Guidance

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Instructions for Non-Financial Markets Projects

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# Contents

1. XSPR PROGRAM OVERVIEW .......................................................... 1

2. COMPLETING YOUR XPSR: GETTING THERE IN NINE STEPS .......... 3

3. ADVICE FROM PREVIOUS XPSR TEAMS .................................. 5

4. GUIDELINES FOR NON-FINANCIAL MARKETS PROJECTS .......... 7

**INTRODUCTION** ........................................................................ 7

**DEVELOPMENT OUTCOME RATING** ....................................... 8

**PROJECT BUSINESS PERFORMANCE** .................................... 9

**ECONOMIC SUSTAINABILITY** .................................................. 11

**ENVIRONMENTAL AND SOCIAL EFFECTS** ............................. 13

**PRIVATE SECTOR DEVELOPMENT** ......................................... 15

**IFC’S INVESTMENT OUTCOME RATING** ................................. 17

**GROSS CONTRIBUTION – LOAN** ........................................... 18

**GROSS CONTRIBUTION – EQUITY** ......................................... 19

**IFC’S WORK QUALITY RATING** ............................................. 20

**SCREENING, APPRAISAL, AND STRUCTURING** ....................... 21

**SUPERVISION AND ADMINISTRATION** .................................. 23

**IFC’S ROLE AND CONTRIBUTION** ......................................... 24

**ISSUES AND LESSONS FOR IMPROVED PERFORMANCE** ......... 26

5. A STAKEHOLDER FRAMEWORK FOR ASSESSING DEVELOPMENT IMPACT ................................................................. 29

6. GUIDANCE NOTE ON PRICE ADJUSTMENT TECHNIQUES .......... 37

7. CALCULATING THE FINANCIAL RATE OF RETURN .................... 41

8. GUIDANCE NOTE ON EVALUATING CORPORATE LOANS .......... 49

9. SOME AVOIDABLE MISTAKES FROM PREVIOUS XPSRS ............ 53
1. XSPR Program Overview

**INTRODUCTION**

An XPSR (Expanded Project Supervision Report) is an addendum to a regular PSR containing an Evaluation Findings. This section describes the purposes of the XPSR system, the processes involved, staff responsibilities, and how the results are disseminated and applied.

**PURPOSES**

**Accountability**

The first purpose of the XPSR system is to meet a Board requirement that IFC accounts to its Board and shareholders for achievement of its Corporate Purpose and objectives in its core investment operations.

(a) IFC's Purpose is stated in Article I of its Articles of Agreement: "The purpose of the Corporation is to further economic development by encouraging the growth of productive private enterprise in member countries ..."

(b) In May 1999, IFC defined its Mission Statement: "To promote sustainable private sector investment in developing countries, helping to reduce poverty and improve people's lives".

(c) High-quality, focused evaluation has become an important requirement for sustaining shareholder support for IFC in the evolved climate of diminished political support in Part I countries for foreign aid in general, reduced budget allocations, competition among the various aid agencies, and increased demands for transparency and accountability by governments.

**Learning**

Even more important is the second purpose of the XPSR: to contribute to learning. The overwhelming feedback from XPSR teams confirms that writing an XPSR is an important personal learning experience. As one of the feedback providers put it, writing an XPSR is "potentially the best training tool for new colleagues". XPSRs also identify lessons to help improve the performance of IFC operations. XPSR findings are synthesized and analyzed by IEG at the end of each XPSR cycle and are presented in the Independent Evaluation of IFC's Development Results (Annual Review). The Annual Review is discussed in a formal meeting of the Board Committee on Development Effectiveness (CODE) and is subsequently endorsed by CODE to the full Board. IEG synthesizes lessons by sector, country and thematic subjects and disseminates these via its website. IEG also synthesizes XPSR findings and lessons for presentations on IFC's portfolio performance in specific sectors or departments, highlighting lessons for future operations. IFC encourages staff to apply the lessons in their analysis and decision-making across the operations cycle, starting from the early review stage.

**Collateral Applications**

The third purpose of the XPSR is to provide updated information and analysis from which IFC can monitor developments against expectations and manage its investments. XPSR findings are also useful inputs to departmental business plans, restructuring work plans, divestment timing planning, IFC’s loss provision...
estimates, and portfolio reporting to the Board. Finally, they are used in IEG's special evaluation studies, as training tools (e.g. IFC's induction training program, credit course, etc.) and in periodic reports on the development contribution of IFC operations.

**Processes**

Every year IEG selects a random sample, which covers projects approved five calendar years prior to the current year and have generated at least 18 months of operating revenues (covered by at least one set of company annual audited accounts).

IEG is responsible for designing and maintaining the XPSR infrastructure, including preparation of these guidelines, the suggested evaluation findings execution steps and instructions for assigning performance ratings and writing lessons emerging from the operation. It also reviews the XPSRs after they are prepared and validates the findings.

Operations departments directors and portfolio managers are responsible for assigning and guiding the XPSR teams, quality control, contributing insights from a continuity perspective and their experience of other operations.

**Content**

The XPSR has two main parts: (i) the Project Supervision Report (PSR); and (ii) the Evaluation Findings. For the purposes of the XPSR, it is essential for the PSR to present sufficient basic information on the project under evaluation.

The text of the XPSR's Evaluation Findings should normally not exceed five pages, accompanied by pages showing FRR/ERR/ROIC/EROIC/ROE calculations, and sub-project information for financial markets projects, as relevant. A field visit is highly recommended. The Evaluation Findings includes:

a. An assessment of the likely achievement of the broad objectives (presented in the Board Paper) for the operation;
b. Rating of the project's emerging development impacts, IFC's investment performance, and IFC's operational effectiveness;
c. A discussion of the rationales for the performance ratings;
d. Comparisons of appraisal projections with actual outcomes for key financial and operating indicators, with brief explanations for material variances; and
e. Identification of emerging lessons from the experience to-date.

**Review Process**

XPSRs follow the PSR policy on distribution, i.e., the portfolio manager circulates them to the Corporate Investment Committee (CIC) on a no-objection basis for projects with no major issues. An electronic copy of the XPSR is sent to IEG at the time the report is circulated to the CIC.

IEG reviews each XPSR and prepares an Evaluative Note (EvNote) to assess the evaluative ratings independently, to ensure corporate-wide consistency in the application of rating guidelines. Following a discussion of the draft EvNote with the XPSR team, IEG revises the EvNote as appropriate and sends it to the CIC. A copy is also sent to IFC's Information Center to be filed as an attachment to the XPSR.
2. Completing Your XPSR: Getting There in Nine Steps

Before embarking on writing up the Evaluation Findings, the XPSR team researches the relevant files, interviews IFC staff involved in the operation over its life, obtains inputs from other functional units, conducts field research as necessary and carries out the analysis needed to respond to the XPSR instructions. Leaving sufficient time to write the Evaluation Findings and obtaining all required clearances well ahead of the scheduled CIC Portfolio circulation date is key. Summarized below are the detailed steps in preparing the Evaluation Findings.

Step 1: Inform team that XPSR is needed

Your XPSR team consists of:
- Investment officer/analyst
- Environmental specialist
- Economist
- “Engineer” (for non-financial markets)

Contacts:
- IEG
- Environment and Social Development Dept
- Former IOs/IAs
- Technical department

Step 2: Review XPSR documentation

Basic documents:
- XPSR guidelines
- XPSR template
- Good practice examples

Reference documents:
- Overview
- Files
- XPSR due dates
- Environmental procedures (contact CES)

Step 3: Review project documentation

For example:
- PDS-ER
- CIC minutes
- Technical appraisal report
- Decision memorandum (PDS-IR)
- Decision minutes
- Board report

For example:
- Board minutes
- Project supervision reports
- Legal documentation
- Environmental monitoring reports
- Correspondence

Sources for project documentation:
- Division files
- IFC Information Center
- Legal library
- Technical departments

Other information sources:
- IFC/Bank intranet
- Internet
Getting there in nine steps

Instructions for preparing an XPSR: Non-Financial Markets

Step 4: Talk to IFC and WB staff

IFC operations:
- IOs
- Economists
- Regional Reps.
- Managers
- Directors
- Company Board Reps

IFC specialized depts:
- Environmental/Social
- Legal
- IEG, Best Practice Groups, Special Ops, B-Loan Mgt, Trust Funds etc.

World Bank Group:
- Operational Networks
- Regional Depts
- FIAS

At an absolute minimum, talk to at least one member of the original project team, ideally the original IO.

Step 5: Send questions to clients

- After reviewing available information against XPSR instructions, the IO/IA should prepare written questions for company/project. The scope should cover still-to-go projections for company and project.
- Include environmental compliance questions.

Step 6: Recommended field visit

- Draft the XPSR (to identify information gaps).
- Develop a list of contacts and arrange key meetings before going to the field.
- Fill-in the required information as you obtain it.
- Verify information – don’t rely only on the company.
- Allow time for meetings with non-company parties.

Step 7: Draft XPSR

- Condense information.
- Assign ratings and explain their rationales.
- Identify and prioritize useful lessons.
- Seek the advice and input of the appraisal team, departmental peers, regional Department, etc.
- Discuss draft with IEG.

Step 8: Obtain clearances

Sign-off by the following parties is required:
- Department Management.
- Department Economist.
- Environment Division.

Step 9: Release XPSR

- Portfolio Manager circulates PSR-bookmark to CIC members and CEXEG (cc: CIC assistants).
- XPSRs are only considered final when the PSR is finalized and circulated and contains all relevant attachments (XPSR, FRR/ERR/ROIC/EROIC calculation, ROE calculation, and where applicable the sub-project template for Financial Markets projects).
3. Advice from Previous XPSR Teams

So here it is, the top 10 suggestions from previous XPSR teams.
The theme throughout is to start EARLY!

- Touch base with your IEG contact early on
- Read the online XPSR Guidelines
- Talk to key players as early possible, e.g. appraisal team members, other responsible IOs, and project company
- Understand the project first by reading through documentation (Board paper, appraisal report, decision book etc.)
- Start organizing early
- Get other XPSR team members (technical, environment, etc.) involved early
- Clearly define the scope of the project in the XPSR
- Get draft out early to have several rounds reviewed
- Look at the XPSR good practice examples
- Talk to colleagues who have worked on an XPSR in the past

INTRODUCTION

IEG encourages short and concise XPSRs with no more information than is necessary to support evaluative judgments (ratings) and lessons. Five pages is usually sufficient. If you have any questions at any stage of the process, please contact your IEG counterpart or the IEG Help Desk at (202) 458-2299.

Definitions used in the XPSR:

- *operation* refers to IFC’s objectives, activities and results in making and administering its investment;
- *company* refers to the legal entity in which IFC is making its investment and that is undertaking the project;
- *project* refers to the specific company objectives and related assets or business activity financed by the IFC investment – it is not a legal entity;
- and *investment* refers to the specific IFC financing instrument (loan, equity, underwriting, etc.).

The XPSR’s Evaluation Findings, and each of its dimensions and indicators, address a project’s contribution to IFC’s purpose and mission: to promote sustainable private sector investment in developing countries, helping to reduce poverty and improve people’s lives. They also evaluate the investment’s impact on IFC’s financial sustainability, and IFC’s work quality in executing the operation. IFC uses XPSR findings to account for accomplishment of its purpose and mission, to learn from past operations, to identify needs for systemic improvements, and to improve selection and execution of new operations and IFC’s strategy.

The XPSR assesses performance of the project since its inception, i.e. what has happened until now, and what might happen in the future. Future prospects should be realistically assessed, taking into account past performance as well as any changes (including external factors) that have affected, or are likely to affect, the project and company over the rest of the project’s life.

**Project Description, Rationale, and Without Project Case:** Start the Evaluation Findings with a brief description of the project, its objectives, its rationale and the “without project” counterfactual – a plausible paragraph on what you believe would have happened if the project had not proceeded. The “without project” counterfactual may be different from the “without IFC” counterfactual (the project may still have proceeded but on different terms). A starting point may be the project documentation at approval, but usually more information about what would have happened without the project is available at the evaluation stage (e.g. knowledge about external factors, etc.).

It is not always easy to assess what would have happened without the project, but this section should offer an educated and plausible guess. For example, without the project, the project’s output would have been imported; the country would have exported less; consumers would have used a substitute; competitors would have produced more; etc.
DEVELOPMENT OUTCOME

DeVELOPMENT OUTCOME RATING

Concept

This rating is a synthesis of the overall impact of the project on the development of its host country, and thus implicitly addresses how well the project has contributed to fulfilling IFC’s purpose and mission. A project’s development outcome encompasses all effects on a country’s economic and social development. Development impacts are evaluated on a “with versus without project” comparison, i.e. considering (i) what happened with the project and, (ii) counterfactually, what would have happened without it. Distin-

guish, to the extent possible, the project from the company’s performance. When a “with vs. without” as-
sessment cannot be done (e.g. the project is a corporate loan or equity investment without easily identifia-
ble components) the costs and benefits to the company as a whole should be done on “before vs. after” basis.

Indicators

In the XPSR, the project’s development outcome is measured across four indicators: project business performance; economic sustainability; environmental and social effects; and contribution to private sector development. Each of these measures a distinct aspect of the operation’s performance in fulfill-
ment of IFC’s Article 1 purpose and mission. The development outcome rating is a bottom-line assess-
ment of the project’s results on-the-ground, and not an “average” of these four indicators.

Evaluation standard

Considering the four indicators, rate the operation’s overall impact on the development of its host country on a six-point scale:

- **Highly successful**: A project with overwhelming positive development impacts, with virtually no flaws. Indicates the type of project IFC should use publicly to illustrate the contribution of private sector de-

velopment to the World Bank Group’s mission.

- **Successful**: A project without material shortcomings, or some very strong positive aspects that more than compensate for shortfalls.

- **Mostly successful**: A project which may have some shortcomings, but with a clear preponderance of positive aspects. The guiding principle should be: if all of IFC’s projects were mostly successful, we should just be able to justify our existence as development institution.

- **Mostly unsuccessful**: A project with either minor shortcomings across the board, or some egregious shortcoming in one area which outweighs other generally positive aspects.

- **Unsuccessful**: A project with largely negative aspects, clearly outweighing positive aspects.

- **Highly unsuccessful**: A project with material negative development aspects with no material redeem-

ing positive aspects to make up for them.

For any rating of mostly successful or better, IFC should be able to explain convincingly (without embar-
rassment) to a public audience why it rates this project a “success”.

**PROJECT BUSINESS PERFORMANCE**

**Concept**

Project business performance measures the project's actual and projected financial impact on the company’s financiers, i.e. lenders and equity investors, the project’s contribution to other business goals articulated at approval and the project company’s prospects for sustainability and growth. Sufficient financial returns are necessary to reward existing private investors and to attract future investment, but the assessment should also take into consideration the sustainability of the results.

**Indicator**

The principal indicator of a project's business performance is its real, after-tax, financial rate of return - FRR or return on invested capital - ROIC, when FRR cannot be calculated (see guidance note on converting nominal to real prices). Show in an attachment how the FRR/ROIC was estimated, and include past actual and key assumptions for future prices, sales volumes, margins, terminal value, etc. FRR/ROIC calculations are also required for most corporate loans. They are harder to estimate, and suggestions are provided in the Guidance Note on Evaluating Corporate Loans.

The project’s FRR should be based on real, after-tax cashflows with clear assumptions set out in a logical and easy to follow spreadsheet. Guidance on FRR/ROIC calculations is provided in Section 7. Consider also looking at some best practice models submitted by previous XPSR authors.

**Evaluation standard**

Project business performance ratings are based on comparing the after-tax FRR/ROIC to an estimate of each company’s real weighted average cost of capital (WACC). You can find the WACC-based benchmarks for each company, which should be used in rating the project’s FRR/ROIC. Where the FRR/ROIC falls near a rating benchmark, the XPSR should evaluate the sensitivity of the performance rating to key assumptions.

