From: Executive Committee
To: BIO Board of Directors, for its meeting on April 24, 2018
Date: April 16th, 2018
For: approval

Evaluation of six BIO MSME Financial Sector Investments in India: Management response to the evaluation's conclusions and recommendations

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Our management contract with the Belgian State foresees that every year BIO commissions an external case study evaluation of at least five of its investments. For the 2017 evaluation, it was decided to focus the evaluation on six financial sector investments in MSME finance in India (3 MFIs, 1 NBFI and 2 Funds). The evaluation assessed how BIO's investments have been able to address the financing needs of MSMEs and how BIO has been able to support these investee institutions to address their financial as well as non-financial challenges.
On the basis of a Terms of Reference, which was approved by the Steering Committee, a team of 4 evaluators from the Indian consultancy firm MicroSave was selected.

The following investments in India were evaluated:

	Type	Name	About	BIO's Support	TA
1	MFI	Annapurna Microfinance Private Limited	Offers SHG loans, micro-enterprise loans and other loans primarily to low-income women	**INR 250 million** (or EUR 3.46 million) equity - investment in local currency (INR) in 2013; **EUR 2 million** equity in 2017	Yes
2	MFI	Utkarsh Microfinance Private Limited	Offers group loans, micro-enterprise loans and affordable housing loans primarily to low-income women	**USD 5 million** (or EUR 3.62 million) senior secured loan 7 years (with 3 years grace period) - investment in USD in 2014	No
3	MFI	Fusion Microfinance Private Limited	Offers group loans to low-income women	**INR 275 million** (or EUR 3.6 million) equity - investment in local currency (INR) in 2014; **USD 2 million** (or EUR 1.83 million) equity - investment in USD in 2016	No
4	NBFI	Srei Equipment Finance Limited	Offers equipment finance and leasing to SMEs and retail customers	**EUR 5 million** loan for 10 years to Srei Infrastructure Finance Limited (SIFL) holding company of SEFL in 2002; **EUR 3.5 million** loan for 8 years with 2 years grace period to Quippo (subsidiary of SIFL) in 2004; **INR 2.65 billion** (or EUR 4.5 million or) investment in local currency (INR) 8 years, compulsory convertible loan in 2008	No
5	PE Fund	VenturEast Proactive Fund	Offers equity to SMEs	**USD 5 million** (or EUR 3.86 million) equity - investment in USD in 2007	No
6	PE Fund	BTS India Private Equity Fund	Offers equity to SMEs	**USD 3 million** (or EUR) equity in 2006	No

Main findings

The primary objective of the study was to assess how BIO's investments have been able to address the financing needs of MSMEs and how BIO has been able to support these investee institutions to address their financial as well as non-financial challenges. The secondary objective was to assess the additionality of BIO's financing in the financial (complementarity) as well as non-financial sense.

The six case studies cover different types of investments (direct/indirect, debt/equity) over an investment period of 12 years. Overall, MicroSave concludes that BIO's investments *have helped improve access to finance among MSMEs'* and that '*non-financial challenges of MSMEs have been partially addressed*.' The consultants conclude that '*BIO's performance has been satisfactory overall*'.

Following the DAC evaluation criteria[1], the evaluators conclude that

'*BIO's investment to address the credit gap among MSMEs through investment in MFIs and NBFC, and the equity finance gap through investment in private equity funds (that focused on early and growth stage small and medium enterprises) is* ***highly relevant'***.
BIO's investment process, being similar to that of other DFIs was found '***fairly efficient***'. Clients have appreciated the '*swiftness of processes and the manner in which the transactions, in most cases, was completed within the expected timelines'*.
Noted is that BIO's development assessment and processes ***'need to be communicated effectively*** *to the investee institutions'*.
In general, the evaluators consider that '*BIO's investments have had a* **good impact** *in addressing the financing gaps of MSMEs in India. Through investment in new and emerging MFIs, BIO has supported access to finance among women especially in the low-income and underserved states in northern and eastern part of India.*'
Specifically for the PE Funds and the NBFI, the evaluators conclude that the investments '*have had a* ***significant impact*** *on encouraging entrepreneurship and innovation*.'
Financial sustainability was considered positive for the financial institutions, but with **mixed results** for the private equity funds and their investee institutions.
Regarding non-financial sustainability, '*BIO's focus on ESG compliance and annual ESG reporting helped sensitise the investee institutions towards environment and social sustainability*.'

