Annual Report 2010

Celebrating 5 years of fostering economic development and prosperity in Southeast Europe and the European Eastern Neighbourhood Region

Shaping and leveraging the new reality for the next 5 years and beyond
Words from our partners

"Apart from the EFSE’s commitment to supporting economic development, we appreciate the Fund’s efforts to foster the principles of Responsible Finance in Southeast Europe. The Bank of Albania will provide every support to the EFSE in promoting them in our country."

Ardian Fullani, Governor, Bank of Albania

"The EFSE is an outstanding role model in terms of simultaneously meeting the needs of public and private investors. Private investors like the BN&P Good Growth Fund can now participate in a well-managed and highly successful development initiative that achieves both social and financial returns for their stakeholders."

Andreas W. Korth, Initiator of the BN&P GOOD GROWTH FUND

"The EFSE has been very responsive to our needs and helped us to identify technical assistance opportunities that are instrumental in our strategy to enhance our institutional capacities. This proved crucial in successfully responding to the challenges in our market."

Sanin Campara, Chief Executive Officer, MIKRA

"Working with the EFSE is a great experience. In particular, we value the Fund’s speed and flexibility in providing a broad array of financial services."

Dragica Mihajlović, Head of Financial Management and Treasury Division, Member of the Executive Board, Banca Intesa Beograd
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Key figures 2010

Since its inception in December 2005, the EFSE has

* facilitated more than 255,000 micro and small enterprise and home improvement loans totalling EUR 1.3 billion;

* committed EUR 894 million in investments to partner lending institutions;

* allocated EUR 5.4 million to 141 capacity building, financial sector support and research projects;

* helped to secure and create approximately 265,000 jobs.

Key development performance, investment portfolio, and funding indicators

* Outstanding subloan portfolio: EUR 433.6 million

* Number of active sub-borrowers: 104,450

* Outstanding investment portfolio: EUR 664.4 million

* Number of partner lending institutions: 65

* Total investor commitments: EUR 758 million
Mission

The EFSE aims to foster economic development and prosperity in Southeast Europe and in the European Eastern Neighbourhood Region through the sustainable provision of additional development finance, notably to micro and small enterprises and to private households, via qualified financial institutions.

In pursuing its development mission, the EFSE observes the principles of sustainability and additionality, combining development and market orientation.

Shaping and leveraging the new reality

The EFSE has been in constant learning mode since its inception in December 2005, growing with micro and small enterprises, partner lending institutions, and investors. This process is shaping the way the EFSE operates going forward, leveraging its expertise, capital and market position for greater development impact.
Dear Investors and Partners,

2010 was another remarkable year for the EFSE, the European Fund for Southeast Europe – not only because it marked our 5th Anniversary. Bound from the outset to the principles of Responsible Finance, the Fund continued to ensure access to funding for micro and small enterprises in the target region, even and especially in these difficult post-crisis times. Innovative products and approaches further that goal: in 2010, the EFSE’s concept of a special local currency financing window for small and medium enterprises (SME) won the G20 SME Finance Challenge Award at the G20 summit in Seoul. This success testifies to the value of the Fund’s public-private partnership structure as a catalyst for strengthening the economic fabric of developing and emerging countries. It also explains why the EFSE model is being replicated around the world.

Some of our partner countries in the EFSE target region are still struggling in the aftermath of the global financial crisis. Due to their predominantly domestic market-oriented growth model, they face greater difficulties in overcoming the recession than Asian economies with export-driven growth models. While the recovery of the real economy remains sluggish, highly liquid financial institutions are aggressively competing for a comparatively smaller universe of customers with good credit. As banks adjust their business models and trend towards refinancing through local resources, good corporate governance is key to ensuring success and sustainability throughout the realignment process. Over the past five years, the EFSE has consistently fostered good corporate governance practices through Responsible Finance.

In 2010, the EFSE followed through on its strategy to strengthen the economic development in Southeast Europe and the Caucasus region, successfully widening its geographic scope to the European Eastern Neighbourhood Region with initial investments in Armenia, Azerbaijan, Belarus and Georgia. Here, the EFSE Development Facility, the Fund’s operational arm for institutional capacity building and technical assistance to partner lending institutions, contributes significantly towards a vigorous and stable regional financial sector.

As a learning organisation that strives to continuously improve its own processes and operations, the EFSE itself has also evolved throughout 2010. A new, streamlined fund structure, for instance, further increases private investor protection.

On behalf of EFSE’s Board of Directors, I wish to thank the EFSE’s public and private investors, the members of the EFSE Advisory Group, the Fund’s PLIs in the field, and last not least the dedicated staff of the EFSE’s service providers, for their continued commitment and support.

2010 was a great year, yet we face new challenges as a new economic reality unfolds. The EFSE looks forward to meeting these challenges with its partners in the spirit of Responsible Finance.

