International Finance Corporation
World Bank Group

MONITOR

Results Measurement for Investments

Are Profits Made at the Expense of Development Impact?

Financial performance of IFC's client companies is highly correlated with development outcome, as well as with environmental and social performance, private sector development impact, and economic performance.

Some observers believe there is a trade-off between a company's profitability and aspects of its development impact, such as its environmental and social performance. Using IFC investments as examples, we now put this to the test: what is the relationship between a company's financial performance, and how does it correlate with other areas such as environmental management, or private sector development? Is financial performance perhaps achieved at the expense of the environment?

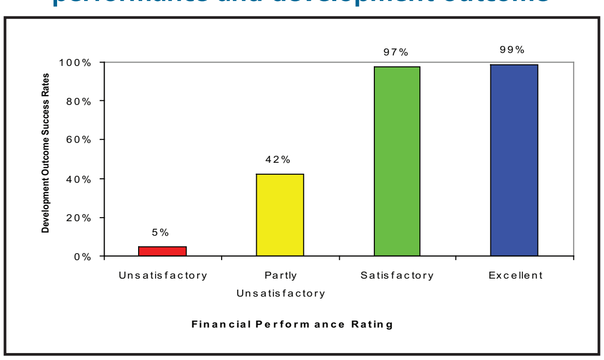
Notes on the analysis

We analyzed results from all active IFC investments that were approved between 1998 and 2003, a total of 469 companies. These investments are sufficiently mature to be adequately evaluated. Their results are tracked in IFC's Development Outcome Tracking System (DOTS). In addition, we drew on a recent study by IFC's Independent Evaluation Group (IEG), which analyzed 63 projects evaluated between 2004 and 2006 (and approved between 1999 and 2001). In addition, we draw on a 2006 analysis of financial and environmental and social performance indicators (relating credit risk ratings, non performing loans, and equity performance with environmental and social risk ratings).

Profits versus development outcome

Strong positive correlation. Financial performance of IFC's client companies is highly correlated with development outcome: over 97% of projects with satisfactory or excellent financial performance also have high development impact ratings, whereas only 5% of projects with unsatisfactory financial performance achieve high development outcome ratings. This finding is not surprising, as financial performance is a key component of how we measure development outcome, for good reason: a company that is not profitable will not be able to generate sustainable development results, nor attract the financing necessary simply to survive. To gain further insights, we look at the relationship between financial performance and the three other components of development outcome: a project's economic, environmental & social performance, and its private sector development impacts.

Figure 1: Strong positive correlation between financial performance and development outcome



IFC's project performance dimensions

In order to be considered a development success, an IFC project must:

- Be profitable (its financial return exceeds the average cost of capital),
- Generate benefits to society above and beyond those to its financiers (usually, the economic rate of return is expected to exceed 10%), and
- Be socially and environmentally sustainable (meet or exceed our performance standards).

We also assess a project's broader private sector development impact (e.g. a project's demonstration effects.)

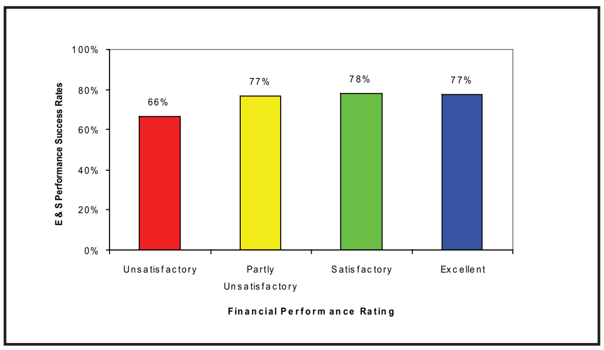
Measures of financial performance

Depending on the sector and project type, we assess a project's Financial Rate of Return (FRR), its Return on Invested Capital (ROIC), or its Return On Equity (ROE). In all cases, we expect successful projects' financial returns to exceed the company's cost of capital.

Profits versus Environmental and Social Performance

Positive relationship. The financial performance of IFC projects is positively correlated with their environmental and social (e&s) performance. We find that the environmental and social performance of IFC projects is consistently rated high in 78% and 77% respectively of investments with excellent and satisfactory financial performance. Projects in some financial difficulty – rated partly unsatisfactory – still display solid environmental and social performance. But where financial performance is unsatisfactory – generally projects in severe financial distress – environmental and social performance has suffered: only 66% of these projects have high e&s performance ratings. Moreover, this relationship holds stronger when assessing different indicators of financial performance: credit risk ratings, non performing loans and equity performance are strongly correlated with environmental and social risk ratings (ESRRs).

Figure 2:
Positive correlation between financial and environmental & social results



Measuring environmental & social performance

Environmental and social performance is one of four components of development outcome at IFC. We expect our clients to manage e&s risks pro-actively, and to meet or exceed our e&s Performance Standards. IFC tracks project e&s risk ratings (or ESRRs) throughout the project life. Significant e&s impacts, and an overall e&s performance rating based on the ESRR, are also tracked in DOTS.