Regarding the evaluated 'additionality', i.e. the degree to which BIO's financing complements – or is "additional" to – commercially available financing, the evaluation concludes that:

- BIO's financial additionality was considered '*particularly high for BIO's first investment in the microfinance sector in 2013'* as it came at the time when the sector was recovering from the Andra Pradesh microfinance crisis in 2010. The equity investments '*helped MFIs to not only raise debt from diversified sources but also raise equity periodically which further helped expand access to finance to MSME*'. For the SME-focused private equity funds and the NBFI, the financial additionality was considered moderate.
- BIO's non-financial additionally was considered moderate as it '*could have been more prominent.'*

The evaluators also assessed how BIO supports its investees in contributing to the UN Sustainable Development Goals (SDGs). Overall, MicroSave considers that BIO '*chose to invest in institutions that already had a business model that impacted the […] SDGs'* and that there '*has been moderate contribution from BIO (except in the case of providing inputs for CSR activities to the MFIs) on the development of concrete processes, strategies or products that could further help enhance the impact on SDGs'*.

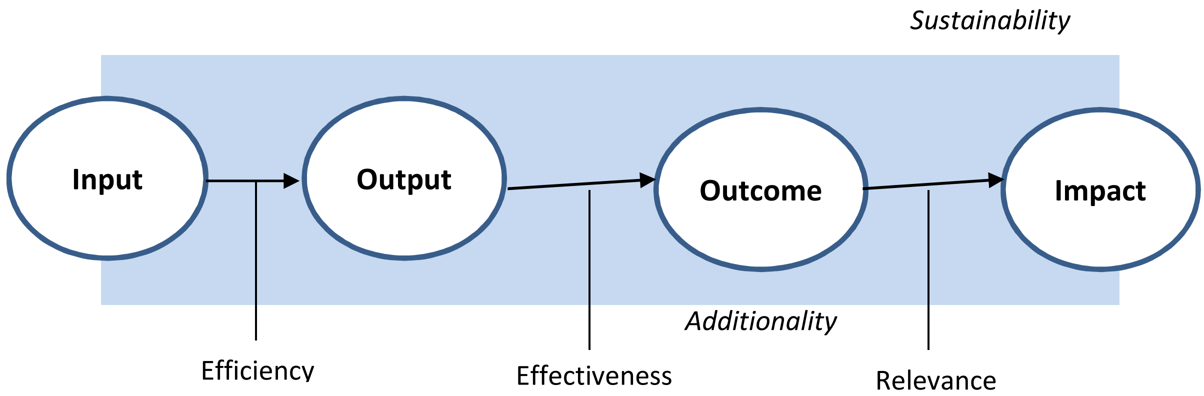
[1] The DAC Criteria for Evaluating Development Assistance are: Relevance, Effectiveness, Efficiency, Impact and Sustainability.

Response of BIO's management to the evaluation

We commend the Microsave team for the very thorough, nuanced and insightful evaluation – although we do think that at 175 pages, the report's length is an obstacle to its use[2].

It was the first time we had an external evaluation done by a team from the country in which the evaluated clients are based. While it can be more enriching that the evaluators are embedded in the national culture and speak the local language, for BIO it also meant spending much more time initially to explain the company and our interest in the evaluation, and to work with the evaluators to shape the evaluation.

We appreciate how the evaluators relate the various evaluation criteria – "efficiency", "additionality" etc. – to BIO's theory of change:



Appreciation as well for the distinction the evaluators make between a microfinance loan and a microbusiness loan, in the sense that the latter is a much better descriptor for BIO's central objective in investing in microfinance. The evaluation indicates that until around 2010, in India the focus was almost entirely on group lending, and that it was only after the 2010 loan reimbursement crisis that loans for microbusinesses started being specifically addressed. We acknowledge the evaluation's assessment that micro-business financing institutions need Technical Assistance to develop targeted business development encouragement strategies, and will develop efforts to sensitize our clients to the need for such strategies and to our willingness to support their development financially.

