdimensioning occurs in the other companies represented on the board. Why, then, should this occur at PIC?

return on equity

In order to earn a return on this type of portfolio adequate to cover PIC s high operating costs and achieve a return of 10% on equity (sufficient for a dollar based organization) the portfolio would have to be much larger. Assuming LIBOR of about 7% p.a. and the present annualized level of operating expenses of about US$ 700,000, and no write offs, an AID loan portfolio (with a net spread of 9%) of about US$ 18 million would be necessary on a US$ 8 million equity base. It should be noted that these figures reflect PIC's offshore advantage of not having any income tax liability. If PIC had to pay income taxes, earnings needs would

be proportionately that much higher.

As costs are already at the US$ 700,000 per year level, and equity is already very close to the US$ 8 million mark, the portfolio would have to increase even more to accomodate any additional coverage needs as costs and the equity base rise. Hence the portfolio would have to be significantly higher than the US$ 18 million above to cover increased operating expenses as they arise and any write offs as they occur, and any future increases in equity as well.

At the present time PIC has an annualized return on equity of 4%, but this return is due exclusively to earnings from marketable securities investments. For analytical purposes, this income should not be included within PIC s revenue generation because this type of investment operation does not require a 25 person organization. It can be handled by one person in his/her spare time. If this income is eliminated from PIC's statements, PIC would be losing money, as the ratios mentioned above indicate.

Even the reported income could be diluted further this year as the remaining amount of the Paco investment is written off (accounted on the books as a reduction in the value of the investment, pursuant to the equity method of valuation). For this reason there is little solace for shareholders. This is especially so since PIC has not yet paid any dividends, and there is no real market for PIC shares. Shareholders, especially the smaller ones that cannot obtain collateral benefits, are thus "stuck" with their investment.

capitalization and leverage

With a 7-31-87 leverage of 0.79, PIC's balance sheet is highly uncharacteristic, i.e., over capitalized, for a financial institution. With such a low leverage, it will be difficult for PIC ever to achieve an acceptable return on equity.

This situation could be remedied in one of two ways. The first is to leverage up over time, obtaining additional financing, concessionary or otherwise, to permit greater growth in the portfolio, and, hopefully, economies of scale to permit profitability. That is, the present salary structure, considered as a fixed expense, could be better absorbed, or distributed, within the earnings of a larger portfolio. This presupposes that a larger portfolio could be managed with the same, or a similar, salary structure.

But this is a long term solution since, as present operations indicate, the PIC management team has been booking loans at a measured pace. Assuming this would be manintained at about US$ 4 million per year, it would still take about 4 years to achieve a leverage in the range of 2.0 to 1, assuming that the additional US$ 12 million from AID is forthcoming (PIC still has the US$ 4 million in marketable securities to invest in loans + US$ 12 million more = 4 more years). However, this pace of bookings could be accelerated, especially if a few "big ticket" deals are done. PIC management hopes to deplete all AID funds (including the additional US$ 12 million) within about two years. Time will tell if this ambitious booking pace can be achieved.

The second alternative could be achieved more This
would be to REDUCE capital by US$ 4.0 millio rom a
liquidation of the marketable securities. Il erhaps
involve a buyback of the smaller shareholde doing,
leverage would be a more appropriate, and st This
level would be sufficient to absorb potentia es in
excess of the reserve for bad debts (currently .

Of special interest to remaining shareholder rn on
equity potential would be improved. Then it w o PIC
management to post earnings on its portfolio; t d have
to be done from portfolio management since th osidy"
in earnings from the marketable securities p ld be
eliminated. This could involve a cost reductio cusing
on decreasing the headcount, and a strong effor nt the
loan portfolio to achieve profitability.

Pressure for profitability at PIC could in it sitive
force, since it would require PIC managemen more
business conscious and cost effective in manag e PIC
may be a development vehicle, it is also ancial
institution with earnings obligations to share uch it
must prosper or be forever dependent on conces ng.

E. Compliance with Terms of the Loan Contract

Under terms of the loan contract signed in Aug AID,
PIC must:

1. establish a risk minimization fund, ite 3%
   annually in average AID outstandings

2. have paid in capital of US$ 10 million in order to access more than the original US$ 8 million from AID
3. not pay dividends until achieving at least two consecutive years of earnings
4. not use AID loaned funds for administrative and operating expenses
5. contribute 2% of the loan and investment portfolio to the bad debt reserve, on an annual basis
6. not make loans in excess of 20% of net worth
7. not exceed leverage of 4 to 1 (during first five years)
8. not participate in traditional banking activities

<u>risk minimization fund of 3% of AID outstandings</u>

A risk minimization fund has been established with the First National Bank of Boston. The loan contract requires a fund of 3% per year. There is some ambiguity as to how this should be measured. It appears that the 3% requirement is on average assets, measured semiannually, and that PIC is therefore in compliance. This explains why the 7-31-87 outstandings on the risk minimization fund are US$ 156,147, which is 2.6% of the PIC debt to AID of US$ 5,991,911 at the same date.