For those investments for which an FRR cannot be calculated (e.g. financial restructurings), the guiding principle should remain the project’s incremental financial impact on the company’s financiers. If the project is a clear failure (e.g. incremental capacity remains unutilized) then there is no need to calculate an FRR. When making a reliable FRR calculation appears extremely difficult, contact IEG and suggest alternatives to assess the project’s financial performance. When a company is listed, its stock price performance can give a good indication of the returns to the company’s shareholders. However, stock price may be an unreliable indicator for project performance, particularly where the project constituted only a relatively small portion of the company’s operations. Where no relevant quantitative information is available, judge performance relative to the project’s business/profit objectives:

The benchmarks are:

- **Excellent:**
  - FRR/ROIC \( \geq \) WACC + [..]%
  - Objectives largely surpassed

- **Satisfactory:**
  - FRR/ROIC \( \geq \) WACC
  - Objectives broadly achieved

- **Partly unsatisfactory:**
  - FRR/ROIC \( \geq \) WACC − [..]%
  - One or more core objectives not met

- **Unsatisfactory:**
  - FRR/ROIC < WACC − [..]%
  - Most objectives not met

Where the project is rated other than satisfactory, explain why, briefly summarizing the main drivers of the FRR/ROIC, e.g. market; prices and margins; sales volumes, production and capacity utilization; project cost, execution schedule, and contractual/management arrangements for execution; procurement; technology, training and productivity; qualitative factors (e.g. management, labor, or product quality); force majeure events. Provide sufficient evidence for the assumptions in the FRR/ROIC model and selected ratings.
The Business Performance rating should also take into consideration, where appropriate, (i) the project’s contribution to other business goals articulated at approval and (ii) the project company’s overall prospects for sustainability and growth. Projects are owned by companies, and successful companies can have unsuccessful projects and vice versa. Comment briefly on the project’s effects on the company and on the company’s prospects as a viable, internationally competitive firm. Focus on any issues that might threaten the company’s survival and thus could endanger realization of the projected still-to-go project benefits.
ECONOMIC SUSTAINABILITY

Note: This section of the XPSR must be cleared by the departmental economist. For projects with significant impacts on the local community, the social development specialist should also be consulted.

Concept

IFC’s purpose is to “further economic development … in its member countries” (encouraging private sector development is the means to achieving that purpose). Growth and development are not synonymous, but economic growth provides the resources necessary for development. Projects with high economic returns contribute to a country’s economic growth, whereas those with low or negative economic returns detract from it. Not all development aspects can be quantified, and this indicator therefore also considers qualitative aspects, including to what extent a project has contributed to IFC’s mission – helping to reduce poverty and improve people’s lives.

Indicator

The best single indicator of a project’s contribution to economic growth is its economic rate of return (ERR) or economic return on invested capital (EROIC), which measures quantifiable net economic benefits to all of society. To determine the net benefits, consider the project’s economic effects on its input and output markets. Consider domestic and international competition and how prices and quantities are determined in relevant markets. What are the principal economic benefits and costs, and how were they estimated? In addition to those identified in the financial analysis, they typically include taxes paid to the government, consumer surplus, effects on competitors, and benefits to suppliers, including labor. Show the economic assumptions and the estimation of the benefits and costs in an attachment. Quantify economic effects where possible, particularly where they are material. The EROIC is calculated only where the ERR on the project cannot be calculated. It is calculated by adjusting ROIC (calculated under business performance) for the factors normally taken into consideration in adjusting the FRR to the ERR, e.g. taxes, subsidies, externalities, etc. However, it is usually not possible to quantify all economic effects. For the overall assessment and rating of a project’s economic sustainability, consider both quantitative and qualitative effects. A good conceptual framework for assessing a project’s economic effects and ERR/EROIC is a stakeholder framework. In your analysis, identify to whom the benefits and costs accrue. For the quantified effects, analyze carefully the difference between the financial cashflows used to calculate the FRR/ROIC and the net economic benefits used to calculate the ERR/EROIC. The difference between the two indicates gains or losses to people other than the project financiers – typically taxpayers/government, consumers, workers, suppliers, competitors and the local community. Present these differences as net present values (NPV, discounted at 10%).

Describe the significant non-quantified benefits. In particular state whether the project had any direct impact – positive or negative – on the poor or on living standards in the local community. Refer to IFC’s sustainability initiative for examples of a project’s possible effects on socio-economic development. Where applicable, also comment on any other contributions to international development goals. Where you believe the non-quantified benefits are sufficient to affect a project’s overall assessment, provide a cogent rationale.
Example: The project’s ERR is estimated at 17% and net benefits to society at $53 million (NPV @ 10%). Of those, $23m accrued to its financiers and $20m to government in the form of income taxes paid ($25m) minus foregone import duties ($5m). Benefits to unskilled workers were estimated at $8m, in the form of better wages than alternative employment opportunities; they mainly accrued to women, 80% of the workforce. Benefits to the local community ($2m) were estimated to equal (at least) the company’s support for the local hospital and school. The project did not affect domestic prices (it substituted for and somewhat reduced imports). Consumers may have benefited from shorter delivery times, but these benefits are likely to be small and have not been quantified. There was no discernible negative effect on the local community, particularly since the project employs modern equipment resulting in minimal environmental effects. The project clearly resulted in increased economic activity in the community (e.g. multiplier effects from the company’s $20m annual expenditures for locally purchased supplies and local consumption by the workers), but these have not been quantified. Sensitivity analysis showed that they are likely to be substantial: if only 15% of expenditures for local supplies result in incremental profits, this would increase the ERR beyond 20%. The rating is therefore excellent.

Evaluation standard

In determining the rating, consider both quantified and non-quantified benefits and costs. Where non-quantified benefits or costs are material, explain why you believe a higher or lower rating than indicated by the ERR/EROIC appears justified and if possible demonstrate it (e.g. in form of a sensitivity analysis). Any project rated satisfactory or excellent should have a demonstrably positive effect on society in the host country. In the absence of significant qualitative effects, economic sustainability should be rated as follows:

- **Excellent**: ERR/EROIC >= 20%
- **Satisfactory**: ERR/EROIC >= 10%
- **Partly unsatisfactory**: ERR/EROIC >= 5%
- **Unsatisfactory**: ERR/EROIC < 5%

When there are other material, documented positive or negative socio-economic effects that could not be quantified, make a case for why you think the rating on economic sustainability should be higher or lower than these benchmarks suggest. If the ERR/EROIC falls outside the satisfactory range, the XPSR should explain the causes.
ENVIRONMENTAL AND SOCIAL EFFECTS

Note: This section of the XPSR must be cleared by the environmental specialist. For projects with significant social concerns (e.g. resettlement), the social development specialist should also be consulted.

Concept

IFC’s Policy and Performance Standards on Social & Environmental Sustainability (2006) consider social and environmental sustainability as an important component of development outcome quality in the projects that IFC finances. That operations are carried out in an environmentally and socially responsible manner is not only sound business practice, but also a necessary condition for sustainable development.

The XPSR’s assessment of Environmental and Social Effects should cover: (i) the project’s environmental and social performance in meeting IFC’s requirements; and (ii) the project’s actual environmental and social impacts, including pollution loads, conservation of biodiversity and natural resources and, in a broader context, social, cultural and community health aspects, as well as labor and working conditions and workers’ health and safety. Compliance with IFC’s individual requirements at appraisal should be clearly stated in the XPSR. IFC’s Policy and Performance Standards and World Bank Group safeguard policies and guidelines should be considered a proxy for what IFC considers acceptable environmental standards, but effects on the ground are what this indicator and its rating should address.

Indicator

Environmental, social, health and safety (ESHS) effects, “Environmental and Social Effects” should be evaluated relative to:

1. IFC’s requirements and guidelines and the local standards that would apply to the same project if appraised today;
2. IFC’s requirements and local standards that prevailed at the time of approval;
3. covenanted requirements in the Investment Agreement and its attachments (e.g. reporting requirements, conditions of disbursement, remediation action plans, environmental management plans); and
4. environmental and social management practices that go “beyond compliance” required by IFC.

The evaluation must specifically state if any of IFC’s pre-2006 environmental and social safeguard policies (e.g. natural habitats, forestry, indigenous peoples) or Policy and Performance Standards of 2006 apply to this project (or would apply, if the project would be appraised today) and, if so, whether the project is (or would be) in compliance.

If you require assistance in identifying the correct version of a World Bank Group policy or guideline that applied at the time of approval, please contact CES.

Evaluation standards

2. The rating addresses only the project’s environmental, social, health and safety effects. Comment on the company’s performance where it differs from that of the project (e.g. because of non-project operations), but consider it only to distinguish between satisfactory and excellent ratings. The section on IFC’s work quality should separately evaluate IFC’s influence on environmental and social performance.

The project’s environmental, social, health and safety effects should be rated based on its performance in meeting IFC’s requirements at the time of evaluation, and any change in its environmental and social performance or practices since approval. The rating should be based on analysis of the project’s key perfor-

Notes:

1. IFC’s requirements in this context include IFC’s policies, performance standards, Environmental & Social Review Procedures and guidelines and – to the extent they are applicable in a specific case – World Bank Group policies and guidelines, as well as host country requirements. IFC’s current and 1998 requirements and the 1993 requirements are online.

2. Where the project scope encompassed the environmental, social, health and safety effects of existing company operations, they should be included in the project description and rating project performance.
mance indicators and objectives (including management performance, operational performance e.g. pollution loads, and environmental and social conditions).

The project’s Environmental and Social Effects should be rated as follows:

- **Excellent**: The project has either: (i) gone beyond the expectations of the company’s environmental action plan (EAP) or (ii) materially improved the company’s overall environmental and social performance (e.g. through training and addressing pre-existing environmental, social, cultural and community aspects, as well as labor and working conditions, or introducing an Environmental & Social Management System (ESMS) or corporate program for environmental and social responsibility broader than IFC’s requirements); or (iii) contributed to a material improvement in the environmental and social performance of local companies (e.g. by raising industry standards and serving as a good practice example for regulators). In addition, the project has met IFC’s at-approval requirements and its environmental and social effects are deemed acceptable in view of IFC’s current requirements. IFC should be able to use projects rated excellent as a role model for positive environmental effects.

- **Satisfactory**: the project is in material compliance with either IFC’s current or at-approval requirements (including implementation of the environmental action plan, if any), including World Bank Group environmental, health and safety policies and guidelines;

- **Partly unsatisfactory**: the project is not in material compliance with either IFC’s current or at-approval requirements (including implementation of the environmental action plan, if any), but is addressing deficiencies through ongoing and/or planned actions; or earlier non-compliance (subsequently corrected) resulted in environmental damage that has not been corrected;

- **Unsatisfactory**: the project is not in material compliance with either IFC’s current or at-approval requirements (including implementation of the environmental action plan), and mitigation prospects are uncertain or unlikely; or earlier non-compliance (subsequently corrected) resulted in substantial and permanent environmental damage.

- **No opinion possible (NOP)**: Where, after best efforts, the relevant information to establish material compliance (or lack thereof) cannot be obtained, e.g. because of insufficient or missing Annual Monitoring Reports (AMRs), a rating of “no opinion possible” (NOP) may be assigned. Use of the NOP rating should be a last resort, after reasonable effort has been made to obtain the necessary information. A sponsor’s failure to report should result in a partly unsatisfactory or unsatisfactory rating only if the sponsor has repeatedly refused to cooperate on this issue.

- **Not applicable (NA)**: If the project was classified as category C (no impact) and that categorization has remained valid over the life of the project so far (and is likely to remain so going forward), then the correct rating is not applicable. If, despite its category C classification, the project has in fact had actual or potential environmental and social impacts, then it should be rated accordingly.4

Where the rating is NOP, the project supervision report should describe the steps IFC is taking to obtain the necessary information, including a timetable. A NOP rating may point to a shortcoming in IFC’s front-end work quality (e.g. if investment agreements did not allow IFC to get access to the relevant information) and/or to a shortcoming in IFC’s supervision (e.g. IFC did not follow up sufficiently to monitor and ensure compliance).

Notes:

3 For example carbon trading, energy efficiency, biodiversity or community programs e.g. using Technical Assistance or other grant funding.

4 For example, the project scope may have changed from that envisaged at the time of approval, such that if reclassified today it would be categorized A or B.
PRIVATE SECTOR DEVELOPMENT

Concept

IFC’s Purpose, specified in IFC’s Article I, is “encouraging the growth of productive private enterprises”, and to that end, IFC shall “seek to stimulate, and to help create conditions conducive to, the flow of private capital, domestic and foreign, into productive investment”. This indicator addresses to what extent the company has developed into a corporate role model – positive or negative – and whether the project has contributed to IFC’s purpose by spreading the benefits of growth of productive private enterprise beyond the project company.

Indicators

Positive project-induced impacts could include:

• significant upstream and downstream supply linkages to local private businesses;
• introduction of new technology, know-how, development or significant upgrade of technical and management skills beyond the project entity, and employee training; enhanced private ownership;
• stronger local entrepreneurship;
• greater competition and competitiveness (greater efficiency, quality, innovation or customer orientation of other suppliers through competitive pressures)
• broad demonstration effects in the local economy;
• follow-on investments by other investors;
• domestic capital market development (e.g. pioneering listing on stock exchange or significant broadening of listed value);
• first-of-a-kind financing instrument;
• introduction of international accounting standards or enhanced disclosure standards;
• development of physical infrastructure used by other private users; and
• the company’s governance quality, reputation and business practices as a positive corporate role model and quality investment asset.

Positive effects also include changes in the legal and regulatory framework and its administration that improved the enabling environment, for example by making transactions more secure and flexible and providing economic actors with the freedom, flexibility, and security to acquire, use, and leverage property rights. The enabling environment includes how the laws and regulations are set, administered, enforced and adjudicated. In a positive enabling environment, a non-intrusive, efficient, and respected public administration sets widely understood rules for economic activity, enforces them uniformly and universally in a predictable manner, and changes them through transparent means. Evaluate whether project-related technical assistance or the project’s activities, goods and services have brought about changes in the enabling environment and cite changes in laws, regulations, or their administration. For example, the introduction of best practice environmental monitoring standards by the company may, in turn, result in these standards being adopted by the local environmental agency.

Negative impacts could include: negative demonstration effects due to poor performance; poor company reputation leading to a negative effect on private enterprises; project-induced restrictions on competition (including protection, uneven treatment of competitors, forming of a cartel, etc.), delays of reforms or entry by private enterprises, introduction of laws and regulations worsening the enabling environment, etc.

Discuss, but do not rate, the impact of the investment climate on the project. “Investment climate” refers to country conditions, including legal, regulatory, and judicial framework, rule of law, institutional capacity, investment incentives and barriers, peace and order situation, level of corruption, and access to cost-effective labor, domestic finance, business support services, information, infrastructure, and other productive inputs. You may want to use Institutional Investor Country Credit Ratings (IICCR) and the Heritage Foundation Index of Economic Freedom at project approval and at present as proxies for estimating investment climate characteristics and changes.
Evaluation standard

Taking into consideration the project’s size, rate the performance according to these standards:

- **Excellent**: the project improved the enabling environment or otherwise made a substantial contribution to the growth of private enterprises or efficient capital markets or transition to a market economy and has virtually no negative impacts in this respect;

- **Satisfactory**: the project contributed to the country’s private sector development, development of efficient capital markets, or transition to a market economy, and had a clear preponderance of positive impacts in this respect, but did not meet the requirements for an excellent rating;

- **Partly unsatisfactory**: the project had mostly negative impacts on the country’s private sector, which, however, are not expected to be of long duration or broad applicability (e.g. a failed project without substantial negative demonstration effects)

- **Unsatisfactory**: substantial negative impacts of broad applicability and/or expected to be of long duration

Briefly describe which of the factors described above (or others) were most important in this judgment and why they are the relevant considerations.
IFC INVESTMENT’S PROFITABILITY

IFC’S INVESTMENT OUTCOME RATING

Concept

Investment performance is essential to IFC’s sustainability and to accomplishing its corporate purpose. This section assesses the extent to which IFC has realized to date, and expects to realize over the remaining life of the investment, the loan income and/or equity returns that were expected at approval.