In discussions with the evaluators, one of the question we asked was whether they considered the interest rates our clients charge to their MSME investees to be excessive. Their answer was negative. Whereas at 36-44% per year before the 2010 crisis they were probably excessive, the cap introduced since then by the regulator has brought interest rates down to 17-26% today. Moreover, as more MFIs are transforming into micro-banks, which will enable them to take deposits and thus reduce their cost of funding, interest rates charged to their MSME borrowers will decrease further.

Finally, this external evaluation covers the largest investment period covered so far in external evaluations, starting from 2002 with BIO's initial investment in SREI, up until today. Such a long time range allows for a very meaningful assessment of the longer-term effects of BIO's financing.

Management response to the recommendations of the evaluation

We take note of the evaluation's general conclusion that "overall, BIO has been able to broadly achieve its investment objectives".

Following is our response to the recommendations as presented on pp. 71-73 of the evaluation report:

[2] . Our Terms of Reference asked for 40 pages excluding annexes, whereas the report sports 75 pages plus almost 100 pages of annexes.

- *More pro-activeness in identifying the target FIs:*

  Whereas the evaluators think that "BIO could be more pro-active in identifying the target financial institutions", because "it seems that most of the investee institutions came to BIO through other DFIs", we would disagree. On the basis of our general strategy for financial sector investments, the research commissioned in 2013 helped us clarify how to best apply this general strategy to India. Since then, we regularly undertake targeted prospection, also to enable us to better select among the many investment options offered and found. In fact, three of the evaluated investments (Annapurna, Fusion and Utkarsh) were the result of this targeted prospection and selection.
  In fact, the challenge is not to find investment opportunities, but to select those that best fit BIO's strategy and specific MSME financing objectives.

- *BIO's investments are generally small, limiting impact and decision-making*

  We disagree. As in general BIO's investments are higher-risk than those of other development finance institutions, and our total investment capital smaller, our average tickets, in particular in equity, may indeed be smaller than those of our colleagues, as a risk mitigation measure. But we also tend to invest in smaller-sized clients, so that our relative influence is generally not less than that of our colleague DFIs. In Annapurna and Fusion, for example, we initially held up to 20% of the shares (before being somewhat diluted by other shareholders coming in).
  Also, the significant growth in our investment means in recent years creates the possibility to increase our average tickets without a concomitant increase in risk relative to our total means.

- *BIO could have been a more active lead partner in case of private equity firms*

  The evaluators believe that BIO could have allowed PE funds longer investment and holding periods, and could have influenced other DFIs and General Partners to accept this.
  We disagree. When negotiating and deciding an investment, the investors in a fund and its manager agree on a comprehensive package of terms regarding the fund's investments and its management. When throughout the life of a fund, major events or developments would justify changes in this package, BIO and the other General Partners are generally willing to consider this. But otherwise, we believe that the agreed timings are a necessary incentive for both the Fund Manager and the investee-SMEs to perform as agreed and to keep the investment costs down.

- *Financial performance of one of the PE Funds was poor and effective monitoring, timely decisions and non-financial support may have helped.*

  We believe that working towards successful investing is first and foremost the responsibility of the Fund Manager: they are specialized and well-positioned to do so, that is why BIO invests in SMEs by means of PE funds and that is what we pay them for. BIO's role is monitoring and strategic advice, not the day-to-day follow-up of PE Fund activities.
  We do acknowledge that we can be more pro-active in proposing Technical Assistance grants. But for a PE fund, managing a TA facility is a lot of work that usually needs an additional dedicated staff to do so, to be paid at last in part out of a fund's management fee. Therefore, all-in-all the conclusion to heed is that BIO should make a point of discussing the desirability and possibility to set up an investee SME TA facility with PE funds during our investment assessment already.

