IFC's Evaluation Framework for Investments

IFC's mission is to promote private sector investment in developing countries as a way to reduce poverty and improve people's lives. To be considered a development success, every project has to make a positive contribution to the host country's development. For each project that has reached sufficient maturity, we provide an overall "development outcome" rating. The development outcome rating captures the overall impact of the project on the development of its host economy, and thus implicitly addresses how well the project has contributed to fulfilling IFC's mission. Development outcome is rated on a 6-point scale, highly successful to highly unsuccessful, and the top 3 ratings are considered a "success".

The development outcome rating is a synthesis based on four key performance areas that encompass a project's multi-faceted contribution to the host economy. These four components are (1) financial performance, (2) economic performance, (3) environmental and social performance, and (4) private sector development. To consider a project developmentally successful, we expect it to be (1) financially sound; (2) provide benefits to stakeholders beyond the project financiers, and not rely on subsidies, protection or other distortions; (3) meet our social and environmental performance standards; and (4) have a broader impact on private sector development. Performance of those four components is rated on a 4-point scale: excellent, satisfactory, partly unsatisfactory, or unsatisfactory; with satisfactory and excellent being deemed a success. This evaluation framework is aligned with widely accepted Good Practice Standards for Private Sector Evaluation.[1]

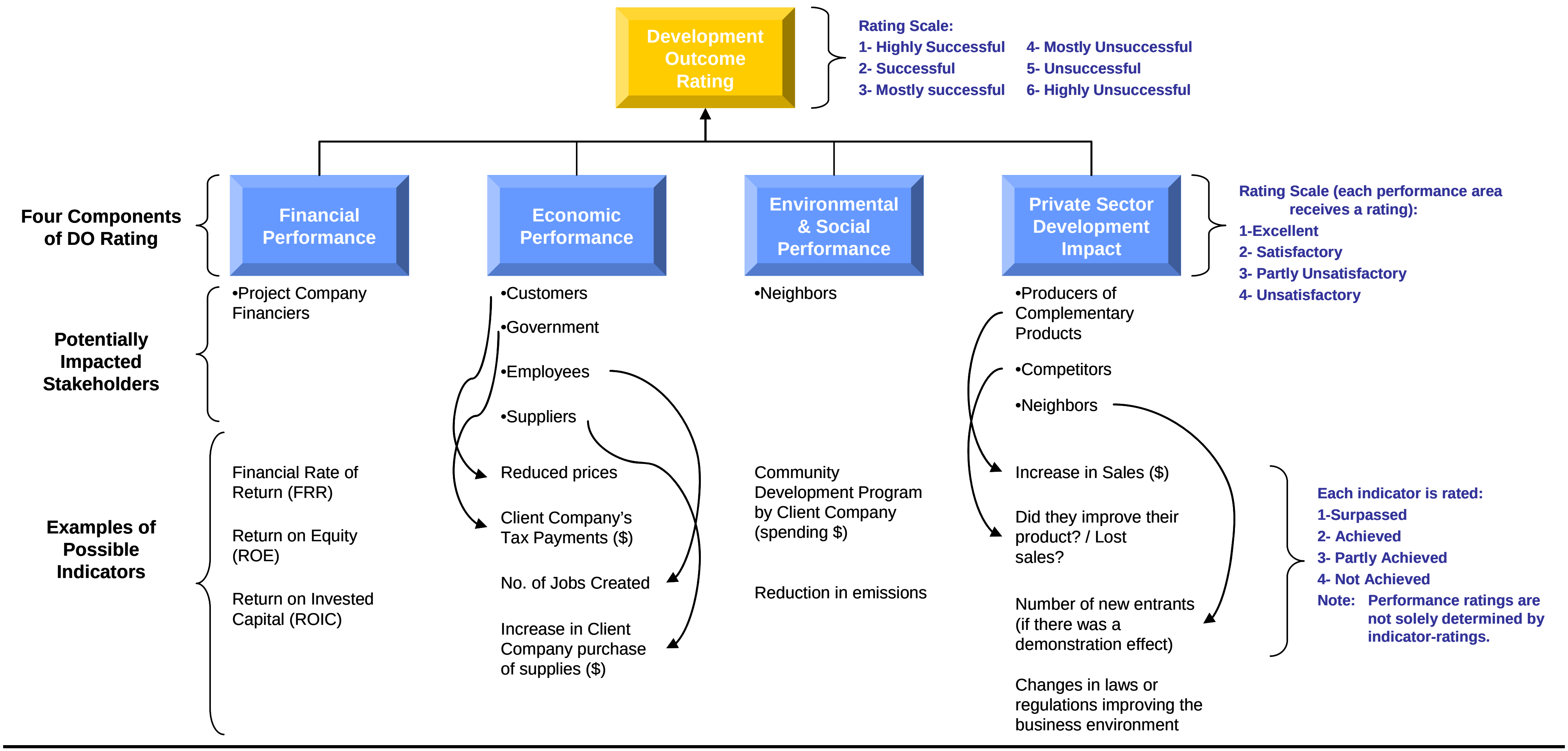
The four performance components are in turn informed by achievement of project-specific indicators. Indicators measure impacts on different stakeholder groups and are mapped into the four key performance areas. For each indicator, clear objectives and timelines are set ex-ante and subsequently tracked during supervision. For example, one such quantitative indicator and objective could be that a company will add 400 employees by 2010. A qualitative indicator could be that a company will adopt a new environmental management system and reach ISO 14001 certification by 2008. Indicators can be rated as: surpassed, achieved, partly achieved, or not achieved.