Evaluation standard

If IFC made only a loan or only an equity investment, then the overall investment outcome rating is the same as the rating for the loan or equity indicator as applicable. If IFC made both loan and equity investments, they are rated separately and the overall investment outcome rating is synthesized from them as follows:

### Investment outcome rating for different gross contribution loan and equity ratings

<table>
<thead>
<tr>
<th>Loan Rating</th>
<th>Equity Rating</th>
<th>E</th>
<th>S</th>
<th>PU</th>
<th>U</th>
</tr>
</thead>
<tbody>
<tr>
<td>E</td>
<td>E</td>
<td>E</td>
<td>S</td>
<td>S</td>
<td>S, PU or U₁</td>
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<tr>
<td>S</td>
<td>E</td>
<td>E</td>
<td>S</td>
<td>S</td>
<td>PU or U₂</td>
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<tr>
<td>PU</td>
<td>S</td>
<td>S</td>
<td>PU</td>
<td>PU</td>
<td>PU or U₂</td>
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<tr>
<td>U</td>
<td>-3</td>
<td>-3</td>
<td>U</td>
<td>U</td>
<td>U</td>
</tr>
</tbody>
</table>

Notes:

- E = Excellent; S = Satisfactory; PU = Partly unsatisfactory; U = Unsatisfactory
- ₁ S if weighted average of effective loan interest rate and equity IRR ≥ FR + [..] bp; U if < FR – [..] bp; otherwise PU.
- ₂ PU if weighted average of FR and equity IRR ≥ FR – [..] bp; otherwise U.
- ₃ For this unlikely event, consult IEG.

Weighted averages should be based on dollar amounts of IFC’s disbursed investment.

If the XPSR team believes the above guidelines to be inappropriate in specific circumstances, they may present the rationale for assignment of a different outcome rating than those indicated above.
GROSS CONTRIBUTION – LOAN

Note: These ratings guidelines refer to senior loans. Other loan-type investments (e.g. convertible loans and other quasi-equity investments) are too diverse to set one evaluation standard. Therefore, please contact IEG.

Indicator

The primary indicator for this rating is whether the company is current on its payments to IFC (interest, fees etc.). It is also important to assess the likely future debt-servicing capacity of the client – for example, recent payments may have been made, but the outlook for future payments is doubtful, whether caused by the deteriorating macroeconomic situation in the country or by deteriorating condition of the project or company.

Evaluation standard

The loan is rated as follows:

- **Excellent:** Fully performing and, through a sweetener (e.g. income participation), it is expected to earn significantly more than a loan priced “without sweetener” would have earned if paid as scheduled. There is no indication that debt service payments will not remain current in future.

- **Satisfactory:** (i) loan expected to be paid as scheduled; or (ii) loan is prepaid in full; or (iii) loan has been rescheduled and is expected to be paid as rescheduled with no loss of originally expected income. In the case of an IFC guarantee, all fees are expected to be received, and guarantee is not called, or called but expected to be fully repaid in accordance with the terms of the guarantee agreement. In the case of an IFC swap or other risk-management facility, IFC has not suffered any loss and expects no loss due to non-performance of the swap counterparty. There is no indication that debt service payments to IFC will not remain current in future.

- **Partly unsatisfactory:** Loan has been rescheduled, or guarantee is called and in either case IFC expects to receive sufficient interest income to recover all of its funding cost but less than the full dollar margin originally expected. If all payments to IFC are current, but there is doubt whether payments can remain current in future, then a partly unsatisfactory rating may be preferable. For example, IFC may establish “flag” loss reserves of modest size (no more than 10%) for reasons such as country conditions, which are not related specifically to IFC’s project. In these cases, a partly unsatisfactory rating may be used rather than unsatisfactory.

- **Unsatisfactory:** (i) loan is in non-accrual status; or (ii) IFC has established specific loss reserves; or (iii) loan has been rescheduled but IFC does not expect to recover at least 100% of its loan funding cost; or (iv) loan has been or is expected to be wholly or partially converted to equity in restructuring of a “problem” project; or (iv) IFC experiences a loss on its guarantee or risk-management facility.

If IFC’s loan is prepaid, then the correct rating is satisfactory. However, the XPSR should note whether or not IFC received compensation for loss of interest income during the remaining term, for example in the form of prepayment penalties. Separately, as part of the assessment of IFC’s work quality, the XPSR should reflect whether IFC structured its investment appropriately to mitigate the risk of prepayment (for example through a step-down in interest margin following project completion) or to provide for compensation in the event of prepayment occurring.
GROSS CONTRIBUTION – EQUITY

Indicator

Calculate the nominal equity IRR (also called return on equity or ROE). Unless more recent information is available, the equity IRR calculated by the Corporate Portfolio Management Group (CPM) may be used. If the XPSR team recalculates the equity IRR using projected dividends and capital gains, it should explain the reasons for divergences from CPM’s estimate and attach the calculations and assumptions.

In projecting equity cash flows, the dividend projections should be based on discussions with company management on dividend timing and payout considerations, and should take into account local company law (e.g. concerning reserve requirements), the company’s loan covenants, and its minimum cash constraints. Indicate how and when IFC is likely to sell its investment. Where IFC’s exit is expected to be through a put at a contractually specified price, assess the enforceability of the put and the prospects for timely realization of the put value.

Evaluation standard

The rating criteria for equity investments are based on a comparison of the nominal equity IRR with the actual (or notional) fixed rate loan interest rate (FR) that was (or would have been) approved to the same project company. Fixed rate loan interest rate . Note that comparison of the equity IRR estimated at evaluation either with the expected return at approval or with the equivalent return on US Treasuries, is not an appropriate standard for rating the investment.

The benchmarks are:

A: For closed investments or active investments with put options that specify a minimum return to IFC (and IFC expects to exercise the option at that value):

• Excellent: Equity IRR >= FR+[..]%
• Satisfactory: Equity IRR >= FR+[..]%
• Partly unsatisfactory: Equity IRR >= FR
• Unsatisfactory: Equity IRR < FR

B: For equity investments firmly planned to be fully sold within 12 months of the XPSR date, such that the exit value is reasonably well-established

• Excellent: Equity IRR >= FR+[..]%
• Satisfactory: Equity IRR >= FR+[..]%
• Partly unsatisfactory: Equity IRR >= FR+[..]%
• Unsatisfactory: Equity IRR < FR+[..]%

C: For equity not fully sold and more than 50% of undiscounted positive cash flows are still-to-go by more than 12 months

• Excellent: Equity IRR >= FR+[..]%
• Satisfactory: Equity IRR >= FR+[..]%
• Partly unsatisfactory: Equity IRR >= FR+[..]%
• Unsatisfactory: Equity IRR < FR+[..]%

Notes:

The “fixed rate” (FR) loan (equivalent) is determined as follows: (1) Investments which have a fixed rate senior loan in addition to the equity: FR is the actual interest rate for the fixed rate loan. (2) Investments which have a variable rate loan in addition to the equity: FR is the Cost of Funds (CoF) plus the spread approved for the variable rate loan. CoF is the 10-year fixed rate swap equivalent of 6-month LIBOR as of the investment’s commitment date. Equity-only investments: Notional FR is the CoF plus the country spread (from IFC’s Weekly Pricing Guidelines) prevailing as of the investment commitment date.

Where IFC’s expected equity exit is by means of a put option specifying a minimum return but enforceability is doubtful, the equity investment should be treated as an active investment with more than 50% of undiscounted positive cash flows still-to-go by more than 12 months (scenario C).
IFC’s WORK QUALITY

IFC’s WORK QUALITY RATING

Concept

This section addresses three areas of IFC’s operational performance: (1) screening, appraisal and structuring; (2) supervision and administration; and (3) role and contribution. Did IFC apply good practice standards in these areas, such as those identified in its policies and procedures and guidance notes (e.g., IFC’s Credit Notes)? The variance analysis of appraisal projections against actual outcomes in the XPSR should help identify the strengths and weaknesses of IFC’s operational performance, as well as valuable operational lessons. However, do not let the outcome unduly affect the work quality ratings. An unsatisfactory development and investment outcome can be caused by external factors, unforeseeable (e.g., force majeure), or foreseen (e.g., realized market risk). A satisfactory outcome can be achieved even though IFC did a poor job appraising and supervising the project, had insufficient role and made no contribution. However, if IFC did (or could have and did not) improve the project’s development or investment outcome, this should be reflected in this section. For example, if the environmental performance is other than satisfactory, the XPSR should specifically address IFC’s environmental work quality.

Evaluation standard

Based on the ratings of the three indicators: (1) appraisal, (2) supervision, and (3) role and contribution, rate IFC’s overall work quality on a four-point scale as below. Bearing in mind that IFC’s ability to influence the quality of an operation is greatest between screening and disbursement, this rating should reflect the overall quality of the value added by IFC, at each stage, to the operation’s development outcome and to IFC’s profitability. The IFC work quality rating can be no lower that the worst indicator, and no higher than the best indicator. The rating should be:

- **Excellent**: if IFC’s performance was exemplary;
- **Satisfactory**: if IFC’s performance was materially up to a high professional standard;
- **Partly unsatisfactory**: if there was a material shortfall in at least one area;
- **Unsatisfactory**: if there were shortfalls in several areas or an egregious shortfall in one area which led (or under less favorable circumstances could have led) to a less-than-satisfactory development or investment outcome.
SCREENING, APPRAISAL, AND STRUCTURING

Concept

Evaluate to what extent IFC has professionally executed its front-end work to a sustainable corporate performance standard. IFC’s operating policies and procedures, as well as its credit notes provide guidance on what IFC considers an appropriate professional standard.

Indicators

Evaluate IFC’s processing of the project at entry. Identify the materially deficient or particularly commendable areas in IFC’s screening, appraisal, and structuring.

Screening and appraisal:

- Examine the Board paper and the various supporting documents – CIC meeting minutes, decision meeting memorandum, appraisal reports, BTO reports, etc.
- Analyze and comment on the effectiveness of IFC’s assessment of project risks (risks that the project would fail to meet the intended development objectives or generate adequate returns), using IFC’s Credit Notes as the best-practice guidelines for analyzing the assessment at appraisal of the project’s creditworthiness. Did the screening/appraisal team adequately identify the main risks? What, if any, were missed?
- Review the assessment at appraisal of sponsors/company/management (their capacity, character, commitment, experience and reputation), country conditions (political, economic, legal, business environment); project concept (fit with the likely market, competitive strength), market dynamics (competitive forces – principal suppliers, cost structures, financial strength, comparative advantages/disadvantages, pricing, market size and forecasts); project configuration (scope, physical characteristics, location, technology, equipment), project costs (completeness of cost reviews and review of implementation arrangements); and private sector characteristics (size and depth compared to the state-owned enterprises, subsidies and other relevant distortions).
- Review the financial plan and assumptions used in the project’s financial projections for completeness. In hindsight, were the parameters used in the sensitivity analysis at appraisal consistent with market and company situation at the time? Were price/margin assumptions realistic?
- Review the effectiveness of implementing IFC’s at-approval procedure for environmental and social appraisal. Were the key environmental risks of the project adequately identified in screening the project’s environmental category and determining the key Environmental, Social, Health and Safety (ESHS) requirements? Were IFC’s environmental procedures, policies, guidelines and performance standards appropriately translated to the requirements in the Environmental and Social Review Summary and legal documents? Did IFC make sure that the EMS and eventual Corrective Action Plan were adequate and the company had trained staff to implement them? Were the baseline study and Environmental Impact Assessment appropriate and disclosed according to IFC’s procedures in category A projects? Were the environmental improvements and costs adequately addressed and integrated in process design in feasibility studies? Did project appraisal assess the adequacy of policies or supervision standards of the local environmental authority? Did the appraisal identify training needs and procedural adjustments? Did IFC take into account available relevant lessons from other operations? (See for example Lessons Learned.) If issues or concerns were raised at appraisal – for example in IFC’s review process, by the World Bank, civil society or other stakeholder groups – were they appropriately addressed?
Structuring:

• Were the risks identified at screening/appraisal addressed in the structuring of IFC’s project, and was their proposed mitigation adequate?
• Were the terms, conditions, and security suitable for both company and IFC’s needs?
• Was loan pricing commensurate with market practices and risks?
• Evaluate whether, in hindsight, IFC’s loan covenants were relevant, practical, adapted to the particular country and project, and contributed to mitigating risks and realizing objectives. Were there any conflicts or coordination issues with the terms of co-financiers’ loans?
• Did IFC structure its loan in a way as to mitigate the risk of prepayment (for example, by permitting a step-down in margin following project completion), or to provide for compensation in the event of a prepayment occurring (for example, through a prepayment penalty).
• Evaluate the decision to take equity (if applicable) and the structuring of the equity investment. Was there a significant upside potential and a realistic exit option to realize a return commensurate with IFC’s risk? Where the expected exit was through a put option, evaluate to what extent it was enforceable, and whether the pricing was adequate. If the anticipated exit was by means of the stock market, evaluate whether this exit was realistic given the depth of that market.
• In case of an equity investment, were the interests of minority shareholders, including IFC, appropriately protected? Note that, even if IFC’s loan has appropriate covenants, it is usually preferable also to cover key issues in the shareholders’ agreement if applicable (since loans may never disburse, or may be (p)repaid before the equity is sold). Consider whether this was, or should have been, done within the project reviewed in the XPSR. Was the role of a technical advisor (if any) carefully defined?
• Were the identified training needs and procedural adjustments, particularly with respect to environmental matters, reflected in project design?
• Did IFC consider improvements to the company’s governance and operating standards?

In summary, did IFC identify the most important risks that could reasonably have been identified at the approval stage, and mitigate them to the extent possible? Keep in mind that not all risks can be mitigated, but the risk-reward profile should be acceptable.

**Evaluation standard**

Rate IFC’s screening, appraisal and structuring as follows:

• **Excellent**: if IFC’s front-end work could serve as a best-practice example;
• **Satisfactory**: if it materially met IFC’s good practice standards (see for example IFC’s credit notes);
• **Partly unsatisfactory**: if there was a material shortfall in at least one important area;
• ** Unsatisfactory**: if there were material shortfalls in several areas or a glaring mistake or omission bordering on negligence in at least one important area.
SUPervision and Administration

Concept

Supervision, for this purpose, starts after commitment of IFC’s funding. Evaluate to what extent IFC has professionally executed its supervision, taking into account that the appropriate level of supervision will depend on a project’s circumstances. IFC’s Operational Procedures provide guidance on what IFC considers an appropriate professional standard.

Indicators

Review previous PSRs prepared on the project/company, compare them to the XPSR findings, and explain any major discrepancies. Assess whether the company’s reporting, and IFC staff visits were adequate to monitor developments, manage risks, identify opportunities, ensure compliance with covenants and more generally contribute to the operation’s financial and developmental success. Evaluate the adequacy of IFC’s monitoring of the company’s environmental performance. Did IFC identify emerging problems, and were IFC’s responses timely and appropriate?

If IFC has Board representation, did IFC use it to enhance its supervision of the company and to gain better access to market and country intelligence? Did IFC’s Board nominee help monitor whether the operating policies and procedures of the company reflected good practices and were implemented appropriately? (See IFC’s Policies and Practices for Directorships for guidance.)

Evaluate the adequacy of IFC’s monitoring of the project’s environmental and social performance. Did IFC adequately re-appraise the project and the environmental category with new appropriate requirements if the project concept and environmental risks changed during implementation? Were Environmental and Social Impact Assessment and Environmental Audit reports and Corrective Action Plans adequate and submitted for IFC’s approval? Was the quality of Annual Monitoring Report (AMR) reviews adequate and were potential deficiencies properly identified with a request for corrective actions? Were the requests submitted to the Investment Officer and the company? Did IFC make sure that the corrective actions were implemented?

Evaluation standard

Rate IFC’s supervision and administration as follows:

- **Excellent**: if IFC has always kept itself promptly and fully informed about the project’s and company’s performance in all material areas and used this knowledge proactively to improve the project’s development outcome and/or IFC’s investment outcome;

- **Satisfactory**: if IFC has kept itself sufficiently informed to react in a timely manner to any material change in the project’s and company’s performance and took timely action where needed;

- **Partly unsatisfactory**: if IFC’s supervision was insufficient to monitor the project’s and company’s performance and/or IFC did not take timely and appropriate action;

- **Unsatisfactory**: if IFC missed material developments, and/or did not use information to intervene in a timely and appropriate manner.
IFC’s ROLE AND CONTRIBUTION

Concept

IFC’s Article I specifies its developmental role, which is captured in three basic operating principles (“IFC’s ABC”). This section evaluates how well IFC fulfilled this developmental role.