- *BIO'S development objective not sufficiently determined at the time of investment and not systematically monitored.*

  This was certainly the case prior the introduction of BIO's development effects methodology early 2015. Most cases studied were investments contracted before the introduction of this new methodology, and their contracts indeed do not include the annual development reporting obligation. To compensate for this shortcoming, clients from before 2015 are being contacted case-by-case to report on specific development indicators. Since the introduction of the development assessment tool in 2015, dedicated development analyses are conducted as part of investment opportunity assessments and annual client reporting on the intended development effects is required.

- *Insufficient investee awareness of BIO's Technical Assistance facility*

  We agree that BIO's TA facility, the MSME Support Fund, can be better encouraged. At the end of 2017, staff of all portfolio clients have been sent an information leaflet on the Fund, and BIO's investment and portfolio officers are being encouraged to take the leaflet with them when going on missions.

- *As MFIs diversify and new Non-Banking Financial Institutions (NBFIs) emerge in the MSME lending domain, BIO may need to look at the wider range of institutions that are now working towards addressing the challenges of MSMEs on the one hand and on the other hand assess the impact of the dynamic market environment of its existing investee institutions.*

  We agree – while taking into account that even though new forms of MSME lending may initially seem adequate responses to unmet MSME financing needs, it is only over a number of years and in having to deal with unforeseen adversity that the quality and sustainability of such new lending forms can be judged.

Furthermore, the evaluators consider that '*the development impacts of BIO's interventions have been limited'* and that *'efforts towards developing a network of organizations that could support BIO's clients in addressing non-financial challenges could increase the level of focus on development objectives and allow for tangible measurement of these results'*.

Whether our development impacts "*have been limited*" or not depends on the perspective and expectations. Our perspective is that the 36+ mln € that BIO invested in the six institutions that were evaluated enabled several ten thousand loans to micro-businesses, enabling them in turn to offer goods and services, work and income, local and regional economic growth and development, tax income for public institutions etc.. This in turn generated considerable indirect economic activity. Although unfortunately a feasible and meaningful way to determine development *impact* has yet to be found, in particular because of the attribution challenge, we believe that our impact has been much less "limited" than the evaluators picked up with their evaluation methodology.

In fact, the evaluators seem to have been looking for specific BIO interventions towards its clients over the lifetime of an investment, that would have translated into directly attributable development impact. Our "theory of change" rather is that we prospect, assess and select those clients that, also thanks to our financing, can achieve the development effect that their investment proposal foresees, or can enhance the impact that they are already having. Besides financing, BIO can then further promote or enable this impact through its strategic and monitoring roles on an Advisory Board, through its encouragement to set up or improve an Environmental & Social Management System, through its encouragement to clients to define (better) and measure their development impact, to reference with the SDGs, etc. etc.
This "theory of change" implies that while our *direct* development impact may indeed be "limited" (and it's hard to imagine it any other way as a financier located in Brussels), our *indirect* impact, by means of our clients, strategic partnering etc. is highly significant, as this external evaluation demonstrates.

As to the evaluators suggestion to develop local investee support networks, having a deep country level involvement in different networks is not realistic due to BIO's size, internal capacity and non-country level presence. We could, however, encourage our clients to develop such networks (more) themselves, to support the investee MSMEs. Also, BIO is developing local presence pilots (in Western and Eastern Africa), as such local presence would indeed facilitate developing contacts with organizations that can support MSMEs in addressing non-financial challenges.

Management response to the evaluation’s lessons learnt and recommendations

The lessons learnt and recommendations of the evaluation focus on the key reasons for the success of the interventions, on how such success can be replicated in other projects, and on how performance might be further improved. Our response to these:^

I. *BIO’s investment limit for India is currently reached, whereas the size, needs and opportunities of the country would justify significant further investment and thus an adaptation of BIO’s investment limits.*

   India is the only one of the 52 countries eligible for BIO’s investments where we have indeed been nearing the investment limit of 10% of our total investment means. Therefore, we propose to maintain this general investment limit, while being open for an exception, if circumstances should indicate this to be appropriate. We generally receive many good proposals to invest in India that would easily enable to double or triple our portfolio in the country. But shouldn’t we aim for a more geographically balanced investment strategy?