IFC's evaluation framework aims to capture the costs and benefits for different stakeholders throughout society: the financiers, customers, employees, competitors, etc. Refer to Figure 1 for a summary of IFC's evaluation framework.

The rest of this brief expands on IFC's evaluation framework and evaluation standards.

[1] The good practice standards for private sector evaluation (GPS) are endorsed by the Evaluation Cooperation Group (ECG). ECG is an alliance of multilateral development banks established to harmonize performance indicators, evaluation methodologies, and strengthen the use of evaluation for greater effectiveness and accountability.

Figure 1: IFC's Evaluation Framework Exemplified



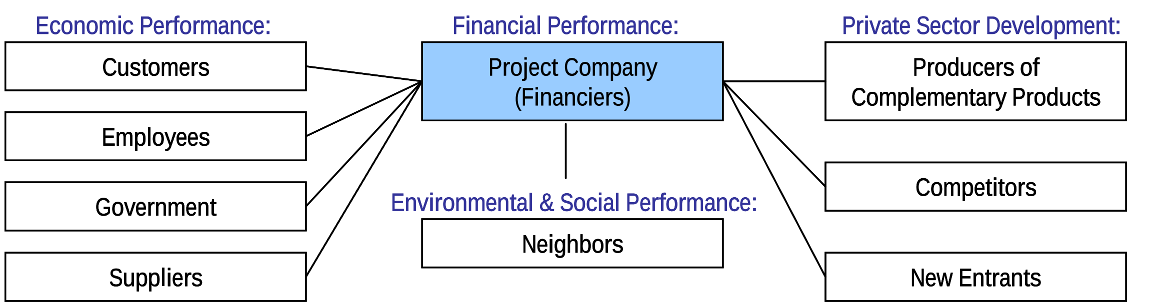
IFC's Evaluation Framework: Benefits For Society – A Stakeholder Approach

In evaluating the performance of our investments, we attempt to assess a project's impact on all affected stakeholders. In order to do so, we need to have a clear understanding of what would have happened without the project. In this way, we can better understand the project's incremental effect. For example, we consider:

- What else would consumers buy? Would they buy imported goods or a lower-quality version of the product? Are they better off because of the project?
- What would major suppliers do without the project? Would they sell to someone else (at the same price?) or produce other goods, such as different cash crops in the case of agricultural inputs? Are they better off supplying the project's inputs?
- What else would workers do? Would they be unemployed, or would they have other opportunities? Are they better off working for the project company?
- Would the government receive more or less money without the project?

Figure 2 below depicts potentially impacted stakeholders and maps them into the performance area under which we generally assess their costs and benefits.