• **Additionality/Special Contribution Principle** – “IFC should participate in an investment only when it can make a special contribution not offered or brought to the deal by other investors.” What was IFC’s additionality? Highlight any pioneering or innovative dimensions, and evaluate whether IFC’s financing could have been replaced by private financing on acceptable terms if the same security had been offered. If IFC has Board representation, to what extent did IFC use it to provide assistance and direction to the company and to improve its governance, financial performance and developmental results? Comment on the effectiveness of project-related technical assistance, if applicable.

• **Business Principle** – “IFC will function like a business in partnership with the private sector and take the same commercial risks.” Did IFC accept the same commercial risks and earn the same returns as private participants in the same risk categories (e.g. co-equity investors, co-lenders)? If performance materially surpassed IFC’s appraisal projections, did IFC receive any upside gain commensurate with its investment risk? If IFC obtained special recourse security, such as a put or guarantee, explain the circumstances and rationale.

• **Catalytic Principle** – “IFC will seek above all to be a catalyst in facilitating private investors and markets in making good investments.” Did IFC bring private investors and lenders to the project opportunity, mobilize funding, or attract better terms for the company than would otherwise have been the case? (Since IFC’s B-loans confer certain advantages to commercial banks, the test is whether they would have entered into the transaction, and on terms as favorable to the company, absent IFC’s involvement.)

Consider the above three operating principles if and as material to your evaluation, and also consider the following:

• **IFC’s Timeliness, Efficiency, and Client Satisfaction** - Were IFC’s interactions with the sponsors and company timely and efficient? Comment on any issues relating to staff continuity and whether and how it has affected the operation. Note any positive or negative feedback from the client or suggestions for improvement.

• **Relevance within IFC’s Country Strategy** - Was IFC’s support for the project relevant in addressing the country’s development priorities and consistent with IFC’s current country strategy? Where the country strategy has evolved over time, you may also want to comment on changes since the project’s approval.

• **Governance:** One of the ways IFC can have an impact on clients is through introducing improved standards of governance. This goes beyond good front-end work in formulating covenants, and can be especially significant where IFC has a board member. IFC’s contribution may include assistance with audit committee creation and functioning, formulating policies and procedures, clarifying the distinction between the roles of shareholders/sponsors and management, helping protect minority shareholders, and clarifying the role of technical advisors. Did IFC’s involvement encourage the company to improve corporate governance? Did IFC insist on introducing higher standards in policies and procedures and was IFC’s effort successful?

• **Environment:** IFC’s role and contribution in enhancing the client’s environmental and social management, identification and mitigation of environmental and social risks, introducing training and additional environmental improvements like carbon trading, energy efficiency and biodiversity programs and Technical Assistance funding in sub-projects.
**Indicators**

Assess the project’s genesis, the rationale for IFC’s support, and IFC’s involvement in the project (at approval and ongoing). As the basis for assessing IFC’s role and contribution, consider what would have happened if IFC had not financed this project.

- Would the company have found alternative financing?
- Would the project have been more or less successful?
- Did the company actively seek alternative financing before coming to IFC, and what was the outcome?
- Did IFC maximize opportunities to improve corporate governance?
- Did IFC deliver on all its expected contributions as set out in the Board approval documents?

Consider what IFC added and what possible additional value IFC could have contributed to the project’s design, or what IFC could have done differently to improve project or company performance and development impacts. For illustrative examples of what constitutes significant added value by IFC, see IFC and the Road to Sustainability.

**Evaluation Standard**

Apply the following rating guidelines:

- **Excellent**: IFC’s role was essential for the project to go ahead and IFC made a major contribution to make it a success;
- **Satisfactory**: IFC’s role and contribution were in line with its operating principles;
- **Partly unsatisfactory**: IFC’s role or contribution fell short in a material area; and
- **Unsatisfactory**: IFC’s role was not plausibly additional and IFC did not deliver its expected contribution.
ISSUES AND LESSONS FOR IMPROVED PERFORMANCE

From the experience to date, identify the most important issues and the lessons for improving IFC’s business in order of priority: focus on how IFC can improve the development and investment outcome of its operations, and its own operational work quality. In particular, identify lessons that illustrate the business case for sustainability: for example, how a good environmental management system or good corporate governance improved the company’s competitiveness or vice versa. Address drivers of ratings other than satisfactory. The lessons may be positive (things that worked and should be repeated) or negative (mistakes that should be avoided). Good, well-written lessons: are specific but widely applicable; describe lessons learned rather than general principles; are derived directly and specifically from the experience of the operation and are self-contained. Be responsive to the following guidelines and suggestions.

- Focus on issues and lessons of general relevance to IFC operations that could guide IFC in screening, structuring, appraisal, negotiation, supervision and post-evaluation.
- Consider (i) the issues’ materiality and relevance to the operation’s outcome, and (ii) what, with hindsight, IFC should have done to improve the operation’s overall performance.
- Consider lessons relating to the three performance dimensions addressed in the XPSR: development outcome; IFC’s investment outcome; and IFC’s contribution and operational work quality.

Be specific and focus on suggestions to improve quality. For example:

- If company management was weak, consider how IFC could have: (i) discovered this weakness at appraisal, (ii) better mitigated the risk, and (iii) intervened more effectively when the problem was detected. It is not a helpful lesson to write “ensure that company management is strong.”
- If the financial projections proved materially optimistic, consider the underlying reasons (e.g. flawed forecasting models, little experience of the forecasters, poor training, and too little skepticism) and formulate the lessons and recommendations for achieving a better forecast next time. It is not a helpful lesson to write “make realistic projections.”
- If the project featured negative sociological or environmental effects, consider whether and how IFC’s procedures should be adapted to address these potential effects in the appraisal, covenant formulation, disbursement and supervision stages. It is not helpful to write “make sure that adequate account is taken of environmental effects.”
- If IFC’s investment featured essentially equity risk but limited upside potential, consider (i) whether the screening tools should be sharpened to make this prospect more evident, or (ii) whether and how IFC might have structured its investment to better balance the risk and reward prospect.
- Avoid repeating what happened, and be concise in elaborating the underlying issues.
**Examples**

The lessons should be self-standing, transparent, prescriptive, and operationally oriented with a view to providing guidance for improving future performance. A concise headline should reflect the lesson’s gist and be written in a way to help IFC staff zero in on relevant lessons quickly. Lessons should be presented in the format of the following examples:

Example of a sustainability-related lesson:

<table>
<thead>
<tr>
<th><strong>HEADLINE:</strong></th>
<th>IFC petrochemical clients located in an integrated complex present an excellent opportunity to achieve environmental and social synergies.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>WHAT IFC EXPECTED AT APPROVAL</strong> – When IFC’s investment in a petrochemical production facility was approved in 1990s, IFC expected that the project’s operations would benefit from the vertical integration at the company.</td>
<td></td>
</tr>
<tr>
<td><strong>WHAT ACTUALLY HAPPENED AND WHY</strong> – The production facility benefited from the integrated complex not only in terms of production efficiency but also in terms of environmental and social performance. Since the production facility shares the same site as other IFC clients, it has adapted and adhered to environmental standards that are higher than those of its competitors. In addition, its location in the complex has enabled the facility to implement an innovative Corporate Social Responsibility initiative by learning from the extensive social programs of its neighbors and by working together with them.</td>
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<tr>
<td><strong>LESSON FOR FUTURE OPERATIONS</strong> – By investing in one or more petrochemical companies sharing the same site and common facilities, IFC can achieve significant environmental and social synergies in the implementation of its sustainability initiative.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>HEADLINE:</strong></th>
<th>If the project scope and environmental risks change during implementation, a new environmental appraisal is necessary.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>WHAT IFC EXPECTED AT APPROVAL</strong> – IFC expected that the Company would comply with plant safety and ESHS standards in its investment to a new chlor-alkali plant for production of KOH flakes.</td>
<td></td>
</tr>
<tr>
<td><strong>WHAT ACTUALLY HAPPENED AND WHY</strong> – After the original investment decision, the Company agreed with IFC to invest in the new PVC plant to utilize hydrochloric acid derived from chlorine that was generated as by-product from the chlor-alkali process. The key environmental aspects in PVC production included major fire and release of toxic VCM, hydrogen chloride, and phosgene gases to adjacent residential areas, and disposal of carbide waste from acetylene production. The Company was not materially compliant with local and WBG environmental and health &amp; safety requirements. Process safety, storing of hazardous materials and dumping carbide wastes to an unlined valley along a stream raised serious concerns. After the PVC plant investment was decided, an additional environmental appraisal was not prepared to address the adverse environmental impacts related to VCM and disposal of waste. IFC had requested the Company to address plant safety concerns. The study and many of the actions requested in the Environmental and Social Review Summary were not implemented. IFC failed to properly identify, monitor and mitigate the adverse Environment, Social and Health &amp; Safety impacts of the PVC plant project, and after the last disbursement IFC had no leverage to urge the Company to comply with IFC’s safeguard policies and guidelines.</td>
<td></td>
</tr>
<tr>
<td><strong>LESSONS FOR FUTURE OPERATIONS</strong> – If, after the first investment and ESHS appraisal, IFC agrees with the client to invest in another environmentally sensitive project, a proper new appraisal should be made to identify and mitigate the potential adverse impacts. In case the client’s environmental and safety performance and reporting continues to be unsatisfactory and the client is not willing to fulfill the ESHS objectives, IFC should quickly take action to urge compliance, if necessary withholding loan disbursement.</td>
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</tbody>
</table>
5. A Stakeholder Framework for Assessing Development Impact

THE STAKEHOLDER FRAMEWORK

A suggested framework for assessing development impact is summarized in Figure 1. The approach is to identify each of the groups who will be affected, directly or indirectly, by a project, and then examine what the impact on that group will be beyond what has already been counted in the financial analysis (the FRR). Care must be taken to ensure there is no double-counting; this is a common error. The overall development impact, that is, the impact on society as a whole, will then be the sum total of the individual impacts. The analysis does not seek to make distributional judgments, where the impact on one group is given greater or lesser weight than the impact on another. That is, we will not get into complex issues of interpersonal comparisons of utility. And to put everything in common units (the term economists would use is a common numeraire), we will examine the costs and benefits in money terms in constant prices. The net profits of the financiers are measured in this way; the other costs and benefits will be measured similarly.

Figure 1: A Framework For Assessing Development Impact

In principle, the costs and benefits are all quantifiable, although in practice this will sometimes be difficult or almost impossible. For example, while there is in principle a quantifiable value to others from the demonstration effect of some project, in practice this may be impossible to measure. In such cases, a qualitative judgment of the value may need to be substituted for any quantitative estimate.

Notes:

Extract from a paper by Frank Lysy, “Assessing Development Impact,” IFC Economics Department, October 1999. For full details of the analysis and practical examples, please refer to the paper.

PAGE 29
case of demonstration effects, the strategic perspective of the project may be particularly useful in arriving at a judgment on the appropriate valuations.

More commonly, it may be possible to come up with a reasonable quantitative estimate of some cost or benefit, but in practice it is just not worthwhile to expend the effort: the overall impact of this particular cost or benefit may be small, so the final valuation of the project (the ERR) will simply not be greatly affected by whatever value is included on this. The mark of a good economist (or engineer or scientist, for that matter) is to have a feel for where it is worthwhile to focus one’s effort, and where there is no need as the overall outcome will be the same.

The benefits and costs to each of the groups, when quantified, would then simply be included in the spreadsheet used for calculating the project’s private financial returns. The benefits to each group impacted by a project would be added as separate lines to the revenue lines of the spreadsheet, and the costs added to the cost lines of the spreadsheet. Adding these up year by year, and then calculating the internal rate of return, will yield the ERR. As a supplement to this, one would then discuss the likely impact of factors which could not be quantified but which may be important. For example, one might not be able to quantify the value to society of a demonstration effect, but one would know it is positive, and hence one would say: “The quantifiable ERR is x%, but in fact is somewhat higher as there were also positive benefits from the demonstration effects of the operation. The benefits of the latter could not be quantified, but we know they were positive.”

In what follows, we will take up each group identified in Figure 1 in turn, reviewing the possible impacts of the project (in terms of costs and benefits) on each.

**The Financiers**

The benefits and costs of the core project itself are depicted in the center of Figure 1, as the square box for the project financiers. The benefits are the private revenue streams the financiers receive from the sale of whatever the project produces, and the costs are investment and production costs. Since these are the returns to the project financiers, all the revenues and costs are calculated at the prices the project pays or receives, i.e. including taxes paid on costs and excluding taxes paid on revenues. Profit taxes are also excluded, while subsidies received are included. (Taxes and subsidies are accounted for elsewhere in this framework, in the costs and benefits to the Rest of Society.)

This is therefore the standard spreadsheet of the project’s private revenue and cost streams, from which one can calculate the annual net benefits, and from this the internal rate of return to the investment (the FRR). It is what the financiers gain from the project, and provides the base on which we will add or subtract the additional benefits or costs of each of the other groups. It is important to keep in mind that the financiers are also part of the economy, and hence the development impact (which measures the return to the economy as a whole) includes the return to the financiers; they are one of the groups affected by a project going ahead.

**Employees**

The project employees are depicted in Figure 1 as part of the central square, as they are directly employed in the project and provide one key input to it (their labor services). The net benefits to the employees can be usefully broken down into two categories:

- **Increased wages** (including all benefits, such as health, pensions, special housing or access to special schools for their children, etc.) the employees receive, to the extent (and only to the extent) they are greater than what the employees would have been receiving in whatever alternative employment they would have had. That is, one includes as a benefit to labor the wages they receive which are greater than the opportunity cost of that labor. In traditional analysis, this benefit would be captured by using an appropriate shadow price for the labor, but it appears that such shadow prices have only rarely been used in IFC project analysis. Note also that the benefits to the employees are not from “jobs created”; they would have been working or doing something else if they did not have these jobs. The benefits to them arise from these being better paid jobs than what they would otherwise have had, with the benefit measured by the difference in the wages (wages broadly defined, including
benefits). And since they chose to take on these new jobs, the benefit here must always be positive (or at least not less than zero).

- The benefit to the worker from training he or she receives, as a consequence of employment in the project company. Note this is not the full benefit of the training: the company provides the training to the worker in order to raise that worker’s productivity, and the higher productivity is already captured in the financier’s private returns (the higher productivity leads to more production, or lower costs). Rather, the benefit to the worker stems from the increased skills (and increased pay as a consequence) he or she gains from the training, which can be of use in other jobs. This is quantifiable: one should be able to obtain an estimate of who was trained and the increase in the grade level (and associated salary) obtained as a result. Note also that training of managers should not be forgotten. Nor should one forget training in the use of some new technology, or some new way of organizing the business or doing things; these are often important for IFC projects. Finally, the benefit here should always be positive, or at least not less than zero.

Customers

Those who consume whatever good or service the project is producing will benefit from enjoying access to a product not available before, or perhaps from a better quality product, or perhaps from a lower price for a product they were already buying. We will take up each in turn:

- **New good or service:** Consumers will benefit if a project brings to the country or region a good or service which previously had simply not been available. This is not uncommon in IFC supported projects. The benefit to the consumer is how much they would be willing to pay for the good or service, i.e. the area under the market demand curve. What they in fact pay is the market price, but this portion of the benefits is already counted as the revenues accruing to the project financiers from the product sales. Hence this portion (the price paid times the quantity) should not be counted twice. But all consumers except the marginal one enjoy a benefit which is greater than the market price, up to the level of the demand curve. This is the consumer surplus, and may be quite significant for certain projects. We do know it is positive. However, it may not be possible to measure quantitatively, as the demand curve is not directly observed. All we can observe for a new product is the price actually paid for the product and the quantity sold at that price, which is just one point on the curve. But with some imagination (e.g. by comparison with demands observed in other, but similar, regions for the same product) one might be able to sum up with a reasonable estimate of what the demand curve might be, and then use this to quantify this benefit.

