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USAID/HONDURAS

**INITIAL FEASIBILITY STUDY OF A
PRIVATE FINANCIAL INSTITUTION
FOR INDUSTRIAL DEVELOPMENT**

January 15, 1992

Price Waterhouse

January 15, 1992

Mr. Reese Moyers
USAID/Honduras
011-504-312776

Dear Reese,

We are pleased to present this initial examination of sources of external funding for a potential Honduran private financial institution offering term lending for industrial development.

Price Waterhouse, prime contractor under PRE's Financial Sector Development Project, looks forward to further collaboration with USAID/Honduras. It was a pleasure to participate in this important project.

Sincerely,



J. Richard Breen
Project Director, FSDP

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EXECUTIVE SUMMARY

As a result of a preliminary survey of international and regional lenders, it appears feasible for a private sector financial institution offering term loans for industrial development in Honduras to access international sources of funds and technical assistance from donor agencies. It should be noted that much of the lending from donor agencies would be at commercial terms.

Furthermore, there appears to be sufficient private sector demand in Honduras for term borrowing to fund industrial projects, especially those that involve foreign trade.

Given the potential for donor agency support, it seems appropriate to carry out a formal feasibility study for a private development finance institution in Honduras. This feasibility study should be presentable to the donor agencies which could provide financing.

I. INTRODUCTION

A. Scope of Work

This study is part of a larger project to assess the feasibility of a new financial institution to provide term loans for industrial development in Honduras. The purpose of this engagement is to identify potential financing sources for this institution to determine its viability. Technical assistance from the Financial Sector Development Project (FSDP) was initiated at the request of the Honduran Council of Private Enterprise (COHEP) through USAID/Honduras. Price Waterhouse, through FSDP, engaged a team of two finance and marketing experts to perform this study.

B. Methodology

The FSDP team completed this study in two parts. The first phase of the project involved meetings in Washington with representatives from various potential funding sources for the proposed Honduran industrial development bank. The team then travelled to Honduras where they conducted a workshop with representatives from the financial community and met with exporters to ascertain the potential for industrial development in Honduras.

II. POTENTIAL FUNDING SOURCES

A. Identification of Potential Funding Sources

Potential funding sources for a term lending bank in Honduras to foster industrial development were identified by the FSDP project team. Meetings were scheduled in Washington the week of December 2, 1991 with representatives from five of the institutions identified. The team met with the following institutions:

- International Finance Corporation (IFC) of the World Bank Group
- International Investment Corporation (IIC) of the Inter-American Development Bank
- European Community (EC)
- Japan International Cooperation Agency (JICA)
- Overseas Private Investment Corporation (OPIC)

The EC, JICA and OPIC can provide loans, investment capital, technical assistance and, in some cases, grants to private sector projects. JICA and the EC, as well as OPIC, on occasion, have a variety of relations with, and frequently work in cooperation with the IFC and IIC.

There are other potential sources of funding for Honduran private enterprise including sources in Taiwan, Hong Kong, and Korea. Development financing may also be available to Honduras from Puerto Rico via Public Law 936 (P.L. 936) funds. Representatives of these sources were not contacted in the course of this study, but they, and others, are potentially able to provide assistance to private sector lending institutions in Honduras.

A synopsis of each meeting is contained in the ensuing sections. A detailed list of the representatives met from each institution can be found in Appendix A.

B. International Finance Corporation (IFC)

The IFC is the private sector financing arm of the World Bank. This international institution has been most active in large developing countries and is now particularly concerned with Eastern Europe. It lends to and invests in private enterprise projects, including development banks. The IFC prefers larger projects, involving an IFC participation of \$2.0 million or more.

Honduras is eligible for funding from this source, as well as technical assistance. As in the case of all five sources, the IFC is interested in the development of capital markets. A

capital market feature in a development bank proposal could elicit interest, if it is a feasible feature.

The IFC, as well as the other four sources, would be interested in providing assistance for the development of an effectively operating stock exchange in Honduras, particularly if it could relate to a regional market.