- For a project to be considered satisfactory, a client is expected to meet or exceed IFC's Performance Standards. An excellent rating usually indicates significant environmental and social improvements or innovations.

E&S performance improvements pay off…

IFC's experience shows that (i) well managed companies tend to perform well on financial as well as on environmental and social matters; and (ii) companies with financial problems may lack the resources to continue to address environmental concerns adequately. For many of our projects we have evidence that client investments in e&s performance improvements pay off and result in significant savings.

Project example 1:
East European Cement Plant

IFC invested in a cement plant with a legacy of poor environmental management: prior to the investment, the project emitted high levels of pollution, negatively impacting the health of people and livestock, degrading soil and water and reducing the catch of local fishermen.

The plant owners implemented highly effective pollution prevention measures, benefiting the entire region. Emissions were reduced by over 98%, saving the plant operating costs of almost $173,000 net per year. The economic benefit was substantial: the net present value of benefits from environmental investments is estimated to be close to US$23 million.

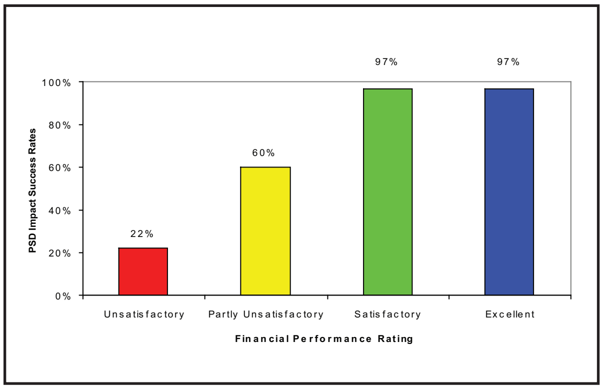
…while financial difficulties are often associated with weak e&s performance

An analysis of IFC portfolio companies with poor performance on both the financial and e&s dimension shows that IFC staff frequently attributed poor environmental and social performance to sub par financial performance. This correlation of poor financial and environmental & social performance holds across all industries. Reversely, as demonstrated by the case of the cement plant described above, proactive and effective management of environmental and social matters can positively impact financial performance. Profits are not made at the expense of environmental and social performance.

Profits versus broader private sector development impacts

Strong positive correlation. IFC projects show a strong positive correlation between financial performance and private sector development (PSD) impacts. This correlation is easy to explain: financially troubled businesses usually have difficulty fulfilling their immediate duties, to pay their workers, taxes etc, and are unlikely to have strong positive effects beyond company boundaries. High profitability, on the other hand, in itself sends signals to the market, and it creates space for innovation. A closer look at IFC portfolio projects with poor private sector development impact highlights the relationship: in 82% of cases poor PSD impacts were attributed to a project's commercial failure. By comparison, the next most common reason, negative demonstration effects, was cited in approximately 10% of cases.

Figure 3:
Strong positive correlation between financial and private sector development impacts



Measuring private sector development impact

In addition to a project's effects on its direct stakeholders, such as workers, local communities, or the project's financiers, IFC assesses its broader private sector development impacts. These can take many forms, such as:

- **Demonstration effects** – the project sends a signal to the market, other companies follow the example and offer a similar product, or make similar upgrades
- **Supplier upgrades** – a project that helps its suppliers upgrade the quality of their goods and services benefits other local companies that can now source local goods and services of higher quality

Project example 2:
Multinational Pharmaceutical Company – Middle East

A multinational generic pharmaceuticals manufacturer headquartered in the Middle East sought to expand international operations in the Middle East, North Africa, Europe, and Asia, while at the same time preparing for an Initial Public Offering (IPO) through upgrades in corporate governance. With this project, IFC aimed to help a Middle Eastern company increase its international presence, and send a signal to the market with high potential for positive demonstration effects.

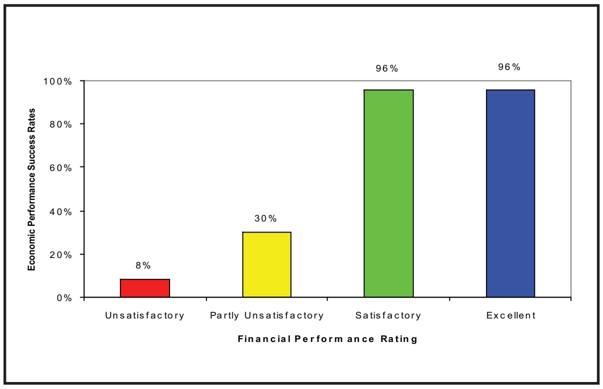
The project has been a great success. The company's revenues and net income surpassed forecasts by 42% and 159% respectively in 2005, with revenues further increasing by over 20% in 2006. In addition to achieving strong financial results, the company successfully listed on a major European stock exchange and demonstrated good corporate governance. For example, it publicly committed to international corporate governance standards, and appointed independent directors to two thirds of its board positions.