- **Better quality product:** If the good or service being produced by the project is fundamentally similar to an existing product, but of better quality and yet is being sold for the same price, there is clearly a benefit to the consumer. One might be suspicious how often this is in fact the case (if in fact better, one would normally expect this to be reflected in a higher price, hence in the financial returns of the project, and hence in the FRR; also what is called “new and improved” is often anything but that). But if there is a quality improvement which is not fully reflected in the price, the value of this to the consumer, to the extent it can be quantified, should be added to the benefits. And if it cannot be quantified, a qualitative judgment should be made as to its importance.

- **Increased supply leading to a lower price for the good or service:** The IFC supported project will in general add to the supply of the product on the market, and if it is a significant increase in supply facing a downward sloping demand curve, the market price will fall. These conditions often hold for infrastructure projects or the production of other non-tradeable goods. One would not expect it to apply in general to the production of tradeable goods, as the demand curve being faced is then normally flat (i.e. increased production and sales does not lead to a significant reduction in the price). But where the conditions do apply, consumers will benefit from the increased availability of the product and the

Notes:

8 The qualitative direction of these and the other impacts are important to keep in mind. When the effects cannot be quantified, but we know they are positive, the calculated ERR will then be a lower bound on the true one. That is, we know the economic value is at least as high as that calculated, and is in fact higher but by an undeterminable amount. And as we discuss below the impacts on the various groups, we will find that with the exception of the possible impacts on neighbors from (in some cases) higher pollution levels or greater congestion, and the possible net impact of taxes, tariffs, and subsidies (which in general should be quantifiable in any case), the impacts in all other cases are positive. That is, the employee of the firm can decide to turn down the job offer or to accept it; if he or she accepts it, then the new job must be better than the old one he or she had. Similarly, the consumer can choose to buy or not, the supplier can choose to supply or not, etc.
lower price. A portion of the increased benefit to the consumer comes from reduced benefit to the producers, due to the lower price, but the producers’ benefit (in this case a partial fall from what it otherwise would have been) is already accounted for in the project’s profits and hence in the FRR calculated. This should not be double-counted. But there is still a net gain to consumers, which can be approximated by a triangle in the supply-demand diagram, whose area is equal to: 1/2 times the change in the price (a fall) times the production of the project.

**Producers of Complementary Products**

There will be a benefit generated by the project to consumers of, and producers of, complementary products. A complementary good is one whose value to the consumer increases when the supply of the good it is complementary to increases. An example would be the service provided by a gasoline station located near the exit of a toll road. The demand for this gasoline will increase, and the owner of this gasoline station will benefit from the resulting increase in demand, and hence will enjoy higher profits. Formally, the demand curve for the complementary good will shift out, which will lead to an increase in both consumers’ surplus and producers’ surplus. The increase in consumers’ surplus may be difficult to quantify (it depends on an estimate of how much the demand curve rises, but the demand curve is not observable), but we know it will be a positive benefit. Producers of the complementary good (the services of the gasoline station in the example above) also benefit, as they will receive a higher price for their product or service, as well as increased sales. There could be further, but more indirect, benefits as well. For example, additional workers now employed in the production of the extra complementary goods will benefit to the extent they receive a wage higher than what they were receiving before. But how far it is worthwhile to go into such indirect benefits depends on the project, and on how important these indirect effects appear to be.

A question to address would always be why, if the producers of complementary goods benefit so much, didn’t the project organizers vertically integrate to include the production of the complementary good, and hence benefit from the higher profits? For toll roads, one in fact often sees such vertical integration (i.e. the toll road builder also gets the development rights around the road exits), and such integration can be critical to the financial success of the project. And if there has been such integration, one is already counting (internalizing) these benefits in the core FRR calculation for the project, discussed above. What one would add here (in addition to the benefits to the consumers) would be the benefits to the producers of complementary products who had not been vertically integrated into the project. But if the benefits are large, why did one not see the vertical integration? There may be good reasons for this (the organizers of the core project may not have special expertise or other advantages which the producers of the complementary products might have, etc.), but these need to be understood. If there is not the vertical integration, it is possible one might simply be over-estimating the benefits to the producers of the complementary products.

**Suppliers**

Suppliers to the project will enjoy increased demand for the good or service they provide, and hence higher profits. An attempt should be made to estimate the size of the increased profits, and include these in the project benefits for the ERR. Similarly, the increase in wages (beyond what they would have been receiving elsewhere) of the additional workers employed by the suppliers, should also be counted. And if there is information and it appears to be important, the chain can continue to the suppliers of the suppliers, etc. In practice, however, such indirect impacts rapidly diminish in importance to the point where it is no longer worthwhile to try and estimate them.

In addition, and importantly for a number of IFC investments, the new project may lead to the creation of a set of new suppliers. For example, a major new car plant may spur the development of a network of

Notes:

9 The increase in producers’ surplus other than what constitutes a shift from consumers (due to the higher prices) will be the area of a triangle equal to: 1/2 times the rise in the price times the increase in sales at the new price from what they otherwise would have been at this price.

10 The increased profits of the supplier (other than that portion offset by losses of other purchasers from the resulting higher prices) will again be a small triangle, equal to 1/2 times the increase in the price times the amount purchased from the supplier by the project. All these are readily measurable.
manufactures of car parts (many of them SME’s) -- firms which did not exist before. The creation of such networks can be extremely important to the development of the country. Quantifying their total value to society may well be difficult, but at a minimum the value would include the extra profits they are now earning (beyond the cost of any additional capital) plus the extra wages of additional workers employed (beyond their opportunity cost, i.e. beyond what they otherwise would have been earning).

But aside from the simple increase in demand generated by such backward linkages, one also observes that the project managers will often take steps explicitly to assist their suppliers in various ways. Such assistance may be especially clear when the IFC supported project is taking the initiative in developing a network of new suppliers (e.g. the suppliers of car parts to a car plant). They may assist their suppliers to produce better quality (or cheaper) products by providing assistance in managerial or organizational skills; or by providing a new technology; or by providing finance (e.g. trade credit); and so on. The actions of course assist the core project (where this benefit would already be reflected in the project’s profits and hence is already in the FRR); that is why the assistance is provided. But the suppliers benefit as well, and this is a benefit to include in the ERR calculation.

The benefits from such linkages may be difficult to quantify in practice, although not impossible. At a minimum they can be reported qualitatively. Albert Hirschman, in his 1958 book The Strategy of Economic Development, argued such backward linkages are critical to generating development, and included such linkages in his later work (discussed above) as one of the “side effects” which are in fact central to the development impact of a project.

**Competitors and New Entrants**

A common mistake that has been made in assessing IFC investments has been to record the decreased production of a good or service by a competitor, as a consequence of the increased production from the project, as a cost from the viewpoint of the economy as a whole. An example would be the reduction in demand from existing hotels when a new, IFC-financed, hotel opens in some market. The analyst has sometimes subtracted the reduction in revenues accruing to the existing hotels from the revenues of the new hotel, and used only these net revenues as the “contribution” of the project. But this is incorrect. Revenues can be broken down into variable costs of production and profits. The reduced production by the existing hotels will be accompanied by lower variable costs: they will not need so much in cleaning supplies, in food purchases for the restaurants, in labor inputs (where the labor will shift to alternative employment, quite possibly in the new hotel), and so on. These variable costs of production will be reduced, and these lower costs accompany the lower revenues and obviously should not be ignored (as a simple subtraction of revenues would do).

What is then left is the change in profits accruing to the competitors (e.g. the existing hotels). The profits these competitors earn will fall, all else being equal, as the demand they face will have fallen when some has shifted to the new producer. But the fall in their profits will be matched by increased benefits to the consumers (increased consumers’ surplus, formally). And this is simply a transfer from the (old) producers to the consumers. The consumers, and the country as a whole, still benefit, and by an amount which is correctly measured by examining the market as a whole.

But there will also be other impacts on competitors, which in general will be positive. Such impacts include:

- **Demonstration effects**: The project investment may demonstrate to others the viability of some new technology or way of organizing a business; the viability of some market which previously had been of uncertain size or strength; corporate best practice; the availability of finance, perhaps in some innovative way for the country or for this type of business; etc. Such demonstration effects are in fact often argued as being the primary development impact of the IFC supported investment. Estimating their value is, of course, difficult, and this is where a strategic perspective on the importance of the project may be of help (discussed below). From a micro perspective, if transactions costs were zero, and if one could exclude those who did not pay a fee for this knowledge from using it (such as can be done, for example, with an enforceable patent right), then there would be a market value (e.g. from license fees or royalty payments) for these demonstration effects. Their value would then be included in the project’s revenues, and hence in the FRR. But transactions costs are not zero, and excluding others...
from making use of this information may be impossible, so this value cannot be internalized by the private project owner. They are still, however, a benefit to the society as a whole, and this benefit should be included in the ERR (and if not quantifiable, at least described qualitatively).

- **Network effects:** As was discussed above, the project organizers may work with suppliers to improve the quality or reduce the costs of what they are providing. For example, a new hotel may work with local farmers to produce better quality fruit for sale in the hotel restaurants. But the better quality fruit may also find its way to the old hotel restaurants as well. Formally, the supply curve of the suppliers has been lowered by the assistance provided by the new producer, and the competitors may benefit from this just as the new producer does. These are network effects, and explain why successful industries are often located in close physical proximity (e.g. Silicon Valley for microcomputers; a town in Northern Italy for eyeglass frames; a city in Germany for high speed printing presses, etc.). The advantages to existing competitors from the lower supply curve of the suppliers can be estimated in the same way as one would value this benefit for the new producer, as discussed above.

- **New entrants** may be drawn into the market because of the value of these demonstration effects and network effects. In contrast to old competitors, there can be no dispute that they benefit: they were not in the market at all before, but are now drawn in as they see through the demonstration effects the possibility of profitable business, or they find that with the lower costs of inputs from suppliers, what had previously not been profitable can now be profitable. Arriving at a social value for this will be difficult, in general, and the most one could normally do is to describe such benefits qualitatively. The new entrants will earn a profit from their production, will employ workers receiving wages higher than they otherwise would have received, and so on. But they will also incur new investment costs, and these should be counted as the investments are new. Nevertheless, the long-term development effects can be significant, as Hirschman has stressed.

**Neighbors**

“Neighbors” is used here as a loose term for all those others who may be affected by a project but who do not have a direct market relationship with the project, i.e. they are not employees, customers, suppliers, or competitors. Impacts include:

- **Environmental externalities:** A project may lead to more pollution in some region, or perhaps (if cleaner than the previous plant) to less than what the region faced before. These are costs to society (if additional pollution) or benefits (if less), and a value can be estimated for such costs or benefits. That is, if a plant using new technology leads to a reduction of 1,000 tons of SO2 emissions per year, and the health and other benefits in that region can be estimated at $100 per ton, then there is a benefit of $100,000 per year. These should be added into the project benefits, or added to the costs if pollution is increased. Coming up with reasonable estimates of the particular values for the benefits or costs may of course be difficult, but in principle it is straightforward to include them in the project benefits or costs. And, as always, if quantification is just not possible, the effects should be described qualitatively, with some sense as to the broad magnitudes.

- **New infrastructure, or increased infrastructure congestion:** A project will often build or expand portions of infrastructure which it needs, such as roads, water and power networks, and so on. Neighbors may benefit from the increased availability of such infrastructure, and may either pay nothing for it (e.g. a road, for which it is not worthwhile to charge a toll due to the transactions costs), or more generally a price which is below what is worth to them (i.e. they enjoy a consumer surplus). If the project has paid for such infrastructure, then the costs have already been accounted for in the project costs, but only the benefits to the private project itself have been accounted for (and reflected in the FRR). The benefits to the neighbors should be added. In other cases, such infrastructure may have been paid for by the Government. The costs of this infrastructure should then be counted as a subsidy to the project (see below), as the benefits to the project itself have been counted (note the benefits may arise from higher productivity and/or lower costs). But one should also then add in a measure of the benefits to the surrounding community, if they exist, to get to the ERR.

Alternatively, the project may lead to increased infrastructure congestion. This imposes a cost on the surrounding community, and an estimate of this cost should be counted as part of the costs of the project when viewed from the perspective of society as a whole for the ERR calculations. And if impossible to quantify, such costs should at least be described qualitatively.
• **Development of social infrastructure**: The construction of a major new plant or other investment in some locale may also lead to further development of the social infrastructure of the community: theaters, restaurants, community centers, and so on. They had not been viable before, but with the new plant (and the new employment brought to the town) they now are. Their value to the community (admittedly difficult to measure), should at least be noted. Some of the social infrastructure may have in fact been constructed by the project itself for the use by the community, e.g. a community center. In such a case, the costs have already been accounted for (they would be part of the project costs, and hence reflected in the FRR), but not the benefits, as these accrue to the community and not the project owners. But they should be counted when taking the perspective of society as a whole. More broadly, firms may establish foundations or give to charities for corporate reasons; the benefits from such work should not be ignored. They may not be easy to measure, but a reasonable assumption would be that the benefits are at least equal to the costs, so one could use the cost figures as a floor to what the benefit figures would be.

**Rest of Society**

The final category is the Rest of Society. One would include here the effects of taxes and subsidies, tariffs and other causes of price distortions, where as a consequence the prices faced by the private project differ from the opportunity costs of society as a whole.

• **Profit and Value-Added Taxes**: The FRR measures the return to the private owners, and hence should be on an after-tax basis. But the project benefits are measured by the value to the consumer, which is assessed at the price the consumer paid for it, and similarly for the costs. The net project benefits are the difference between the two, and just because a portion of these net benefits were then channeled to the government as taxes does not mean the net benefits generated by the project itself were less. Thus any profit or value-added taxes paid by the project entity should be added back into the stream of benefits from the project when calculating the ERR. Note that this has nothing to do with what the government then does with the tax revenues it receives: the taxes are added back in solely in order to get to the measure of the net benefits produced by the project itself. The government could in fact then spend these extra tax revenues wisely, e.g. on education for the poor. These would then be indirect project benefits which are not normally counted in the ERR calculations, but which may well exist. They would be additional benefits, and if important, they could be noted. But one is then getting to second and third round effects, and one has to stop at some point.

• **Subsidies**: Any subsidies paid to the project, while a benefit to the private owner (and hence included in the FRR) should clearly be subtracted out when taking the perspective of society as a whole for the ERR calculation. If the subsidies were used to construct some associated infrastructure (or if such infrastructure was provided in kind), then the costs of that infrastructure should now be included, along with (as noted above) any benefits arising from such infrastructure which accrued to others in that locale (the benefits to the project will already be reflected in the private project accounts, in either higher productivity and/or lower costs).

• **Import tariffs, and export taxes or subsidies**: If the project produces a good which is traded, or makes use of traded goods as inputs, and these goods are subject to tariffs (or non-tariff barriers) if imported (even if the goods used in the project itself may have been produced domestically), then the prices faced privately by the project will differ from the costs to the society as a whole of such goods. The cost to the society is the world price at which they can be imported: tariffs paid are a transfer to the government, and even if not imported, the domestic price of similar goods will rise by this amount as well due to competition (or, more precisely, the restriction on competition from potential imports). The economic cost to the society of producing the good domestically rather than importing it is the world price of the good, i.e. the price paid minus tariffs. Thus for goods the project produces, the revenue stream should be reduced by the portion of the price which is accounted for by the tariff (or the tariff equivalent of any non-tariff barriers). For goods the project uses as inputs, the costs should similarly be reduced by the portion accounted for by tariffs (or the equivalent tariff if a non-tariff barrier). Similar adjustments (with the appropriate sign) should be made to take into account export taxes or subsidies.
• **Sales or excise taxes:** Prices should similarly be adjusted for any sales or excise taxes paid. On a good or service produced by the project which is subject to a sales or excise tax, the value to the consumer is at least equal to the price that consumer pays (and is in fact more, as consumers' surplus). The price received by the project is, however, the price after tax, and hence these taxes should be added back in to the revenue stream when calculating the ERR rather than the FRR. On inputs, the project has paid the price inclusive of any sales or excise taxes, but the opportunity cost to society of producing the good is the price before taxes. Hence the taxes paid on such inputs should be taken out of the costs when calculating the ERR. Note that prices paid as “user fees”, such as for water or to use a toll road, are still prices and reflect costs to society of providing such services, even if the entity producing the water or the toll road is a government agency. These should not be viewed as taxes, even if they go to a governmental entity, as they reflect a fee for a service rendered, where the fee is normally proportionate with the cost of producing that service.
6. Guidance Note on Price Adjustment Techniques

INTRODUCTION

This note addresses:
• Why use constant prices?
• When to use constant prices, when to use current prices?
• Which currency should be used?
• How to convert between different units of measurement.