Figure 2: The Stakeholder Framework



In assessing a project's impacts from a stakeholder perspective, we consider costs and benefits to each of the stakeholder groups. Where possible, we quantify a project's impacts on stakeholders; for example, employees could be earning 15% over the wage they would have earned in the absence of the project in other employment opportunities. Sometimes it is not possible to quantify such effects, in which case we try to consider such effects qualitatively in assessing the project's overall development results.

Financial Performance

To assess costs and benefits to project financiers, we look at measures of investment profitability. In the case of project finance, we calculate the project's financial rate of return (FRR), typically ex-ante and again at evaluation, and use annual proxies, such as return on assets, equity or invested capital to monitor ongoing performance. In the case of corporate loans and financial market investments, we use return on equity or return on invested capital. We compare these rates of return with our client's weighted average cost of capital. Meeting the cost of capital is necessary for business to be sustainable. Profitable investments are also an essential signal to attract other investors: it shows that supporting developmentally sound projects can be good business.

Economic Performance

Economic performance assesses the project's impact on all of society. In addition to the impact on financiers, the impacts on the following stakeholder groups can typically be assessed, and often quantified:

Customers can benefit from being able to buy a new, better, or cheaper product. This type of benefit can often be quantified. For example, for non-tradable products and services (e.g. infrastructure and financial services), consumers will benefit to the extent the price falls, and that consumer surplus can be estimated (change in price times project output divided by two). Note that customers may further benefit from demonstration effects as competition ensues and prices fall further. Typically these second-round effects are not quantified, but noted under private sector development.

Employees will benefit to the extent the wages they earn as an employee of the project company exceed what they would have earned without the project. A wage above the next best opportunity represents a benefit. Furthermore, training received by employees can also be a benefit to the extent that better skills allow employees to command a higher wage in the future (within or outside the company).

Governments typically benefit from IFC-supported investments in the form of tax revenues. In some cases, however, governments lose revenue, for example from foregone import tariffs on goods now produced domestically. Moreover, governments may choose to incur costs to create incentives for private sector development, for example, through the provision of infrastructure or tax breaks. Overall, however, the private sector tends to be a large net contributor to government revenues.

Suppliers benefit from increased demand for their products and services. These benefits can be estimated (e.g. the project's purchases of supplies times the change in price divided by two). In some of our projects, suppliers also benefit from capacity building. Where suppliers are supported, an entire sector may benefit from improved services or products.

Private Sector Development Impact

Producers of Complementary Products benefit through increased demand for their product. For example, a successful hotel attracts additional tourists and business travelers that also make use of locally offered tours, restaurants, and other products and services. However, such second-round effects are typically difficult to quantify.

Competitors may see a reduction in demand for their products. Such increased competition, however, is usually not a loss from the perspective of society as a whole. The loss in competitors' profit will be more than compensated by the benefits to consumers from the resulting lower prices. Thus, this simply represents a transfer from one group to another and not a loss from the viewpoint of society. We consider the loss to competitors by only taking the net benefits to consumers into account. Furthermore, a successful project may have demonstration effects for its existing competitors, which will represent a benefit to them as they adopt new measures and begin to operate more efficiently. These effects are difficult to quantify, but considered in the rating.

New entrants also benefit from demonstration effects. New entrants choose to enter the market in which the project company operates after observing the project's financial success. It is difficult to value such impacts, but they are materially important for a country's development, sometimes facilitating benefits to an entire economic sector which may eventually become internationally competitive.

Environmental & Social Performance

IFC assesses project effects on neighboring communities and the environment for each project. First and foremost, we help our clients manage social or environmental risks and meet our performance standards. We also measure the benefits a project creates for host communities where this is possible. For instance, a mining project may require new roads to transport supplies to the site. That road can create real benefits for a community: it may for example reduce the time it takes to get to the nearest market or school. It can also, however, create environmental hazards like deforestation, which we require our clients to manage pro-actively, i.e. avoid or mitigate.

Aggregating Stakeholder Impacts: the Economic Rate of Return (ERR)

The financial rate of return (FRR) assesses a project's return from the point of view of its financiers. As a development institution, IFC also wants to know whether a project benefits society as a whole. To that end we calculate an economic rate of return (ERR), which is the internal rate of return on an investment after accounting for the costs and benefits a project entails for all stakeholders across society.