<u>paid in capital of US$ 10 million to access additional AID funds</u>

The 7-31-87 paid in capital at PIC is US$ 8.2 million, although with accumulated losses the net worth figure is US$ 7.9 million. A new shareholder, a German public sector development entity, has expressed interest in investing US$ 1 million in PIC equity.

not pay dividends until 2 years of profits

PIC has never paid a dividend, and there are no plans to declare one for this year. The loan agreement is not clear whether the two year requirement is after coverage of the accumulated loss, as it might well be. This should be clarified because the loan contract is not clear on this point.

not use AID funds for administrative and operating expenses

AID drawdowns are made only for purposes of funding loan activities.

maintain a bad debt reserve of 2% of the loan portfolio

The 7-31-87 bad debt reserve was US$ 235,401, which was 2.7% of the US$ 8,704,656 loan portfolio at the same date. It should be noted that the probable loss of the remaining amount of the Paco investment, listed at this same date as US$ 232,807, will not necessarily be liquidated against this reserve because the amount is not a loan. It could be "written off" monthly with Paco's liquidation as the amount of the company's net worth is reduced, since the investment is carried on the books by the equity method of valuation. The asset value of the investment would be reduced commensurately, with a parallel reduction of net worth. However, it would not be inappropriate to liquidate this against the loan loss reserve if feasible since it is in the nature of a loan.

maximum loan size of 20% of net worth

The largest loans on PIC's books are US$ 1,964,169 to Hules Tecnicos and US$ 1,500,000 to Liga de la Caña. The first of these loans exceeds PIC's present limit of US$ 1,631,178. A waiver for booking of this loan was obtained from AID.

maximum leverage (liabilities to net worth) of 4 to 1

At 7-31-87, PIC's leverage was 0.79.

not participate in traditional banking activities

Although this limitation is somewhat vague, it is apparent that PIC does not engage in "traditional banking activities" other than lending, such as letters of credit and documentary collections, money transfers, liquidations of foreign exchange, etc. Indeed, this is one of PIC's major disadvantages in the market. The investment banking alternatives now being pursued by PIC should not be construed as "traditional banking activities" especially since one of the principal reasons for establishing PIC was to promote investment banking activities by PIC.

III. CONCLUSIONS

PIC has complied with its mandate of development bank lending, compiling, in general, a portfolio that achieves additionality and higher than commercial bank risk. With the projects already approved but not yet disbursed, and with other projects in the pipeline, it appears that this trajectory will continue.

The credit process at PIC, having been deficient in several areas, is now improving under the new management, although continued improvement is necessary. Specifically, financial analysis skills need be upgraded, and a greater consolidated viewpoint is adviseable in credits dependent on related companies for commercialization of the Costa Rican producer's product.

The present organizational structure within the credit analysis department is, in the opinion of the writer, not optimal. A credit officer system would provide greater credit understanding, accountability, and continuity with the client, as mentioned and recommended in other sections of this report.

PIC's financial situation is confusing. The balance sheet is overly capitalized from a financial institution perspective, which renders adequate profitability in the future very difficult. But perhaps this is a moot point because with the present over dimensioned staff structure at PIC, a suitable profitability on the portfolio is a long way off. PIC's operating costs are presently a high 9.28% of the portfolio.

The organization, with 25 people, is too large to be adequately

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supported by a portfolio of the present size. However, in defense of PIC, the organization does not have other activities, i.e., other banking activities, to share some of the institutional costs (premises, accounting, support staff) associated with being a local financial institution. The investment banking activity is not yet ready to absorb some of these costs and is presently a drag on earnings.

Nevertheless, we question the propriety of the present PIC dimensions to project itself in the market now and in the near term. At the present time, PIC offers nothing to potential market investors. And if PIC cannot achieve financial viability in the market, it will be totally dependent on concessionary funding for its future existence. Both PIC and AID should take a long term view of this to establish objectives and directions for PIC. Otherwise, its future as an independent private financial institution is questionable at best.

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IV. RECOMMENDATIONS

For PIC

In order to improve the effectiveness of the PIC risk asset management process, PIC senior management should implement anew an account executive mode of organization, with delegated account management responsibilities, as outlined in this report. Each credit should have one person responsible and accountable for all matters pertaining to it, under the supervision of the unit head.

As part of this organizational structure, each account executive should present his/her particular credit directly to the board, once recommended by the credit committee, instead of having the general manager or unit head do the presentation. This will foster greater accountability and account "ownership" within the system, and will permit the board to become more involved with the executive employees to measure their worth and "promotability" when opportunities arise. All analyses and recommendations should emanate from a person, with the concurrence of supervisors, not from a department.

This change must be implemented carefully and deliberately, not by a mere "stroke of the pen." Responsibilities must be defined for the account executives, the follow up people, and the credit supervisor. Outside help in this implementation context could be of particular value.

The credit supervisor should also take on a more active adversarial and demanding role in questioning financial and other analyses, as needed. The credit supervisor should also be willing to take on more of a coaching role. This function may be delegated as appropriate, permiting more veteran account executives to assist in the development of less experienced officers, thus sharing the supervisory role and responsibilities in a limited way.