II. BIO’s investment is perceived to be like any other DFI without any unique value proposition for the investees.

   If that is indeed the case, we do not *a priori* consider this problematic. DFIs operate on the basis of a common vision, mission and strategy, often co-invest and we do not consider ourselves to be in competition with our colleagues regarding (potential) clients.
   Still, we do think BIO, like other DFIs, has its UVPs, in that there is a varying degree of specialization among DFIs so as to better cater to various (potential) investees’ needs. BIO for example has a strong MSME focus, is promoting Environmental & Social Management Systems among MFIs, has been leading DFI harmonization on measuring Greenhouse Gas Emissions Avoidance, etc..
   This, by the way, led us to be the first DFI to invest equity in Annapurna and Fusion, at a time when these MFIs were still too small or immature for other DFIs to do so – clearly demonstrating that in these two cases at least, our MSME specialization led to a unique value proposition.

III. BIO has limited in-country presence that limits access to first-hand information about the country and the sector;

   We agree. As such in-country presence requires significant upfront expenditure which is justified only by a significant in-country portfolio, it is not economically feasible as long as a DFI is relatively small. But as BIO total assets are growing rapidly and approaching 1 bln €, we intend to pilot in-country presence in Western and Eastern Africa.
   In parallel, our strategy of progressive specialization on regions, sectors ad sub-sectors is enabling us to deepen our knowledge and understanding and thereby enhance the quality of our interventions.

IV. BIO’s investment are small compared to other DFIs;

   See above.

V. BIO’s long-term funding together with a mix of financial products (e.g. equity, long-term debt, etc.) is highly relevant with regard to improving the provision of financial services to MSMEs;

   We acknowledge this assessment and agree with the evaluators’ recommendation to expand such funding consider innovative financing model, in particular relating to fintech. This will be considered further in the review of our general investment strategy, later this year.

VI. *BIO's technical assistance grant facility is under-utilised;*

We agree, client awareness of our MSME Support Fund needs to increase and several efforts are being made since mid-2017 (information leaflet, direct contacting of clients, encouraging Investment and Portfolio officers to promote the Fund etc.). Still, it should be made sure that the Fund's use is not driven by BIO, but by clients' real priority needs and requests.
We do acknowledge the evaluators' finding that the client threshold for accessing BIO TA is high, that the application process is relatively complex and requiring extensive documentation, whereas FMO's TA approach is more pro-active and its TA is more easily accessible for clients. We will investigate how we can simplify and make our MSME Support Fund more easily accessible.

VII. *There is scope for more active support to SME investees of Private Equity Funds to further enhance development impacts of BIO's interventions;*

Certainly, but in first instance such support should be given by PE Fund Managers, not by BIO. These Fund Managers have a much more intimate knowledge of their SME investees and their support needs, are better placed to enable such support and are being paid by the PE Fund investors to do so. BIO's biggest opportunity is actually in its selection of Funds to invest in, in selecting those Funds whose investment propositions and Fund managers are most aligned with BIO's development objectives.
As mentioned above, we can at this stage discuss with PE Fund managers the establishment of a TA facility for their SME investees, with a dedicated staff person to manage this.
Once invested, BIO can indirectly support Fund managers in working towards these objectives through its participation in Boards or Advisory Committees, and by ensuring that Fund managers are aware of the possibility to apply for MSME Support Funding for TA for its investee MSMEs.

VIII. *The understanding of BIO's development objective among its investee institutions was limited. Also, the development objectives were not stated clearly at the time of investment. The awareness about the Development Assessment Tool is also limited among investees.*

See above.

Finally, the evaluators signal that BIO's Development Effects Methodology is not fully-aligned to the UN Sustainable Development Goals (SDGs). This is indeed the case and currently being addressed, whereby BIO has been encouraging all European DFIs to develop a common approach to the SDGs. The Development Effectiveness specialists of these DFIs have recently agreed to do so, and Germany's DFI DEG has taken the lead to work in this direction.

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