Ex Post-Evaluation Brief
South Africa: Promoting Small and Medium-Sized Enterprises

Programme/Client	Promoting Small and Medium-Sized Enterprises – BMZ No. 2001 65 704*	
Programme executing agency	A development bank in South Africa	
Year of sample/ex post evaluation report: 2011/2012		
	Appraisal (planned)	**Ex post-evaluation (actual)**
Investment costs (total)	EUR 30.67 million	EUR 30.67 million
Counterpart contribution (company)	---	---
Funding, of which budget funds (BMZ)	EUR 20.45 million EUR 10.22 million	EUR 20.45 million EUR 10.22 million

* random sample

Project description: A development credit facility was granted to a development bank (DB) in South Africa. This enabled the DB to refinance the business loans it provided to small and medium-sized enterprises (SMEs) in South Africa. The project objective was to make an effective contribution to improving the economic position of SMEs and thereby to help creating jobs and safeguarding employment. The credit line amounted to DEM 60 million, which was financed by DEM 20 million from FC funding and DEM 40 million from market funds (a total of EUR 30,677,512.87).

Objective: Overall objective: To improve the business situation for SMEs by providing investment loans. In doing so, the FC project aimed to contribute to economic growth, sector diversification and to building viable SMEs which would create jobs with long-term security.

Project objective: To provide lending to medium and small-sized enterprises on a sustainable and efficient basis at terms close to market conditions.

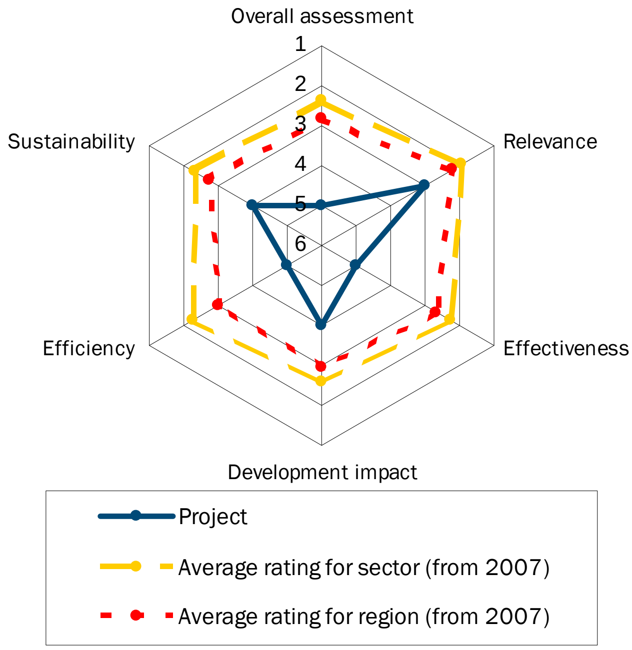
Target group: The project's target group comprised SMEs in the industrial and service sector with total fixed asset values between EUR 140,000 and EUR 10 million.

Overall rating: 5

The overall rating is poor because the loan default rate (25 % of total lending and 51 % of borrowing companies) is clearly too high. Some of the remaining portfolio is also at risk; overall, this causes serious difficulties for the provision of investment loans on a revolving basis. It is clear that sustainable employment can only be created if support is given to those SMEs that are already successfully established in the market.

Of Note: The project suffered from significant delays and unforeseeable events, including that the required government guarantee was not provided until 2007. Eventually, however, the DB assumed full liability for the FC funds. The funds were not disbursed until the second half of 2008 - i.e. just before the financial crisis - and were paid out as a supplementary financial assistance, with no means of monitoring. The DB's internal reforms only were taking hold after a large number of borrowers had got into difficulties.

Rating by DAC criteria



EVALUATION SUMMARY

Overall rating: Because loans were sometimes granted based on political criteria, because no systematic monitoring of borrowers was in place, and because the worldwide economic crisis that followed the global financial crisis had a negative impact on the South African economy, especially on the MSME sector, the default rate of loans granted was much higher than expected. Due to its lack of sustainability, the project has been assessed as being clearly insufficient. **Rating: 5**

Relevance: For SMEs in South Africa, access to lending remains limited. Although more of the population than ever before now has access to financial services (roughly 65 % at present compared to 25 % in 1994), for many of the country's inhabitants - particularly those living in rural areas - the situation remains unsatisfactory. It is similar for the provision of business loans: Not only micro, small and medium-sized enterprises (MSMEs), but also SMEs are scarcely seen as potential customers by the traditional banking sector that mainly focuses on securities. Numerous well-regulated microfinance organisations, as well as state development banks, are trying to fill this gap.