Whether or not the above is implemented, PIC should make sure that its analysis staff receive help in financial analysis, the sooner the better.

PIC should immediately adopt a loan approval summary form for all credits, both for control and administration purposes. As it is now, it is necessary to dig through the credit files to find out what has been approved, when, to whom, and under what conditions. While most of the analysis staff may have this information in their heads since the loan volume is so small, this is obviously inappropriate.

All financial institutions should have such a form to recommend a credit, and most do, to define clearly what has been approved and under what conditions, and to document approvals. While board resolutions now provide this function, these resolutions are too cumbersome and do not normally include all the pertinent information. The Credit Approval Summary form should include:

* the name of the company and its location
* its ownership structure, in one line (not a detailed list)
* client category (i.e., industry, agriculture, etc.)
* net sales, total assets and total capital (for purposes of

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comparing to the amount of total credit approvals, not for financial analysis)

* date of recommendation and approval
* date of credit revision to be made
* total credit approval in thousands, including existing facilities
* present outstandings, if any, and under what facilities
* amount of increase or decrease in total credit facilities
* brief description of credit facilities, including major terms (if a term loan with numerous conditions, the term loan summary should be attached to the C.A. Summary)
* a listing and brief description, noting the value, of all collateral and support taken for new and existing credits
* a space for the initials of the account executive and other members of the credit committee, and the board members recommending and approving the credit
* a brief, two page maximum, credit remarks section appended outlining the major risks and the reasons for approving the credit (this would be a summary of the project analysis)

For AID

The ambiguous situation with the dividend limitation should be defined. It would be appropriate to require sufficient profits to cover accumulated PIC losses before permitting any dividends.

AID should confirm with PIC the situation regarding the 3% requirement on the risk minimization fund and define procedures

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to make sure the amounts on the balance sheet accounts are in concurrence.

AID should define the financial objectives for PIC viv a vis the desireability of widespread and minority investment in PIC, and determine the relative importance of earnings and of having PIC project itself as a viable financial institution in the market. At present, there appears to be inconsistency, as outlined in the financial analysis part of the findings section, and the executive summary, of this report.

Related to this issue, AID should reconsider the necessity of PIC achieving US$ 10 million in capital for eligibility to the additional concessionary funding. Whether or not PIC should receive this funding should depend on other factors such as compliance with the spirit and requirements of the loan agreement, PIC competence and effectiveness as a development banking vehicle, and efficency in the task. Additional capital is not necessary from a financial point of view.

PRIVATE INVESTMENT CORPORATION - Comparative Financial Statements

thousands of dollars	audited 12-31-85	audited 12-31-86	internal 7-31-87
RATIOS (* annualized)			
return on avg. assets %	N.A.	0.73	2.30 *
return on avg. equity %	N.A.	0.98	3.96 *
return on avg. securities %	N.A.	9.33	7.41 *
net spread on avg. portfolio %	N.A.	11.32	9.08 *
oper. exp. / avg. portfolio %	N.A.	20.59	9.28 *
risk min. fund / AID debt %	N.A.	1.62	2.61
loans / AID debt	N.A.	1.23	1.41
liabilities / equity	.00	0.66	0.79
loan loss reserve / portfolio %	N.A.	2.40	2.73
BALANCE SHEET			
cash	84.2	11.3	27.0
marketable securities	5269.1	6023.9	4770.8
risk minimization fund	0.0	80.3	156.2
Liquid Assets	5353.3	6115.5	4954.0
loans, net	2000.0	6100.4	8469.3
receivables & other	111.3	142.5	230.7
Normal Risk Assets	2111.3	6242.9	8700.0
investments	0.0	238.8	232.8
fixed assets, net	229.2	205.1	187.4
Illiquid Assets	229.2	443.9	420.2
Total Assets	7693.8	12802.3	14074.2
	======	=======	=======
short term payables	30.8	117.9	201.1
loan payable - AID	0.0	4967.5	5991.9
Total Liabilities	30.8	5085.4	6193.0
common stock	8153.9	8153.9	8155.9
FX and other adjustments	-13.6	-34.8	-52.5
deficit	-477.3	-402.2	-222.2
Total Net Worth	7663.0	7716.9	7881.2
Liabilities + Net Worth	7693.8	12802.3	14074.2
	======	=======	=======
INCOME STATEMENT			
interest on marketable sec	982.9	527.0	233.3
interest on loans	70.8	464.8	430.9
commissions on loans	5.0	62.0	22.7
Asset Related Income	1058.7	1053.8	686.9
interest & commissions paid	64.1	68.3	67.8
operating expenses	524.6	834.0	394.4
Total Expenses	588.7	902.3	462.2
other income	50.2	132.9	46.8
Operating Income	520.2	284.4	271.5
less: loan loss provision	0.0	150.0	87.4
less: loss on investment (Paco)	0	59.4	2.5
less: FX loss & other	495.5	0.0	1.5
Net Income	24.7	75.0	180.1