Why use constant prices?

Due to inflation, the value of money changes over time: US$100 would have bought over 5 times as much 50 years ago, and about 10% more 5 years ago. To make meaningful comparisons which are not affected by inflation, we have to use the same “unit of account”: constant prices. Constant prices always have a “base year”, usually the appraisal year. Please make sure you specify what year you use as base year for your analysis.

When to use constant prices, when to use current prices?

It is not necessary (nor meaningful) to convert an entire balance sheet or income statement into constant prices, since several line items (e.g. depreciation, interest payments, etc.) would require differentiated conversion factors. It is usually also not necessary to compare actual and estimated project costs in constant prices, unless the implementation period is particularly long or inflation particularly high. However, projected and actual prices (and US$ margins), revenues and costs should be compared in real terms. The financial rate of return (FRR) and the economic rate of return (ERR) should also be estimated in constant prices / real terms. However, some measures use nominal benchmarks to evaluate performance, such as accounting returns (e.g. return on equity), and should therefore be calculated in nominal terms.

Which currency should be used?

Many of IFC’s loans (and payment obligations for the client company) are denominated in US$. IFC evaluates equity returns in US dollars, last not least because IFC’s financial performance is being evaluated based on dollar-denominated income statements and balance sheets. (Many foreign investors do the same.) Therefore, US$ are usually the appropriate measure. However, when a company is selling into the domestic market, is owned by domestic investors and has debt obligations in local currency, constant local currency comparisons can sometimes be more appropriate to evaluate its success and can supplement the dollar-based analysis. How to deal with this situation is elaborated in the section on ‘special cases’.
HOW TO CONVERT BETWEEN DIFFERENT UNITS OF MEASUREMENT

Converting actual results (in current LCU) to constant US$ of the appraisal year

In most cases, IFC staff prepares projections at appraisal in constant prices, using the appraisal year as base. The actual results are usually available in current local currency (e.g. from income statements) and can be compared to projections by using the following steps:

1. Divide the actual results (e.g. prices, revenues, costs, etc.) in current local currency units (LCUs) by the average exchange rate for the period under consideration to obtain current US$. For balance sheet data, use the exchange rate of the date the balance sheet.

2. Multiply the current US$ (a) by the US GDP deflator of the base year (in this case the appraisal year, c=100) and divide them by the US GDP deflator of the year for which you have the results to obtain constant (appraisal year) US$ (b).

<table>
<thead>
<tr>
<th>Conversion from current $ values to constant 2001 $ values</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
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<th>2006</th>
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<tbody>
<tr>
<td>(a) Current $ values</td>
<td>80</td>
<td>125</td>
<td>160</td>
<td>150</td>
<td>140</td>
<td>130</td>
<td>135</td>
<td>140</td>
</tr>
<tr>
<td>(b) GDP-Deflator: 2001 Base Year</td>
<td>95.6</td>
<td>97.7</td>
<td>100</td>
<td>101.7</td>
<td>103.8</td>
<td>106.5</td>
<td>109.5</td>
<td>112.2</td>
</tr>
<tr>
<td>Constant 2001 $ values = (a/b)*c</td>
<td>84</td>
<td>128</td>
<td>160</td>
<td>147</td>
<td>135</td>
<td>122</td>
<td>123</td>
<td>125</td>
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</tbody>
</table>

Converting constant US$ from one base year into constant US$ of another base year

In some cases you might wish to choose a different base year, for example the year in which you write your report. To do that, convert the original projections, say they are in constant 2001 US$ (a) to constant 2006 US$ by multiplying them by the US GDP deflator for 2006 (c=112.2) and dividing them by the US GDP deflator for 2001 (b=100).

<table>
<thead>
<tr>
<th>Conversion from constant $ values of one year (2001) to constant $ values of another year (2006)</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<td>84</td>
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<td>147</td>
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<td>123</td>
<td>125</td>
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<td>97.7</td>
<td>100</td>
<td>101.7</td>
<td>103.8</td>
<td>106.5</td>
<td>109.5</td>
<td>112.2</td>
</tr>
<tr>
<td>Constant 2006 $ values = a*(c/b)</td>
<td>94</td>
<td>144</td>
<td>179</td>
<td>165</td>
<td>151</td>
<td>137</td>
<td>138</td>
<td>140</td>
</tr>
</tbody>
</table>

Converting current US$ into constant US$ of today

Since many people relate better to today’s prices, you may sometimes wish to compare in today’s US$. To do that, multiply the data in current US$ (a) by the 2006 US GDP deflator (c=100) and divide them by the US GDP deflator of the respective year (b).

<table>
<thead>
<tr>
<th>Conversion from current $ values to constant 2006 $ values</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Current $ values</td>
<td>80</td>
<td>125</td>
<td>160</td>
<td>150</td>
<td>140</td>
<td>130</td>
<td>135</td>
<td>140</td>
</tr>
<tr>
<td>(b) US GDP deflator, 2006 base year</td>
<td>85.2</td>
<td>87.1</td>
<td>89.1</td>
<td>90.7</td>
<td>92.5</td>
<td>95.0</td>
<td>97.6</td>
<td>100</td>
</tr>
<tr>
<td>Current $ values converted to constant 2006 $ = (a/b)*c</td>
<td>94</td>
<td>144</td>
<td>179</td>
<td>165</td>
<td>151</td>
<td>137</td>
<td>138</td>
<td>140</td>
</tr>
</tbody>
</table>

SPECIAL CASES

Board Report in current US$

Sometimes Board Report figures are in current US$. In those cases, you will usually also find an assumption regarding (US) inflation. It is still preferable to compare the projections to actuals in constant US$, since otherwise the comparison is influenced by how well inflation was forecast. To convert to constant US$,

1. Calculate the inflation index using the US-inflation rate projected in the Board Report. The base year has an index of 100. Each subsequent year has an index of the index of the previous year times (1 + inflation rate, in percent).

2. Multiply the figures from the Board Report (projected current US$) by the inflation index of the base year and divide them by the inflation index of the respective year.
Board Report in current local currency units (LCU)

In some cases, Board Report projections are in current local currency units. In these cases, you will usually also find projections for domestic inflation.

1. Calculate the domestic inflation index using the inflation projections (see above).
2. Multiply the current LCU by the base year index (100) and divide them by the projected inflation index of the respective year to obtain constant (base year) LCU.
3. Divide the constant (base year) LCU by the base year exchange rate to obtain constant (base year) US$. 


Analysis in constant Local Currency Units

When a company
• is selling into the domestic market;
• is owned by domestic investors; and
• has debt obligations in local currency,

can be more appropriate to evaluate its success and can supplement the dollar-based analysis.

The previous example illustrates how Board Report projections in current LCUs can be converted to constant LCUs (by just omitting the third step). If projections are in constant US$, simply divide by the exchange rate to obtain constant LCUs.

For actual results, use the (actual) domestic inflation rate to calculate the inflation index. The procedure is the same as explained above. The base year (say, 1996) has an index of 100, each subsequent year has an index of the previous year’s index multiplied by (1 + inflation rate). To obtain constant LCU, multiply the actual results (in current LCU) by the index of the base year (100) and divide by the index of the year in which they occur.
7. Calculating the Financial Rate of Return

The purpose of this note is to explain the calculation of the financial rate of return (FRR), with a view to clarifying the FRR concept and standardizing procedures for its determination.

**BACKGROUND**

The FRR is a common metric to measure the actual or expected rate of return to all the financiers, including both debt and equity investors, of an investment project. It is computed as the discount rate which equalizes the present value of the net cash flows from the project accruing to the financiers and the present value of the total investment by the financiers during the timeframe under consideration. The FRR is a measure of overall profitability from the viewpoint of the project as a whole, rather than from the viewpoint of a particular type of financier.

The FRR is an absolute measure of profitability. An appropriate assessment of the relative attractiveness of an investment should consider the FRR in relation to the cost of the capital being deployed by the financiers. The Weighted Average Cost of Capital (WACC) is the commonly accepted measure to compute the overall cost of capital. In general, the higher the FRR compared to the WACC, the more attractive is the investment to the financiers.

**CASH FLOW COMPONENTS**

The FRR computation involves assessing the amount and timing of cash income (losses) that can be claimed by the financiers, and the amount and timing of investment outlays by the financiers during the timeframe under consideration. The timeframe under consideration to calculate the FRR generally extends to multiple years (e.g., 5, 7, 10 or 15 years) based on considerations such as the commercial life of the assets, expected investment holding period for the financiers, and the ability to make reasonable forecasts.

The cash income to the financiers consists of: (i) the Cash Flow Stream during the timeframe under consideration; and (ii) the Terminal Value of the project at the end of the timeframe under consideration.

*Cash Flow Stream*

Cash flow stream to the financiers include the cash income stream that the enterprise generates, net of the cash expense stream that the enterprise incurs to operate, sustain and grow the business during the timeframe under consideration. In other words, the cash flow to the financiers during a specified period includes the sum of all cash payments that the business makes to its financiers from income that it generates from its ordinary course operating and investing activities during the specified period. Such cash payments to financiers can be in the form of interest and principal repayment to lenders, and regular dividends to preferred or common shareholders. Shareholders also receive cash proceeds in the form of special dividends or through share repurchases when the enterprise generates excess cash that it deems best to return to its shareholders. Hence, one way to calculate the cash flow stream to financiers would be to add up the various payments to financiers for each period within the timeframe under consideration.
Where project financial projections are available, the net cash flows to the financiers in a specified time period can also be computed by adjusting the accounting net income (profit) to common shareholders in that period:

- add back depreciation & amortization, and other non-cash components of the income statement that are above the net income line;
- add back interest expense and preferred dividends which are payments to the financiers; and
- deduct capital expenditures and increases in working capital, which are cash outlays of the project.

Working capital is defined as current assets minus current liabilities, and refers to the cash needs of an enterprise to operate the business on an everyday basis. An increase in operating working capital indicates an increase in cash requirement (for example, due to inventory build-up) and hence is a deduction when computing the cash flow to financiers. Conversely, a decrease in operating working capital indicates a decrease in cash requirement (for example, lower accounts receivables) and hence is an addition to the cash flow to financiers.

A profitable enterprise will generate excess cash (cash in excess of the operating and investing needs of the enterprise). Shareholders typically are averse to accumulating cash on the company’s balance sheet and would prefer harvesting the cash. While calculating the cash flow stream to financiers, it is important to make the assumption that excess cash, where legally feasible and financially prudent, will be returned to shareholders.

**Terminal Value**

The investment return to the financiers is derived from both the cash flow stream during the timeframe under consideration and the terminal value at the end of such a timeframe. In calculating the expected FRR, it is critical to ensure that most of the contribution to returns is being derived from the cash flow stream during the timeframe under consideration and not the terminal value. The underlying rationale is that normal investors would expect to derive most of the returns to their investment during the investment period under consideration rather than rely heavily on value to be derived at some exit date in the future.

The terminal value at the end of the timeframe under consideration is either the realized or expected terminal market value of the business, assuming a sale of the enterprise or the terminal salvage value of the enterprise's assets assuming sale of the assets. The terminal market value is defined as the expected present value of all the cash proceeds to the financiers from the end of the FRR timeframe into perpetuity. However, given the difficulty of projecting cash flows into perpetuity, general industry practice involves either assuming a constant cash flow growth rate into perpetuity from the terminal date or an estimation of the market value based on a multiple of the expected operating profit for the final (terminal) period of the FRR timeframe. For the sake of conservatism and simplicity, the recommended alternative to calculating the terminal value for a going-concern business is to assume the expected book asset value from the balance sheet at the end of the terminal period as the terminal market value of the enterprise. For capital projects where the assumption is that in the terminal year, the property, plant and equipment (PP&E) of the project is going to be sold, the salvage proceeds to the financiers of the project can be estimated as the book asset value of the PP&E. The terminal value is a residual value concept and should only play a marginal role in the overall returns proposition to the financiers.

**Computing the FRR Based on Investment Typology**

There exists a wide spectrum in terms of the financiers' ability to identify, allocate and measure the cash flow stream and the terminal value associated with their investment program. For some investment programs, the project can be easily identified and the cash flow associated with the project measured easily on a standalone basis. However, for corporate investments, it might be rather challenging to disentangle the financial results of the project associated with the new investment from the financial performance of the entire company. The following examples are provided as a guide:
Case A: A Clearly Identifiable, Standalone Investment

Where the investment program and the cash flows from the resulting project are easily identifiable and measurable, the FRR calculation will not be hindered by attribution issues. The cash flow stream for such a project is simply the stream of cash profits (losses) the project yields during the timeframe under consideration. Such cash profits can be calculated by deducting from cash income during the period all the cash expenses in that period, including capital expenditures but excluding any payments to the financiers such as interest expense, dividends and principal repayments. Alternatively, as explained previously, the cash profits can be calculated by making adjustments to the project net income. The terminal value can be estimated based on the book asset value as described earlier under the terminal value section.

Case B: An Investment Program Influencing Corporate Results

Where the financial results of the investment project alone cannot be easily identified and separated from the corporate financial results, it might be possible to compare the “with and without project” scenarios to determine the cash flows associated with the investment program. The “without project” scenario captures the corporate status quo without the investment program. The “with project” scenario will encompass the financial results of the company inclusive of the new investment program. The cash flow streams and the terminal value to the financiers could then be computed for both with and without scenarios. Deducting the cash flow stream for the “without” scenario from the “with” scenario will provide the cash flow stream for the project. Similarly, deducting the terminal value for the “without” scenario from the “with” scenario will provide the terminal value of the project.

Case C: A Non-Identifiable Investment Program

The ability to perform a “with and without project” analysis hinges on knowledge of the investment program and its significance to the company. In some cases the investment program is not clearly defined or the program might constitute a small proportion of the company’s “with project” operations, making it challenging to create “with and without project” scenarios. Under such circumstances, it would not be possible to apply the methodologies in Case A and B to compute the FRR for the investment program. Since the investment program and its effects can neither be well-articulated nor enumerated under Case C, an alternative solution is to consider the new investment as part of the overall corporate investment program and thus instead of attempting to analyze the FRR for the particular investment program, compute the return on invested capital (ROIC) for the entire company. The corporate ROIC is the proxy for the investment FRR. The corporate cash flow stream can be obtained through adjustments to net income and the terminal value estimated from the book asset value, as previously described.