However, the DB was not the ideal partner for handling SME-financing, since their procedures for SMEs were similar to those for larger loans (their core business) and for share acquisitions. The DB had no department which was specialised in SME business, nor any procedure specifically designed for SMEs. Meanwhile, the DB has taken action in relation to their business activities and withdraw from the risky market areas (eg. franchising, construction companies), which in the past had particularly high NPL rate. In addition, the DB has made a number of structural and organizational changes. These improvements include the introduction of a Post-Investment Monitoring Department (PIMD), the establishment of a Business Support Unit, and the bundling of SME-activities by establishing an independent entity, the Small Enterprise Finance Agency (SEFA), founded as a result from the merger with a SME promotion agency and the DB's SME business unit. However, the DB was the only possible partner for SME loans above the level of microlending. Large business banks scarcely have any involvement in SME funding. This is also reflected in the fact that the DB has also received lines of credit from other multilateral development financiers (including the African Development Bank and the European Investment Bank), as well as additional credit lines from the German Financial Cooperation (FC). Sub-Rating: 3

Effectiveness: The following indicators were defined to measure the progress made towards the project objective: (1) the proportion of loans at risk (i.e. arrears > 180 days) in the DB's outstanding loan portfolio is less than 10 %; (2) the average proportion of new commitments made to SMEs, calculated over the project lifetime and expressed as a percentage of all the commitments, is increasing. As part of this evaluation the following benchmarks were also taken into consideration, since they were mentioned, albeit not explicitly as project objective indicators, in the project appraisal report: (3) the credit line has been fully disbursed within a maximum of three years, and (4) the rate of interest for end borrowers is no less than 2 % below the Prime Rate (i.e. aligned with interest rates in the market).

Due to the long absence of government guarantee (which was not issued until six years after the 2001 project appraisal), payments could not be made until the second half of 2008. The DB had to carry the default risk itself, as usual in many FC projects. No fresh assessment of the executing agency was undertaken at that time, nor any accompanying measure was introduced to improve the performance at the bank.

Via this credit line, the DB granted a total of 113 loans to SMEs in 11 different business sectors. Out of 113 borrowers, 32 (28.3 %) no longer exist. A further 25.7 % faced difficulties at the time of ex-post evaluation, and their survival is not assured.

Several reasons have let to this poor portfolio quality: Besides external factors, political pressure was a major driver: In the run-up to the 2010 Football World Cup (WC) competition so-called “WC 2010” construction companies were favoured in the extension of loans. Without these political guidelines and given the time constraints prior to the World Cup, many of these companies would not have been considered eligible to receive loans, due to their lack of qualifications or insufficient own financial contributions. Furthermore, the DB’s processes in the SME domain were unsuitable. Borrowers’ problems were not tackled through appropriate action, such as relevant monitoring measures and business support. The entire budget was rapidly disbursed within a six-month period - partly because loans being refinanced had already been granted - and therefore, a careful selection of good borrowers was not possible. Most of the firms were already customers, or payment had already been made and the FC credit was just used for refinancing. The negative effects of the global economic and financial crisis have further deteriorated the portfolio quality due to the fact that especially in South Africa many SMEs were, either directly or indirectly, seriously impacted by these global financial and economic turmoils.

Loans were granted to a very wide variety of business sectors; interest was charged according to the DB’s own individual assessment. At times it was above the target of “prime rate less 2 %” (up to + 2), and at times significantly below (down to - 5). This indicates that loans were granted at interest rates clearly beneath the market level, contrary to the original objective. The objective indicator “the average proportion of new commitments made to SMEs, expressed as a percentage of all commitments, is growing” is not conclusive and little meaningful. This is due to changes in the definition of SMEs, the lack of base data, and - most of all - the small proportion of SME financing compared to the DB’s total financing volume. This indicator has therefore played a minor role in the assessment of this project.