Because the IFC has relatively little experience in Honduras, some time and effort would be required to develop a project with this source. Any such project must be well conceived and well presented to receive funding.

The IFC lends at commercial rates. Although the interest rate can and does vary, it is never concessional. This institution can make longer term loans, however, making it a more suitable funding source for a specific project, rather than as a source of funds for on-lending by a new development bank. The IFC finances companies which show a strong probability of being profitable.

Nevertheless, the IFC could be a source of technical assistance to a new bank. Such assistance could be an effective way to initiate a relationship which might benefit a new Honduran financial institution. In spite of the cost of its funds, the IFC has lent money to numerous financial organizations throughout the world; many of these institutions have benefitted greatly from the relationship.

The IFC does not object to potential clients discussing their projects with other sources. In fact, the IFC works with other institutions on mutually compatible projects.

B. International Investment Corporation (IIC)

This institution bears many similarities to the International Finance Corporation. The IIC has the same relationship to the Inter-American Development Bank that the IFC has to the World Bank. Both organizations were created by large international public sector oriented institutions for the purpose of dealing with private sector projects. Like the IFC, the IIC makes term loans and equity investments, preferably in excess of \$1.0 million, to potentially profitable companies. The IIC recently made a \$1.0 million loan to a vegetable freezing plant in Guatemala and will consider smaller projects. Presentations made to the IIC must be based on a sound, detailed analysis of the project.

The IIC has an advantage over the IFC with respect to Honduras because it deals solely with Latin America. The IIC has recently financed two large industrial parks in the San Pedro Sula area. However, like the IFC, it finances term loans at commercial rates

and is not able to provide concessional interest rates which new financial institutions promoting industrial development often seek.

Those presenting projects to the IIC should be prepared for a lengthy review process, however, despite this institution's familiarity with Central America. Quality of a project is a definite determining factor in accelerating consideration.

The IIC cooperates with other institutions, both public and private, and can help make technical assistance arrangements for projects it considers worthy.

D. European Community (EC)

The European Community Office in Washington has been instrumental in providing term loans and technical assistance to Latin American countries from EC sources. It is especially interested in Central America because of the Common Market. The EC has already made loans to the Central American Bank and would consider projects which have a regional feature.

E. Japan International Cooperation Agency (JICA)

This Japanese agency is principally involved with technical assistance but is also an entree to numerous other Japanese sources. The Overseas Economic Cooperation Fund (OECF), the Japanese Export Import Bank, and other agencies of the Government of Japan make loans to private borrowers.

Japan is particularly interested in providing technical assistance to Honduran companies with a view towards forming joint ventures. Equity participation is not a condition of Japanese technical assistance, nor is the offer of assistance, in any sense, a commitment to invest.

JICA has an office in Tegucigalpa headed by Mr. Takashi Magase. It is located at Colonia Palmira, Avenida Juan Lindo, 4a Calle 201.

Dealing with the Japanese could be complex. The Japanese tend to analyze very carefully before taking action. However, this same characteristic, in one way or another, applies to all of the major Washington-based institutions.

F. Overseas Private Investment Corporation (OPIC)

This U.S. Government institution is more business oriented than some other U.S. Government agencies, offering a variety of services such as loans, guarantees, and technical assistance arrangements. One common element of all its services is the

requirement that there be a U.S. "feature" in the proposed project.

Like most lenders, OPIC is reluctant to negotiate in the abstract. The question of what constitutes an acceptable U.S. relationship to a project, and which among its services they feel particularly apply to a borrower, is best left to discussions of specific projects directly with the institution.

One activity mentioned by OPIC as having potential application to Central America is the support they have given to establish regional investment funds. For example, the Africa Fund, structured by OPIC, consists of a portfolio of equity shares in African companies. Such funds are typically first marketed regionally with the goal of ultimately placing them on major international stock exchanges.