To estimate the economic rate of return, a good starting point is the FRR. The FRR is an overall measure of profitability from the viewpoint of the company and its financiers. It is the internal rate of return that makes the present value of the net project cash flows zero. A company should only invest if the FRR is greater than its weighted average cost of capital (WACC), otherwise returns are insufficient to pay lenders and adequately compensate equity investors. The FRR is solely based on financial cash flows, but does not capture the economic costs and benefits from the viewpoint of society. In order to integrate these effects into the ERR the impact on each of the stakeholders is analyzed separately as described above. All quantifiable impacts are then added or subtracted from the net financial cash flows in order to calculate an ERR. The ERR is used to inform a project's economic performance rating.

Indicators to Assess Impacts on Specific Stakeholders

Outside of being informed by the ERR, a project's economic performance rating is also informed by project-specific indicators, as are the other performance areas. Indicators are tracked in an ongoing manner throughout the project cycle – indicator achievement levels are compared to target levels which are defined ex-ante. Indicators are identified prior to project approval to articulate the expected development impact of the project. These expectations are reflected in time-bound targets, and the extent to which they are achieved constitute a basis for rating the four key performance components and their synthesis, the overall development outcome rating (see Figure 1). Once the project reaches early maturity, typically a few years following project approval, indicators are rated as: surpassed, achieved, partly achieved, or not achieved.

IFC's Evaluation Framework – Summary: Indicators, 4 Performance Components & Development Outcome

Indicators capture a project's impacts on different stakeholders. Ratings on indicators are then used to inform a project's ratings on the four key performance areas: financial performance, economic performance, environmental & social performance and private sector development impact. We have developed a set of guidelines, or evaluation standards, for rating the four key performance areas:

Financial Performance: Was the project financially beneficial for the financiers as a group?

→Real Sector Projects: The most relevant indicator is the project's real financial rate of return (FRR) compared to the company's weighted average cost of capital (WACC).

- Evaluation Standards for Ratings Assignment:
  - Excellent: FRR ≥ WACC + 2.5%
  - Satisfactory: FRR ≥ WACC
  - Partly Unsatisfactory: FRR ≥ WACC – 2%
  - Unsatisfactory: FRR < WACC – 2%

→Financial Sector Projects: For targeted funding (e.g. a credit line), we assess the profitability of that activity, otherwise the profitability of the financial institution (FI) as a whole. The most relevant indicator is the return on equity (ROE) as compared to the cost of equity (COE)[2].

- Evaluation Standards for Ratings Assignment:
  - Excellent: ROE ≥ COE + Risk Premium
  - Satisfactory: ROE ≥ COE
  - Partly unsatisfactory: ROE < COE
  - Unsatisfactory: ROE < T-bill rate of return

Economic Performance: Was the project economically beneficial after considering impacts across all stakeholders? At a minimum, the project should not depend on market distortions (subsidies, tariffs, etc.) for its financial viability.

→Real Sector Projects: The most relevant single indicator for a project's economic sustainability is the project's economic rate of return (ERR). However, other indicators that capture unquantifiable impacts should also be considered.

- Evaluation Standards for Ratings Assignment:
  - Excellent: ERR ≥ 20%, plus substantial unquantifiable economic benefits.
  - Satisfactory: ERR ≥ 10%
  - Partly Unsatisfactory: ERR ≥ 5%
  - Unsatisfactory: ERR < 5%

→Financial Sector Projects: We consider the project's contribution to the efficiency of financial markets (e.g. efficient asset allocation, etc.). For corporate loans or equity investments, we consider the company's financial performance (before tax) and the extent to which that may be affected by distortions (e.g. subsidies, interest or exchange rate distortions, or real sector

[2] COE = T-bill + Risk Premium

distortions such as concentration in protected sectors). For targeted funding, e.g. a credit line, consider the volume and performance of the relevant sub-portfolio.