Profits versus benefits to society

Strong positive correlation. To calculate economic benefits, we calculate an economic rate of return (ERR) that accounts for costs and benefits to different project stakeholders. The economic performance rating in DOTS also accounts for qualitative impacts that cannot be valued in monetary terms. In the vast majority of IFC projects, economic benefits exceed project returns to financiers. Economic and financial returns are highly correlated: 96% of projects with satisfactory or excellent financial returns had high economic performance ratings, whereas only 30% of projects with partly unsatisfactory financial performance and a mere 8% of financially unsatisfactory projects achieved high economic ratings. This result is to be expected: IFC screens investments up-front to avoid investing in projects that are profitable at the expense of society, for instance by profiting from market distortions such as monopoly power or government protection.

To illustrate how this relationship works in practice, consider the construction of a new factory as an example. The construction will create jobs that may pay salaries and benefits above the local standard; the factory itself may generate new tax revenue or a new improved product to consumers. Financiers are the last to get paid: only once wages, taxes, supplies etc. are paid and accounted for, is a profit made. We should thus expect financial and economic performance to be closely related, and they are.

Figure 4:
Strong positive correlation between financial and economic performance



Measuring economic performance

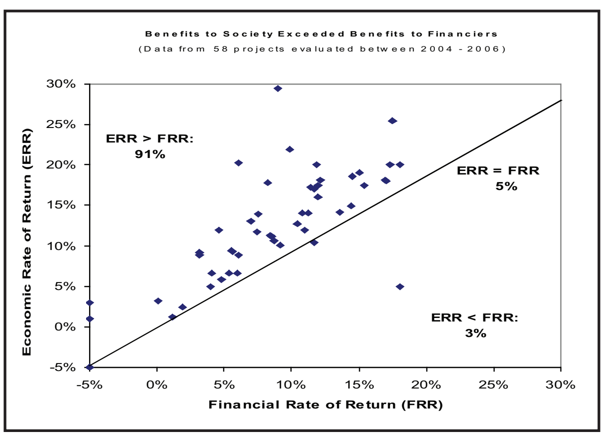
The benefit of an investment from society's standpoint, calculated as the economic rate of return (ERR), accounts for costs and benefits to all stakeholders impacted by the investment. For example, while tax payments constitute a cost to financiers they are merely a transfer to governments from the point of view of society. To be considered satisfactory, we typically expect the project's ERR to exceed 10%, although we also account for qualitative impacts that cannot easily be valued in dollar terms and accounted for as part of the ERR.

Project example 3: Telecommunications in Africa

To illustrate benefits to society, consider one of IFC's telecommunications investments in Africa. IFC made a senior loan and took an equity stake of 11% in a company that owned and operated a nationwide digital GSM cellular telephone network. Since IFC's investment, the company has enjoyed stronger than projected revenue growth, resulting in a return on invested capital (ROIC) of 25% in 2005. For the same time period, the economic return on invested capital (EROIC) was 41%. The high economic return reflects increased tax payments resulting from high project revenues. In addition, the company now employs over 500 people. Financial and economic performance go hand in hand.

The strong, positive relationship between the financial and economic rates of return bears out for IFC's portfolio overall: for 91% of IFC projects, societal returns exceeded returns to project financiers, and in only 3% of cases was the reverse true. A recent analysis of projects by IFC's Independent Evaluation Group (IEG) concluded that, on average, investors achieved returns of 13% in real terms, and returns to society overall amounted to 20%.

Figure 5:
Benefits to society typically exceed benefits to financiers



Society benefits from IFC investments

- **Financial Rates of Return (FRR)** measure financial performance in the form of returns to financiers of private sector investments.
- **Economic Rates of Return (ERR)** take the FRR as a basis but add benefits to other stakeholders (e.g. additional tax income for government), and subtract costs to other stakeholders (e.g. foregone import tariffs by government where the project produces previously imported goods locally).

Plotting Financial Rates of Return against Economic Rates of Return shows that in the vast majority of IFC projects – 97% – society benefits are equal to or superior to financial benefits.

Very high profits often bring larger than proportional benefits to society

For IFC projects we often observe that where the FRR is particularly high, the magnitude of society's benefits is many times larger, as can be observed in the graph above. The reverse does not hold true however: projects with low returns for their financiers can still provide significant societal benefits

Implications

It has been IFC's experience to date that the financial performance of our projects is highly correlated with other components of development outcome. IFC screens projects to ensure that projects that rely on market distortions such as government subsidies for their profitability are not supported, and among other requirements IFC clients must meet comprehensive environmental and social standards.

Our analysis supports the business case for responsible investment: sound environmental and social management and economic benefits are compatible with profitable business. In fact, profitability goes hand in hand with benefits to society such as new jobs and increased government revenue, and sound environmental and social management.

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