G. Summary of International Funding Sources

Several conclusions can be drawn from conversations with offices of the five sources of international funding. Direct concessional financing for a term lending financial institution to foster industrial development in Honduras is not readily available. However, technical assistance that can offset the institution's operating costs is available. The desirability of a relationship with any or all of these sources can only be decided after establishing a close relationship with them. In most cases, this requires travel, perhaps frequent travel, to Washington, D.C. and elsewhere to make, at least initially, well thought out presentations of the proposed project. The presentations need not be in the form of a fully developed application for financing, but it must rationally and thoughtfully address the major issues that might affect the success of the project.

An important point for consideration is the fact that the United States, which has financed many development banks on concessional terms, is no longer providing such financing.

In many respects the scene has shifted to Asia now. Sources of funds from this region are beginning to show interest in Central America. Pressure to establish bases from which to sell into the North American trade zone is only one of several motivations for Asian investments and aid to Central America. Honduran private sector members who explore this source will be pioneering: there is not much of a track record. It seems certain, given a modest degree of social and political stability, that much more Asian capital will find its way to Central America.

The European Community is a potential source of funding which is less often considered. The EC does have a particular interest in Central America and it does have funds. However, it does not

have the same volume of funds available as the Asian countries, nor the same special interest in foreign investment.

It should always be kept in mind that all of these institutions are in the business of providing money and services to good projects in developing countries. Patience and a good project are eventually likely to be rewarded by these sources.

Applicants who are already known to a particular source have a distinct advantage. Honduras is not entirely at a disadvantage. The country is well known to the IIC, of some interest to the JICA, and of a special sort of interest to the European community.

OPIC is clearly interested in the region as well. In fact, OPIC is close to making a large investment in an industrial park in Honduras. However, OPIC is somewhat inhibited by U.S. legislation which places restrictions on loans and investments that include manufacture of textiles and shoes for the U.S. market. Whether or not this restriction is an obstacle should be determined in discussion with OPIC itself. Regardless of this U.S. law and other potential obstacles, it is advisable for the organization seeking funding to meet with all potential sources when in Washington.

In the final analysis, projects are negotiated based on their individual characteristics. Borrowers should have some capability to be flexible to meet specific institutional guidelines. In the course of long term negotiations, the institutions often are more flexible than they at first appeared to be.

III. POTENTIAL PRIVATE SECTOR HONDURAN BORROWERS

A. Seminar for Honduran Financial Institutions

An informational seminar was held at COHEP on December 10, 1991 for representatives of Honduran financial institutions and investors to brief them on the various international financing options available for a term lending financial institution. The findings of the Washington meetings were communicated to seminar participants. The briefing was followed by a question and answer session and informal group discussions on the subject. Attendees from San Pedro Sula, the business center of the country, were the most interested in establishing a financial institution to promote industrial development.

B. Honduran Business Sector

The FSDP team visited the Choloma Export Processing Zone to assess the potential for future industrial and export development in Honduras. Currently the eight companies operating in the zone employ approximately 7,000 people. In the textile company visited by the team, the working conditions were notable for their ample space, good lighting, air conditioning, and other amenities. The zone is currently expanding and has sufficient space to do so.

The FSDP team also visited an agribusiness operation under construction to gain insight into entrepreneurship in the region. Several fish ponds and pork fattening facilities whose products will be sold primarily in the export markets are under development. This project is receiving technical assistance and supplies from the international agribusiness company, Cargill.

Based on this limited exposure to business conditions in Honduras, the FSDP team nonetheless concluded that the San Pedro Sula region has the potential for continued export growth, both in the agribusiness and light manufacturing sectors.

IV. RECOMMENDATIONS

A. Background on the Establishment of Term Lending Institution for Industrial Development

This report recommends that international sources of funding be pursued. The recommendations are made in consideration of the nature of international financing available to a new banking institution in Honduras and the apparent direction of international trade and investment.

The sponsors of Banco del Pais seek assistance to establish a new Honduran commercial bank to extend medium and long term loans and provide banking services to foster industrial development. Plans are for Banco del Pais to have a broadly based ownership with no single individual or family group holding more than three percent of the bank's shares. The sponsors believe that this ownership structure will permit the new institution to respond to projects according to their merit, rather than just their ownership.