- Evaluation Standards for Ratings Assignment:
  - Excellent: EROE (Economic Return on Equity)[3] ≥ COE + Risk Premium
  - Satisfactory: EROE ≥ COE
  - Partly unsatisfactory: EROE < COE
  - Unsatisfactory: EROE < T-bill rate of return

Private Sector Development Impact: Did the project help create conditions conducive to the flow of private capital into productive investment? Here we consider the project's impact beyond the implementing company, e.g. changes in the legal and regulatory framework, demonstration effects (including, for example, corporate governance), linkages, knowledge or know-how transfer, increased competition or improvement in services, etc. We specifically consider to what extent the project has fulfilled the private sector development objectives that were defined at approval. In assigning ratings, we use specific rationales, e.g. we qualify a positive demonstration effect with the number of other companies that have started-up because of the project example.

- Evaluation Standards for Ratings Assignment:
  - Excellent: Project substantially improved the enabling environment or contributed to the efficiency of markets.
  - Satisfactory: Project had some demonstrable positive impacts.
  - Partly unsatisfactory: Project had some negative impacts which, however, are expected to be short-lived (e.g. a failed project without additional consequences for private sector development).
  - Unsatisfactory: Substantial negative effects on private sector development (e.g. reducing competition, introducing or prolonging distortions).

Environmental and Social Performance: Did the project comply with IFC's environmental, social, health and safety (ESHS) policies and guidelines, and did it substantially change the company's ESHS performance? In our rationale, we take into account specific improvements in performance.

- Evaluation Standards for Ratings Assignment:
  - Excellent: Project materially improved company's ESHS performance or raised industry standards and is in material compliance with IFC's ESHS requirements.
  - Satisfactory: Project is in material compliance with IFC's ESHS requirements (or corrective action plan agreed at commitment is being complied with).
  - Partly Unsatisfactory: Project is not in material compliance, but corrective action is underway.
  - Unsatisfactory: Egregious non-compliance or material non-compliance without realistic short-term prospects of corrective action.

→ Note for Financial Market Projects: Consider both the FI's systems (e.g. screening, structuring, and supervision of ESHS risks) and the performance of projects it finances.

[3] EROE stems from the cash flow used to calculate ROE plus or minus costs or benefits to other stakeholders, such as taxes, subsidies, or estimates of consumer surplus (e.g. for microfinance projects), while accounting for changes in equity value.

The 4 performance ratings collectively inform a project's overall development outcome rating. The development outcome rating is a synthesis judgment, which considers the 4 performance components as well as the achievement of objectives and monitorable indicators (see Figure 1).

- Evaluation Standards for Ratings Assignment:
  - Highly successful: Overwhelming positive development impacts with virtually no flaws.
  - Successful: No material shortcomings, or some very strong positive development aspects that more than compensate.
  - Mostly successful: Clear preponderance of positive aspects, notwithstanding some shortcomings.
  - Mostly unsuccessful: Minor shortcomings across the board, or egregious shortcoming in one are with otherwise positive aspects.
  - Unsuccessful: Largely negative aspects, clearly outweighing positive aspects.
  - Highly unsuccessful: Material negative development aspects with no material redeeming positive aspects.

For projects rated '*mostly successful'* or better, we are able to justify why we consider the project, on balance, a developmental success.

Our Evaluation Framework in Practice

With the introduction of the Development Outcome Tracking System (DOTS) in October 2005, we began tracking our development results for all IFC investments. The new system is consistent with the ongoing work of the Independent Evaluation Group[4], but it differs in that it permits contemporaneous monitoring of IFC investments throughout the project cycle for IFC's entire portfolio. DOTS allows us to aggregate our results across regional and industry departments. When reporting on IFC's performance we report success rates as follows:

- Development Outcome Success Rates refer to the percent of projects with a rating of *'mostly successful'* or better.
- Success Rates for the 4 performance areas refer to the percent of projects with ratings of *'satisfactory'* or better.

Our reporting universe for the 2007 Annual Report consisted of projects started between 1998 and 2003 that are still active in our portfolio. The idea is to always report on a rolling time frame such that we do not include investments that are too immature to measure results reliably or too old and thus less relevant for today's operations.

[4] IEG engages in evaluating a random selection of IFC investment projects for their development results.