Nominal versus real returns

The calculation of FRR (or ROIC) in real terms rather than nominal terms is the preferred measure as it avoids the artificial impact of inflation on returns from the investment, and makes comparison of returns over time and across countries more meaningful. To compute real FRR, financial projections should be based on prices on a “base year” (usually the appraisal year). In making investment decisions, management should compare the real FRR to the real WACC. In evaluating results, the cash flows should be adjusted for inflation to make them comparable with original projections.
### Case A: Clearly Identifiable, Standalone Investment Program

**Financial Rate of Return (FRR)**

<table>
<thead>
<tr>
<th>Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>0</td>
<td>15,000</td>
<td>22,500</td>
<td>31,500</td>
<td>40,950</td>
<td>53,255</td>
<td>63,882</td>
<td>75,685</td>
<td>91,990</td>
<td>101,189</td>
<td>111,308</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>10,500</td>
<td>15,750</td>
<td>22,050</td>
<td>28,665</td>
<td>37,225</td>
<td>47,670</td>
<td>57,915</td>
<td>68,450</td>
<td>79,125</td>
<td>90,050</td>
<td>101,000</td>
<td></td>
</tr>
<tr>
<td>Gross margin</td>
<td>4,500</td>
<td>6,750</td>
<td>9,450</td>
<td>12,285</td>
<td>15,971</td>
<td>19,165</td>
<td>22,998</td>
<td>27,579</td>
<td>30,537</td>
<td>33,392</td>
<td>35,308</td>
<td></td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>1,200</td>
<td>1,560</td>
<td>2,028</td>
<td>2,636</td>
<td>3,427</td>
<td>4,456</td>
<td>5,792</td>
<td>7,530</td>
<td>9,789</td>
<td>12,725</td>
<td>15,124</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>2,000</td>
<td>2,350</td>
<td>2,925</td>
<td>3,586</td>
<td>4,352</td>
<td>5,075</td>
<td>5,986</td>
<td>7,272</td>
<td>8,903</td>
<td>10,789</td>
<td>12,936</td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>1,500</td>
<td>1,940</td>
<td>4,777</td>
<td>6,257</td>
<td>7,687</td>
<td>9,111</td>
<td>10,614</td>
<td>12,310</td>
<td>14,544</td>
<td>17,128</td>
<td>20,675</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>2,500</td>
<td>3,250</td>
<td>4,025</td>
<td>4,844</td>
<td>5,734</td>
<td>6,677</td>
<td>7,661</td>
<td>8,772</td>
<td>9,941</td>
<td>11,241</td>
<td>12,710</td>
<td></td>
</tr>
<tr>
<td>Profit before taxes</td>
<td>-2,000</td>
<td>-1,500</td>
<td>-1,150</td>
<td>-1,392</td>
<td>-1,927</td>
<td>-2,376</td>
<td>-3,199</td>
<td>-3,122</td>
<td>-3,768</td>
<td>-4,467</td>
<td>-5,180</td>
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</tr>
<tr>
<td>Taxes</td>
<td>0</td>
<td>2,250</td>
<td>2,925</td>
<td>3,586</td>
<td>4,352</td>
<td>5,075</td>
<td>5,986</td>
<td>7,272</td>
<td>8,903</td>
<td>10,789</td>
<td>12,936</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>0</td>
<td>-450</td>
<td>-925</td>
<td>-1,549</td>
<td>-2,276</td>
<td>-3,000</td>
<td>-3,651</td>
<td>-4,290</td>
<td>-5,208</td>
<td>-6,212</td>
<td>-7,246</td>
<td></td>
</tr>
</tbody>
</table>

**Balance Sheet**

- **Cash**: 3,000
- **Accounts receivable**: 900
- **Inventory**: 250
- **Total current assets**: 3,000
- **Long-term assets**: 25,000
- **Total assets**: 28,000
- **Short-term debt**: 9,000
- **Total current liabilities**: 9,000
- **Total liabilities**: 18,000
- **Common stock**: 10,000
- **Retained earnings**: 0
- **Total equity**: 10,000
- **Total liabilities & equity**: 30,000

**Cash Flow Statement**

- **Net income**: -2,400
- **Depreciation**: 3,200
- **Change in accounts payable**: -900
- **Change in inventory**: -525
- **Change in accounts payable**: 1,500
- **Total cash from operating activities**: 4,750
- **Capital expenditures**: -500
- **Change in long-term debt**: -2,000
- **Change in common stock**: 0
- **Dividend to common stockholders**: 0
- **Net change in cash during year**: -2,075
- **Cash at end of year**: 3,000

**Instructions for Preparing an XPSR: Non-Financial Markets**
## Case B: Investment Program with Identifiable Corporate Impact

### Financial Rate of Return (FRR)

<table>
<thead>
<tr>
<th>Without New Investment Program</th>
<th>Historical</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>8,600</td>
<td>8,050</td>
<td>9,257</td>
<td>10,461</td>
<td>12,430</td>
<td>14,795</td>
<td>17,250</td>
<td>19,875</td>
<td>22,669</td>
<td>26,625</td>
<td>30,828</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>7,000</td>
<td>6,625</td>
<td>6,909</td>
<td>7,656</td>
<td>8,640</td>
<td>9,858</td>
<td>11,348</td>
<td>12,972</td>
<td>14,630</td>
<td>16,325</td>
<td>18,143</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,600</td>
<td>1,425</td>
<td>2,348</td>
<td>2,805</td>
<td>3,760</td>
<td>4,942</td>
<td>5,902</td>
<td>6,903</td>
<td>8,039</td>
<td>10,493</td>
<td>12,685</td>
</tr>
<tr>
<td>Depreciation</td>
<td>6,500</td>
<td>5,800</td>
<td>5,130</td>
<td>4,600</td>
<td>3,700</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>EBIT</td>
<td>8,500</td>
<td>8,850</td>
<td>11,063</td>
<td>13,338</td>
<td>16,460</td>
<td>18,995</td>
<td>23,921</td>
<td>28,625</td>
<td>34,170</td>
<td>40,493</td>
<td>47,369</td>
</tr>
<tr>
<td>Interest expense</td>
<td>6,000</td>
<td>5,600</td>
<td>4,400</td>
<td>2,510</td>
<td>5,705</td>
<td>7,505</td>
<td>9,252</td>
<td>11,031</td>
<td>13,285</td>
<td>16,700</td>
<td>20,113</td>
</tr>
<tr>
<td>Profit before taxes</td>
<td>1,500</td>
<td>1,250</td>
<td>6,658</td>
<td>10,830</td>
<td>10,725</td>
<td>11,493</td>
<td>14,670</td>
<td>15,594</td>
<td>14,254</td>
<td>13,793</td>
<td>17,354</td>
</tr>
<tr>
<td>Taxes</td>
<td>150</td>
<td>1,043</td>
<td>1,849</td>
<td>2,771</td>
<td>3,828</td>
<td>5,039</td>
<td>6,426</td>
<td>8,018</td>
<td>9,843</td>
<td>11,848</td>
<td>14,073</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>890</td>
<td>840</td>
<td>5,809</td>
<td>6,002</td>
<td>5,634</td>
<td>5,267</td>
<td>3,901</td>
<td>4,476</td>
<td>3,577</td>
<td>1,866</td>
<td>2,412</td>
</tr>
</tbody>
</table>

### Balance Sheet

<table>
<thead>
<tr>
<th>Without New Investment Program</th>
<th>Historical</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>8,670</td>
<td>6,970</td>
<td>7,665</td>
<td>10,933</td>
<td>12,590</td>
<td>14,970</td>
<td>17,625</td>
<td>20,050</td>
<td>21,750</td>
<td>24,350</td>
<td>27,050</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>7,150</td>
<td>5,090</td>
<td>6,025</td>
<td>7,985</td>
<td>9,200</td>
<td>10,825</td>
<td>12,590</td>
<td>14,050</td>
<td>15,600</td>
<td>17,200</td>
<td>18,750</td>
</tr>
<tr>
<td>Inventory</td>
<td>5,500</td>
<td>4,825</td>
<td>5,492</td>
<td>6,102</td>
<td>7,000</td>
<td>8,046</td>
<td>9,318</td>
<td>10,757</td>
<td>12,310</td>
<td>14,159</td>
<td>16,099</td>
</tr>
<tr>
<td>Total current assets</td>
<td>17,000</td>
<td>15,137</td>
<td>11,685</td>
<td>19,995</td>
<td>21,795</td>
<td>22,865</td>
<td>23,793</td>
<td>25,852</td>
<td>27,659</td>
<td>28,740</td>
<td>30,598</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>7,000</td>
<td>6,625</td>
<td>6,909</td>
<td>7,656</td>
<td>8,640</td>
<td>9,858</td>
<td>11,348</td>
<td>12,972</td>
<td>14,630</td>
<td>16,325</td>
<td>18,143</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>20,000</td>
<td>15,137</td>
<td>11,685</td>
<td>19,995</td>
<td>21,795</td>
<td>22,865</td>
<td>23,793</td>
<td>25,852</td>
<td>27,659</td>
<td>28,740</td>
<td>30,598</td>
</tr>
<tr>
<td><strong>Stockholders' Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

### Cash Flow Statement

<table>
<thead>
<tr>
<th>Without New Investment Program</th>
<th>Historical</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Income</strong></td>
<td>890</td>
<td>840</td>
<td>5,809</td>
<td>6,002</td>
<td>5,634</td>
<td>5,267</td>
<td>3,901</td>
<td>4,476</td>
<td>3,577</td>
<td>1,866</td>
<td>2,412</td>
</tr>
<tr>
<td>Depreciation</td>
<td>6,500</td>
<td>5,800</td>
<td>5,130</td>
<td>4,600</td>
<td>3,700</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Change in accounts receivable</td>
<td>625</td>
<td>-947</td>
<td>1,209</td>
<td>-1,135</td>
<td>-1,483</td>
<td>-1,659</td>
<td>-1,908</td>
<td>-2,324</td>
<td>-2,902</td>
<td>-3,659</td>
<td>-4,659</td>
</tr>
<tr>
<td>Change in income</td>
<td>-525</td>
<td>-904</td>
<td>-694</td>
<td>-798</td>
<td>-918</td>
<td>-1,056</td>
<td>-1,214</td>
<td>-1,397</td>
<td>-1,666</td>
<td>-1,847</td>
<td>-2,031</td>
</tr>
<tr>
<td>Change in cash flows from operating activities</td>
<td>10,968</td>
<td>12,744</td>
<td>13,915</td>
<td>14,381</td>
<td>15,157</td>
<td>15,701</td>
<td>16,075</td>
<td>17,020</td>
<td>18,025</td>
<td>19,025</td>
<td>20,025</td>
</tr>
<tr>
<td><strong>Capital Expenditures</strong></td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
</tr>
<tr>
<td><strong>Cash Flows from Investing Activities</strong></td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
<td>-5,000</td>
</tr>
<tr>
<td>Change in long-term debt</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Change in common stock</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Dividends to common stockholders</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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</tr>
<tr>
<td>Total cash from financing activities</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Net cash in operating year</strong></td>
<td>5,000</td>
<td>4,408</td>
<td>6,151</td>
<td>6,151</td>
<td>6,151</td>
<td>6,151</td>
<td>6,151</td>
<td>6,151</td>
<td>6,151</td>
<td>6,151</td>
<td>6,151</td>
</tr>
</tbody>
</table>

### PLEASE SEE BELOW FOR UNDERLYING FINANCIAL STATEMENTS
Case B: Investment Program with Identifiable Corporate Impact (continued)

### Income Statement

<table>
<thead>
<tr>
<th>New Investment</th>
<th>Historical Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>20,000</td>
<td>15,000</td>
<td>15,000</td>
<td>14,500</td>
<td>15,000</td>
<td>15,000</td>
<td>15,000</td>
<td>15,000</td>
<td>15,000</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>7,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>30,000</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
<td>20,500</td>
</tr>
</tbody>
</table>

### Balance Sheet

<table>
<thead>
<tr>
<th>New Investment</th>
<th>Historical Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total liabilities &amp; equity</td>
<td>15,000</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
<td>11,750</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>10,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Total equity</td>
<td>5,000</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
<td>4,750</td>
</tr>
</tbody>
</table>

### Cash Flow Statement

<table>
<thead>
<tr>
<th>New Investment</th>
<th>Historical Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>2,856</td>
<td>5,058</td>
<td>7,601</td>
<td>10,609</td>
<td>13,948</td>
<td>17,791</td>
<td>22,195</td>
<td>27,244</td>
<td>32,984</td>
<td>39,117</td>
<td>45,340</td>
</tr>
<tr>
<td>Capital Expenditures</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
<td>5,500</td>
</tr>
<tr>
<td>Change in long-term debt</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
<td>-7,000</td>
</tr>
<tr>
<td>Net change in cash during year</td>
<td>-583</td>
<td>2,516</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Cash at end of year</td>
<td>5,000</td>
<td>4,417</td>
<td>6,933</td>
<td>6,933</td>
<td>6,933</td>
<td>6,933</td>
<td>6,933</td>
<td>6,933</td>
<td>6,933</td>
<td>6,933</td>
<td>6,933</td>
</tr>
</tbody>
</table>
Case C: Non-Identifiable Investment Program

Corporate Return on Invested Capital (ROIC)

<table>
<thead>
<tr>
<th>Historical Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment outlay by financiers</td>
<td>11,000</td>
<td>22,000</td>
<td>33,000</td>
<td>44,000</td>
<td>55,000</td>
<td>66,000</td>
<td>77,000</td>
<td>88,000</td>
<td>99,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Net income to common stockholders</td>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
<td>5,000</td>
<td>6,000</td>
<td>7,000</td>
<td>8,000</td>
<td>9,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Dividends to preferred stockholders</td>
<td>500</td>
<td>1,000</td>
<td>1,500</td>
<td>2,000</td>
<td>2,500</td>
<td>3,000</td>
<td>3,500</td>
<td>4,000</td>
<td>4,500</td>
<td>5,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
<td>5,000</td>
<td>6,000</td>
<td>7,000</td>
<td>8,000</td>
<td>9,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
<td>5,000</td>
<td>6,000</td>
<td>7,000</td>
<td>8,000</td>
<td>9,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
<td>5,000</td>
<td>6,000</td>
<td>7,000</td>
<td>8,000</td>
<td>9,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Change in working capital</td>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
<td>5,000</td>
<td>6,000</td>
<td>7,000</td>
<td>8,000</td>
<td>9,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

IRR of periodic cash flow: 14.8%

Periodic cash flow to financiers: 88,000

**PLEASE SEE BELOW FOR UNDERLYING FINANCIAL STATEMENT**

**Income Statement**

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Cost of goods sold</th>
<th>Gross margin</th>
<th>SG&amp;A</th>
<th>Depreciation</th>
<th>EBIT</th>
<th>Interest expense</th>
<th>Profit before taxes</th>
<th>Tax expense</th>
<th>Net income</th>
<th>Dividends to preferred stockholders</th>
<th>Net income to common stockholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>100,000</td>
<td>20,000</td>
<td>80,000</td>
<td>10,000</td>
<td>2,000</td>
<td>8,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>110,000</td>
<td>22,000</td>
<td>88,000</td>
<td>12,000</td>
<td>4,000</td>
<td>8,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>120,000</td>
<td>24,000</td>
<td>96,000</td>
<td>14,000</td>
<td>6,000</td>
<td>8,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

**Balance Sheet**

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash</th>
<th>Accounts receivable</th>
<th>Inventory</th>
<th>Total current assets</th>
<th>Total assets</th>
<th>Long-term assets</th>
<th>Total liabilities</th>
<th>Preferred Stock</th>
<th>Common stock</th>
<th>Retained earnings</th>
<th>Total equity</th>
<th>Total liabilities &amp; equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>5,000</td>
<td>5,000</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
<td>30,000</td>
<td>30,000</td>
<td>5,000</td>
<td>10,000</td>
<td>15,000</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>6,000</td>
<td>6,000</td>
<td>12,000</td>
<td>24,000</td>
<td>36,000</td>
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<td>6,000</td>
<td>12,000</td>
<td>18,000</td>
<td>30,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

**Cash Flow Statement**

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income</th>
<th>Depreciation</th>
<th>Change in accounts receivable</th>
<th>Change in inventory</th>
<th>Change in accounts payable</th>
<th>Total cash from operating activities</th>
<th>Capital Expenditures</th>
<th>Change in long-term debt</th>
<th>Change in common stock</th>
<th>Dividends to preferred stockholders</th>
<th>Dividends to common stockholders</th>
<th>Total cash from financing activities</th>
<th>Net cash in cash during year</th>
<th>Cash at end of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

**PLEASE SEE BELOW FOR UNDERLYING FINANCIAL STATEMENT**
8. Guidance Note on Evaluating Corporate Loans

GENERAL

IFC’s Article 1 defines IFC’s Purpose as “… further[ing] economic development by encouraging the growth of productive private enterprise…”. Real sector projects financed by IFC usually comprise a defined capital investment program with distinguishable cost and benefit cash flow streams. It follows that, relative to IFC’s Purpose, a project’s estimated financial rate of return (FRR) and economic rate of return (ERR) are core measures of sound and complete project analysis at both appraisal and evaluation. In the XPSR, the FRR is the basis for the Project Business Success indicator rating, and the ERR for the Economy Sustainability indicator rating. Projects are rated by comparing their FRRs and ERRs to consistently derived benchmarks, allowing inter-project and portfolio (sectors, regions, etc) performance comparisons.