The sponsors of Banco del Pais have asked for advice on the new entity's potential role as a development institution. Its single, but apparently logical development feature, in view of Honduran market characteristics, probably will be its medium term lending capability.

B. Market for Medium Term Lending

Medium term loans, those with maturities of up to five years, have been established through the operations of Latin American Agricultural Development (LAAD) and other development lenders. However, medium term lending is a niche that is not adequately supported by the existing financial community. Neither LAAD nor the few other development banking sources in Central America have sufficient funds to meet more than a small fraction of the reasonable demand for such loans.

The issue, therefore, does not appear to be one of market but, rather, of the availability of long term funds to finance this kind of operation. Assuming Banco del Pais proposed to offer financing at terms of up to five years, it would need to meet this demand with funds from sources other than those normally available to a commercial bank in Honduras.

The Banco del Pais would need to obtain funding abroad in order to meet demand for medium term loans in Honduras. Since most international lending is denominated in a basket of foreign currencies, the Banco del Pais probably would be compelled to lend to clients who export and generate foreign exchange. Otherwise, Banco del Pais would need to devise ways to hedge its foreign exchange exposure. Such lending would need to be through an offshore banking facility to deal with legal restrictions

governing dollar financing. Offshore lending is a common practice in Honduras and poses relatively few difficulties for the bank.

There is reasonable demand for medium term dollar financing by Honduran exporters. It is also important to note that the increase in foreign exchange activity is a high priority of the Government of Honduras. This niche is a logical one for the Banco del Pais.

C. Feasibility of the Banco del Pais

The "term lending window" of the Banco del Pais would be expected to pay its own way, at least within a few years of its establishment. The bank's ability to do so will depend on three factors:

- the quality of its loan portfolio,
- the spread between the bank's borrowing and lending rates, and
- the size of the portfolio.

It would be reasonable to assume a placement capacity of \$2.0 million annually in quality term loans. The bank should not consider projecting a higher level of lending during its first few years of operation. The bank will also need a fairly high degree of flexibility in the use of funds provided by an international source. There is considerable demand and real need for permanent working capital in Honduras. Some international lenders would prefer to finance only fixed assets. This issue would merit intense negotiation with potential funding sources.

No matter how high the quality of the portfolio and how flexible the source, some loans will be rescheduled. This eventuality means that the bank must borrow at a term that provides for this outcome and allows the bank to get second and third uses of the funds.

To develop a medium term (five year average) portfolio, funds ideally should be borrowed at a fifteen to twenty year term, and certainly not less than ten years. Initial draw down of funds should be scheduled for a period of no less than three years.

The major financing issue is the spread. Dollars can be loaned at 13 to 14 percent to good projects in Honduras. Most lending from the institutions we interviewed is at commercial rates. Assuming these rates could be as low as 8 percent, the spread to the Banco del Pais could be 5 percent. This spread is not sufficient to cover operating costs, maintain an adequate reserve of 3 percent, and provide for a reasonable profit. A 1 percent

net profit on the principal of loans would be adequate, at least during the start-up years, for a \$100.0 million portfolio but would not be satisfactory for the level of portfolio the bank could reasonably develop and maintain.

If concessional financing is not available to the Banco del Pais, it will need to acquire the same benefits through other means in order to support a term lending window. Such funding is feasible. Funds probably can be obtained at interest rates at the low end of commercial rates. It is likely that at least some portion of operational costs could be passed on to clients. Purveyors of technical assistance also could cover some portion of the bank's operating expenses, at least during the start-up years.

Portfolio quality will be a critical factor for an institution which must function without enough spread to support a conservative level of bad debt reserve. The Banco del Pais, thus, cannot be a pure development bank per se, but rather it should be a commercial bank providing some medium term financing and other special services to support industrial development. These special services could become the bank's most distinguishing, and, in the long range, most profitable feature.