On a positive note, it is worth highlighting the modifications and organisational changes that have taken place at the DB since the loans were disbursed (e.g. the introduction of post-investment monitoring and business support). Today, certain types of customers (e.g. construction companies) would not receive SME loans from the DB[1]. This can be seen as an improvement; but it did not benefit the FC-financed line of credit. However, these modifications are not the result of the project itself. Sub-Rating 5

Efficiency: The DB is an important financier of SMEs in South Africa, but its loan portfolio is relatively small compared to its balance sheet. Large industrial shareholdings account for a major proportion of the balance sheet. Despite the bank's significance in the SME domain, it must be pointed out that, prior to the restructuring undertaken over the last three years (i.e. PIMD and business support), the DB did not have an established mechanism which focused on the SME market and was able in particular to deal with those borrowers who were in difficulties. Its Sector Business Units (SBUs) concentrated mainly on preparing and signing off new projects by sector. Supervising the existing portfolio - contrary to present practice - was neglected due to lack of resources and frequent personnel fluctuactions. For that reason, the PIMD and the Business Support Unit were founded. By the time these units were fully functional in 2010/2011, many SMEs had already become insolvent. Production efficiency can therefore no longer be considered as satisfactory. In view of the extremely high NPL rate and the lack of evidence of any positive impact on employment, allocative efficiency must also be rated as unsatisfactory. Sub-Rating: 5

Overarching developmental impact: This FC programme's development objective was to improve the economic situation for SMEs and to create jobs and other employment opportunities, especially for poorer strata of the population. The following indicators were defined to measure the progress made towards the overall objective: (1) two years after the start of the investment, profitability has improved at 80 % of those SMEs which received funding; (2) investments that were financed out of the FC credit line have created or safeguarded a total of around 1,500 jobs; and (3) 90 % of all those SMEs financed out of the FC credit line are still in existence three years after the new investments were commissioned.

Due to the high NPL ratio, the objective of creating or securing jobs was not achieved. In view of the high rates of overdue payments, the indicators which relate to company survival and profitability must also be considered as not having been met. Furthermore, because of the negative results described, scarcely any positive effects which were either sustainable or relevant to poverty were achieved in the SME sector. Nevertheless, without this credit line, job losses would probably have been even higher. Evaluation in the field did not identify a particular focus on especially disadvantaged groups of people. Sub-Rating: 4

Sustainability: In 2010, Fitch awarded the DB, which was still unrated in the year 2000, with a National Long-Term Rating of AA, primarily because of its implicit government guarantee (since the South African government owns 100 % of the DB). On 15th November 2011, Moody's downgraded its outlook from stable to negative, with a foreign currency is-

[1] E.g. loans were granted to franchisers, and franchisees were not individually assessed. Franchising companies would not receive loans today.

suer rating for the DB of A3 (good). Looking to the future, this institution will therefore remain an important component of the South African financial system.

As at October 2011, the DB had written off ZAR 74.5 million (roughly a quarter of the total loan amount). A total of ZAR 76.8 million remain outstanding, so about half has already been repaid. Out of a total of 113 borrowers, 32 (28.3 %) no longer exist. Some of the remaining portfolio is also at risk; a further 25.7 % faced difficulties at the time of ex-post evaluation, and their survival is not assured. Due to the negative results described, hardly any sustainable impact has been achieved, neither at the DB (despite the observed positive changes), nor at the SME level. It should be mentioned, however, that the organisational modifications introduced at the DB (described earlier under the heading of Efficiency), together with changing the selection criteria's, as well as the bundling of SME-activities within the SEFA, should contribute to better results from future credit lines. Sub-Rating: 4

Notes on the methods used to evaluate project success (project rating)

Projects (and programmes) are evaluated on a six-point scale, the criteria being relevance, effectiveness, efficiency and overarching developmental impact. The ratings are also used to arrive at a final assessment of a project's overall developmental efficacy. The scale is as follows:

1	Very good result that clearly exceeds expectations
2	Good result, fully in line with expectations and without any significant shortcomings
3	Satisfactory result – project falls short of expectations but the positive results dominate
4	Unsatisfactory result – significantly below expectations, with negative results dominating despite discernible positive results
5	Clearly inadequate result – despite some positive partial results, the negative results clearly dominate
6	The project has no impact or the situation has actually deteriorated

Ratings 1-3 denote a positive or successful assessment while ratings 4-6 denote a not positive or unsuccessful assessment

Sustainability is evaluated according to the following four-point scale:

Sustainability level 1 (very good sustainability) The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability): The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected).

Sustainability level 3 (satisfactory sustainability): The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability): The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and is very unlikely to improve. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The overall rating on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. Ratings 1-3 of the overall rating denote a "successful" project while ratings 4-6 denote an "unsuccessful" project. It should be noted that a project can generally be considered developmentally "successful" only if the achievement of the project objective ("effectiveness"), the impact on the overall objective ("overarching developmental impact") and the sustainability are rated at least "satisfactory" (rating 3).