It follows that as a general rule, FRR and ERR estimates are expected to be included in all XPSRs for real sector projects involving capital expenditure programs. To derive them, the XPSR assessment must isolate the cash flows attributable to the project within the company’s total cash flow in each of the project years, by applying a “with/without project” incremental analysis. Capital programs featuring multiple components present more of a data-gathering challenge, and the purpose of this Note is to clarify what is expected for these types of projects in particular.

The FRR estimate is essential for judging and rating the Project’s Business Success on a level playing field across operations. Failure to provide an FRR, particularly when an FRR estimate has been previously presented in the Board report, may reflect unsatisfactory supervision oversight (in the context of waiver requests granted or not sought) and/or an unsatisfactory company MIS capacity and/or non-responsive evaluation research. Presented here is a framework for providing an FRR estimate, or in genuinely data-constrained instances, a second — or third — best alternative.

CORPORATE LOAN TYPOLOGY

Real sector “corporate loans” comprise two distinct project loan types:

• Financial restructurings/capital expansions (or “right side” projects) which include loans for improving the asset-liability maturity profile (e.g. reduction of short-term debt), ADR issue facilitation, equity capital expansion or privatization. Generally speaking, financial restructurings were considered corporate transactions at approval and were not associated with capital programs with FRR/ERR estimates; as such they can be considered “ex-ante” corporate loans.

• Corporate capital expansions (or “left side” projects) which include an investment program consisting of multiple, and possibly diverse, components. Corporate capital expansions generally featured a projected FRR and ERR at Board approval and were not described as corporate loans until the evaluation stage; hence, they can be considered “ex-post” corporate loans.
EVALUATING FINANCIAL RESTRUCTURINGS

For financial restructurings, the absence of an investment program (defined asset expansion and attributable cash flows) renders a FRR/ERR calculations moot. However, the restructuring will have affected the company, with a judgment of project success feasible through a synthesis of the findings relative to the following:

• To what extent were the project objectives that were described in the approval documents, achieved?
• Was the debt structure altered as expected? How does the current debt service profile compare with Board paper projections? Have there been debt service reductions as determined through a “with vs. without project” comparison?
• Did the revised debt structure influence operating efficiency and cash flows? How?
• Did the revised debt structure shield the company from interest rate fluctuations?
• How did the “with project” debt structure affect the company’s profitability in local currency terms?
• Did the project support the introduction of ADRs? A public listing?
• How has the index of the company’s market valuation (equity price) changed in relation to that of comparators on a pre- vs. post-project basis?

EVALUATING CORPORATE CAPITAL EXPANSION PROGRAMS

The evaluation of corporate capital expansion programs hinges on knowledge of the investment program and the determination of “with vs. without project” cash flow data. Scenarios of decreasing evaluative quality follow. In particular, the reliability of the inferential judgments under scenarios 2 and 3 may be highly doubtful, the more so to the extent the project is a smaller proportion of the company’s “with project” operations.

1: For known investment programs with few components and:

• Complete financial results for all components. Cash flows attributed to each component can be identified and combined into an overall FRR. This scenario characterizes many multi-component projects covered by XPSRs to date, which – if there are no data or XPSR execution problems – have seldom resorted to the “corporate loan” classification.

• Complete financial results for primary components. Depending on the few major components’ share of the overall investment program (and other judgments), an FRR can be estimated for the major components. Judgment can then applied in determining whether the contribution of the remaining capital expenditures and their cash flows would be likely to pull the total program FRR up or down sufficiently to change the performance rating.

2: For known investment programs with partially identified project-related financial results (FRR not feasible)

Depending on their share of the overall investment program and other judgments, the as-executed investment program components can be independently analyzed using other performance measures, and related to at-approval project objectives or targets:

• Output improvements (e.g. sales volumes/revenues) can be compared to pre-project historical and Board projections, or by comparing growth rates to industry data.

• Efficiency gains or quality improvements can be measured by sales per employee or margin comparisons to both Board projections and competitors.

• Market share can be compared to Board projections and competitors.

• Value: have any components been sold or liquidated? What were the “with-project investment” returns?
3: For known investment programs with no available financial results

- **Pro-rata to company return**: A fall-back when there are no project-specific operating data is to calculate an FRR for the company and allocate a pro-rata share of “with project” company cash flows to the project investments (methodology outlined in Example 1).

- **For publicly traded companies**: The movement in the index of the company’s share price from just prior to investment approval up through the date of evaluation, can be compared with the movements in the index of the local stock market and of the share prices of the company’s competitors (see Example 2).

- Note that the lack of identifiable project financial results may reflect on IFC’s supervision or evaluation research.

4: For unknown investment programs with no available financial results

- Given the project description in the Board paper and investment documentation, why is the investment program not known? Is the company in violation of the investment agreement (IA) relative to its project description? On what basis are we satisfied that the company is in compliance with the IA and has applied the IFC funds to the legally defined project?

- The lack of any information on financial results of a legally defined project may reflect on IFC’s supervision diligence and/or company MIS and strongly suggests unsatisfactory XPSR research.

- Depending upon the capital program’s relative magnitude within the company’s gross fixed assets, project business performance may or may not be broadly inferable from the company’s “with project” efficiency, share price and profitability indicators.

- For publicly traded companies, the movement in the index of the company’s share price from just prior to investment approval up through the date of evaluation, can be compared with the movements in the index of the local stock market and of the share prices of the company’s competitors (see Example 2).

For all scenarios, a related concern is how the investment program expenditures (components) compare to Board projections and if different, whether this flexibility was reflected in the Board report and incorporated into the IA. If not, where there is a planned vs. actual “disconnect”, it should be taken into account in the evaluation of IFC’s effectiveness in front-end structuring and supervision.

Looking ahead, if at approval, IFC does not expect that the project definition is firm enough to support later evaluation based on measurable results necessary for FRR/ERR estimates, then these estimates should not be included in the Board report. Investment disbursement by IFC should not proceed ahead of the satisfactory demonstration of each project component’s viability.

Conclusion

At evaluation, an updated estimate of the FRR and ERR will normally be feasible and should be included in all XPSRs on real sector projects for which these indicators were estimated in approval documentation. Failure to establish a transparent basis for an FRR and ERR estimate seriously compromises the quality of evaluative judgments and related ratings of what are typically relatively large IFC investments that were approved on the explicit expectation that they would generate attractive returns. In cases where IFC presented an estimated FRR (and ERR) at Board approval, the inability at the XPSR stage to properly re-estimate an FRR reflects, at a minimum, non-responsive evaluation research, and also possibly poor company record keeping and inadequate IFC project supervision.
1: Pro-Rata Company Return-based FRR

As mentioned previously in the evaluative scenarios, a third best alternative is to calculate a “with project” FRR for the company and attribute the FRR to the project. This proxy can be derived as follows:

f. Value the company’s non-project assets (approximately, net fixed assets plus gross working capital prior to project execution).\textsuperscript{11}

g. Value the project (investment program).

h. Define the project’s share of company’s new value \([b/(a + b)]\).

i. Define the total company returns (historic and projected) that contain results attributable (even partially) to the project, (i.e. a company’s total returns derived during the useful life of the project).

j. Define the project’s pro-rata share of the company’s total returns \((c * d)\).\textsuperscript{12}

k. Calculate an FRR proxy based on the investment program \((b)\) and the stream of deemed investment program results \((e)\).

Notes:

\textsuperscript{11} The value of the company at disbursement is highly debatable. Recognizing sunk costs, the company’s value could be less than the net assets booked on the balance sheet. For a company that without the project would have closed shop – with no purchaser or residual assets – the value could be negative (cost of site remediation). Conversely, a company’s value may include goodwill – high replacement cost, brand loyalty, customer base, technology, etc. – that is not booked on the balance sheet.

\textsuperscript{12} The project’s share of total company returns is also debatable. The project may involve a failed product line expansion that negatively impacted company sales as a whole – or negative returns. Conversely, the project may provide the only profitable line of business within the company – 100% of returns – or may enable the returns from the non-project assets to continue (e.g. an environmental remediation project).
9. Some Avoidable Mistakes From Previous XPSRs

After reviewing several hundred XPSRs, IEG staff drew up the following list of the errors that we encountered most frequently, as reflected in the Evaluative Notes. IFC is a learning-oriented institution, gifted with a bright and well-motivated staff. Think of this list as an incomplete map of a field with landmines. Your job is to get through the field and emerge on the other side as a hero...or a Director. We hope that, by circulating this map, we will help people to avoid revealed landmines and make a safe passage. Alternatively, if you make a mistake it will be by stepping on a new landmine and we can update our map accordingly.

1. No clear description of the project

It may seem obvious that you have to know exactly what the project is before you can evaluate it, but a few souls have made it difficult on themselves by not identifying clearly and analyzing the project. (This arose most often in the case of corporate financings.) A related problem is:

2. Not separating the components of a project

If a project comprises distinct and diverse components, then these should be described and analyzed separately – their performances may vary widely, and it’s misleading to ignore the variances and their causes. Still, the assigned performance ratings should reflect a synthesis of the sub-component performances.

3. Confusing the project with the company

They are not the same, and the XPSR requires independent judgments of each according to its relevant performance parameters. A related problem is:

4. Mixing up different operations with the same company

Think in terms of incremental commitments. Where IFC has financed a series of projects through several investments in a company, despite how well or badly the other projects went, each XPSR is meant to evaluate only a specific operation, project, and investment – the one selected for this XPSR. The XPSR team has to sort out the marginal contribution of the operation, and to isolate its effects from those of other operations.

5. The heart by-pass operation was a success ... but unfortunately, the patient died

A company’s and project’s business performances must be rated solely on the basis of their outcomes, not in relation to the source of their shortcomings, or what might have been if only there hadn’t been an unfortunate turn of events subsequent to disbursement (such as a market collapse, “irrational” competitive response, change of management and/or business strategy, adverse currency movement, etc.). The quality of IFC’s front-end appraisal and supervision intervention are addressed separately in the operational effectiveness section, so there’s plenty of opportunity to show how extraneous factors affected the project.

6. Inadequate field research

The Board’s primary expectation of the XPSR system is that it evaluates results on the ground in a developing country, not on a piece of paper in your office. The best XPSRs were those whose teams visited all
the key actors in the project from customers to suppliers, local government officials, and trade associations. An XPSR cannot be fully responsive without this research, and IFC’s selective system of evaluation provides sufficient resources for the marginal cost of the field time.

7. **Weak economic analysis**

An economic analysis begins with a clear statement of benefits and costs and a model – either explicit or implicit – of how the project will affect market-determined prices and quantities. Financial analysis is something different. It can be complementary, but it is generally a poor surrogate for economic analysis.

8. **Ignoring the “without project” case in analyzing project economics**

(1) If the project sells into a slack-capacity market, its incremental value-added to the economy was generally below the border value of replacement imports; (2) If the company would have produced a net cash flow of X without the project, then the project economic benefit stream cannot include X.

9. **Changing models between ex ante and ex post evaluations**

An important part of the XPSR is a comparison of expectations, at the time of appraisal, to actual outcomes. However, if different financial or economic models are used, this must be explained and the variance should be qualified. If there was an error in the models at appraisal, the error should be corrected – rather than repeated – but the XPSR should be clear about how much of the variance is explained by changes in the model and how much by the parameters.

10. **Investment objectives**

Those cited in the XPSR should be the same as in the Board Report.

11. **Poor labeling of tables to indicate currency, constant, or current**

Some comparisons require constant currency (either local or US$) and some require nominal. A good XPSR will make the units of account clear, in every table, and will provide the conversion factors (exchange rates, inflation rates) that would allow an independent evaluator to check results and to understand the relationship of the tables to each other.

12. **Asserting rather than demonstrating or convincing**

Evaluation must be based on objective data and relate results to objectives. The burden of proof falls on the XPSR team to assemble enough objective data to convince a skeptical but open-minded audience that their judgments of performance are correct.

13. **Using V-shaped projections**

Price and quantity projections should be based on probability-based expected values and not on the hope that future fortuitous developments will salvage a heretofore disappointing rate of return performance. We often see price and quantity data that show a weak or even declining trend from the day the project was approved until the day the XPSR was written. Then, miraculously, the trend reverses and the future is where we hoped it would be when we appraised it. Now, it’s true that most markets have their ups and downs, but it can’t be true that the best predictor of a market bottom is the date that an XPSR is written!

14. **Weak demand analysis**

Mistakes in the identification of the fundamental driving force underlying demand and overlooking its significance in case of a downturn.

15. **Unanswered questions**

A well-crafted XPSR will raise many questions about what was (or was not) done, how, and why. What makes an XPSR stand out from the rest is that it will also answer all the questions it raises, or at least say why the answers couldn’t be had – and what should be done about that in future reporting requirements.
16. Repetition and verbiage

Looking at an operation’s outcome from several perspectives encourages repetition, and the accountabili-
ty demands of the pro forma’s structure encourages it. Our advice, here and elsewhere, is “Say it once, and say it concisely.” Or, at the risk of being pedantic, “Less is more. Be selective. Figure out what’s material, and focus on it. Don’t reiterate. Five pages, no more.” And, respect the section emphasis (length) balance.

17. No statement of assumptions

All financial and economic projection models are based on assumptions. A good model is one in which the assumptions and the derivation of results are transparent. Sometimes, there is even a sensitivity analysis to show the significance of the assumptions. A bad model is one where you search all day and still can't figure out what the analyst did or why.

18. Misunderstanding sustainability and viability

The sustainability and viability judgment is sometimes rendered on the basis of the project’s performance alone, rather than on the basis of the whole company (where there are several product lines) or the group (where IFC’s investment is in one of the subsidiaries) within the enabling environment (the country and sector). If it’s like a corporate onion with several layers, then each layer needs to be independently evaluated to arrive at the prospects judgment.

19. Financial calculations

(1) Non-transparent equity exit assumptions. (2) Some staff have used a multiple of company earnings as the terminal value of the project investment, instead of the residual value of the project’s assets. (3) The value of the initial working capital investment should be recouped at the end of the project life. (4) Missing basic price comparison with major competitors (i.e. room prices, etc.) and forgetting industry discount practices. (5) Variance analysis not done in constant dollars – Board projections in constant approval year dollars with actuals in current dollars.

20. Projections of the enabling environment

Companies and projects don’t operate in a vacuum jar, but we see projections of future results that were consciously made through the famed “rose-colored lenses.” The problem is also reflected in optimistic assumptions about exit values for equity investments in volatile countries. The appropriate solution is to use expected values that explicitly incorporate upside and downside valuations and not a “most likely” or “most favorable” outcome.

21. Inadequate upstream review of draft XPSRs

Teams need to allow time for comments and peer discussion among a range of staff and managers including specialists, regional, and – if the project warrants – World Bank. Drafts of the XPSR should be sent to anyone who has worked on the project and who is still in IFC.

22. Confusion among standard terms: operation, company, project, investment

In the context of an XPSR, the operation refers to IFC’s objectives, activities and results in making and administering its investment; the company refers to IFC’s investment counterparty; the project refers to the specific company objectives, capital program and related business activity that was partially financed by the IFC investment selected for the XPSR, as described at approval in its Board report; and the investment refers to IFC’s investment instrument (loan, equity, underwriting, etc.). “Through this operation, IFC supported the Acme Mining Company’s zirconium expansion project with an investment comprising a $5 million in equity investment in the Company’s shares and a $25 million loan.”
23. Using the before-tax FRR as the basis for the Project business success rating

The tax-collector must be paid and, moreover, has a ranking claim ahead of lenders and shareholders. Most Board report estimates of the FRR have been based upon pre-tax FRRs. But, as an indicator of the Project’s expected business success over its life – reflected in its net cash flow – we are interested in the after-tax FRR. For the purposes of the variance analysis, compare apples-with-apples – if the Board report projected only the before-tax FRR, base the comparison accordingly.