D. Role of Honduras in International Trade

The prospects are good for Central America to have an opportunity to participate advantageously in the development of an American free trade zone. As this endeavor progresses, and other world areas are partitioned into trade blocks, there should be an increasing number of opportunities for trade between Honduras and these areas, as well as within the North American area.

To create an environment conducive to investment and to maximize its export potential to these trading regions, it is important for the Government of Honduras to pursue policies compatible with an export orientation. The most important of these policies is the maintenance of a competitive foreign exchange rate that keeps pace with inflation and does not become overvalued. Frequent small devaluations may be necessary as inflation currently exceeds 20 percent per year.

Related to exchange rate policy is the importance of allowing market forces to determine wage rates. Competitive wage rates are vital to the success of export processing zones. Labor productivity, which is partially a function of low labor costs, helps attract foreign firms to such enclaves. In other countries, these foreign firms have been known to move out quickly if labor costs become high relative to other countries and there are no other reasons for the firm to maintain its operations in the country.

V. CONCLUSION

Productivity and trade are now the major issues for international financial institutions. The five entities visited for the purposes of this report expect to be important financiers of emerging new trade activities. The EC office in Washington has already indicated its desire to establish relations with Central America's banking community.

While Honduras may not be high on their list of priorities, it does have a place on these lists. The absence of a point of reference for businesses interested in providing and receiving investment financing, technical assistance, and other services is an obstacle. This issue is not new to Central America. In the 1960s, major international firms were aggressively seeking opportunities to establish plants in the region to take advantage of the newly formed Central American Common Market. A substantial number of these investors came to Nicaragua, not because they intended to, as the country had been low on their priority lists, but because Nicaragua actively sought them. Investors came to Nicaragua because INFONAC, a public development bank, acted as an aggressive private promoter, implementer, and financier.

INFONAC was a focal point of knowledge regarding foreign sources of know-how and money. INFONAC created projects. A public institution generally has a greater capacity to perform this kind of function. But if INFONAC had been private, had the same staff and management, and the same strong cooperation of the Government of Nicaragua, it could have been a profitable enterprise.

Times have changed and with them the motivations of foreign sources of capital and term lending. However, the need for an intermediary institution has increased, rather than lessened.

Potential Asian investors and, to a lesser degree, European investors need more guidance and assistance than did the largely U.S. group of investors in the 1960s. The concept of some national institution performing this function is neither new nor controversial, and the idea may be particularly timely right now.

The prospects of such a private institution would be enhanced if it had regional capabilities. Relationships with other similarly motivated private banks in the region could become a useful linkage to foreign investors and markets.

This may seem to be a presumptuous course for a commercial bank to follow, and there are clearly a few important steps to be taken before becoming an international merchant bank. If this were the objective of Banco del Pais at the outset, there would very likely be a variety of sources of grant aid to help in the start-up years. The Banco del Pais would have a good chance of

receiving funds to cover the costs of key staff, especially those related to international and capital markets activities. Such financing was provided to the Africa Fund.

In sum, the IIC appears to be the most logical source of funds to finance a medium term loan portfolio. But the bank would be well advised to consider this funding as a means to establish an identity, rather than as an end objective.

An aggressive, promotional private bank with an international character that can offer full services to prospective investors or importers could be a financial success and eventually make a major contribution to Honduras.

APPENDIX A

Representatives Met from International Funding Sources

International Finance Corporation (IFC)

Damian Von Stauffenberg	Director of Advisory Services for Central America and the Caribbean
Sidney Edelman	Investment Officer Central America and the Caribbean
Elena Gonzalez	Investment Officer Central America and the Caribbean
Peter Trapter	Manager Emerging Markets Database
Deborah Farrel	Capital Markets (International)

International Investment Corporation (IIC)

Benjamin Vides	Department Manager
Carlos F. Aguilar	Investment Officer

European Community (EC)

Jennifer Tufts	Development Programs
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Japan International Cooperation Agency (JICA)

Hideki Abe	Resident Representative USA Office
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Overseas Private Investment Corporation (OPIC)

Michael Stack	Director of Special Projects, Investment Development
Jeffrey Crawford	Associate Investment Officer