Sincerely,

Dr. Klaus Glaubitt
Board of Directors

Standing (from left to right): Syed Aftab Ahmed, Dominik Ziller, Dr. Christoph Achini, Michael Neumayr, Marc Schublin.
Seated (from left to right): Klaas Bleeker, Monika Beck, Dr. Klaus Glaubitt, Franz-Josef Flosbach.
The EFSE: a vital component of the growth strategy for Southeast Europe and further EU integration

Like other parts of the world, the countries in Southeast Europe were severely hit by the economic and financial crisis. They are now making their way out of the crisis, and the European Fund for Southeast Europe has proved an important partner for the European Union in its efforts to help overcome the crisis and foster economic and political integration. True to the principles of Responsible Finance, the EFSE contributed to the development of the local financial sectors and fostered economic development and prosperity.

A crucial element of the European Union’s Enlargement Policy is to strengthen the economies of our closest neighbours to pave the way for stabilisation and integration into the European economy. Attracting private sector investments with the help of the EFSE strengthens the local market economies and is a prerequisite for them to be able to cope with competitive pressures in the internal market.

I welcome the fact that the EFSE was able to expand into the European Eastern Neighbourhood Region through its European Eastern Neighbourhood Fund window, backed by the funding from the European Union Neighbourhood Investment Facility. 2010 was the year of the EFSE’s first investments in Armenia, Azerbaijan, Belarus and Georgia.

Over the coming year, the EFSE will continue to contribute to the Europe 2020 strategy, which is dedicated to the creation of high levels of employment, productivity and social cohesion. The EU counts on the EFSE’s continued commitment to the region and its valuable support to our Enlargement and Neighbourhood policies.

Štefan Füle
European Commissioner for Enlargement and Neighbourhood Policy
Building momentum in development finance

Much has been accomplished in 5 years. More to be done lies ahead.

2010 marked the 5th Anniversary of the European Fund for Southeast Europe. In just a few years, it has become one of the most successful chapters of German development policy. In times of drastic change and reluctant international capital, the EFSE remained committed to its target region and made sure small enterprises continued to obtain funding.

The success of the EFSE rests with its unique public-private partnership model. Other development finance funds even see it as a blueprint for leveraging public sector donations and mobilising private capital. The Federal Ministry for Economic Cooperation and Development (BMZ) has been a prime supporter of the EFSE from the day the public-private partnership idea was born, and its appreciation of the Fund is as strong as ever.

In 2010, the Fund reached out to the European Eastern Neighbourhood Region, investing in Georgia, Armenia, Azerbaijan and Belarus. We are also particularly proud that the EFSE won the G20 SME Finance Challenge Award. International recognition for a public-private partnership model ‘made in Germany’ yet again confirms the EFSE is on the right track.

The new reality requires creativity. The EFSE will continue to strive for innovation within the framework of Responsible Finance practices. Beyond investing, the EFSE is committed to funding technical assistance to partner lending institutions, and supporting the financial sector in adapting to a changing environment.

I am confident the EFSE, as one of the world’s largest development finance vehicles, will be effective in shaping and leveraging the new reality.

Dirk Niebel
German Federal Minister for Economic Cooperation and Development (BMZ)

A solid track record that sets the course

The European Fund for Southeast Europe has come a long way in 5 years. It is safe to say that the EFSE has exceeded expectations – not only with respect to geographic scope and investment volume, but also in terms of development impact and resilience in adversity. The global financial crisis was the acid test for its ability to ensure funding in target countries and maintain a healthy portfolio.

The strength of the EFSE’s public-private partnership structure translated into stability for the partner lending institutions who channelled EUR 1.3 billion to more than 255,000 end-borrowers. Also, active risk management made it possible to minimise impaired assets, with no realised losses so far.

Intensive and continuous dialogue on responsible business practices with all key stakeholders remains at the core of the Fund’s mission. As this is especially important to us in our role as the EFSE’s initiator and lead investor, we joined forces with the Fund to organise Responsible Finance conferences with central banks in the target region.

The EFSE’s technical assistance window, the EFSE Development Facility which is sponsored equally by public and private investors, has also been a strong driver in maximising the EFSE’s impact. It is proving exceptionally effective in institutional capacity building, and the portfolio of services to PLIs addresses end-borrower issues as well – educational booklets and television adverts to enhance financial literacy are just one example.

This holistic approach will define the way forward for the EFSE. All of us at KfW are confident as ever that the EFSE is well-equipped to meet future challenges and will remain a role model in development finance.

Dr. Norbert Kloppenburg
Member of the Executive Board of KfW Bankengruppe, Member of the Executive Board of KfW and Chairman of the Board of Supervisory Directors of KfW IPEX-Bank GmbH
More than a farmer, Dilaver Hysa, 43, is an agricultural entrepreneur. Born and raised in Mnik, a village just 8 miles west of Tirana, he was doing reasonably well selling milk and cheese at the market. Still, it was hard work: though very fertile, the land around Mnik was almost impossible to till efficiently without modern farming equipment. By 2007, farm revenues were just enough to keep his family in relative comfort – a tractor was simply out of the question. Realising that the other farmers were in the same situation, Hysa wondered: with a tractor, he could rent out ploughing, tilling, seeding, and all sorts of other services ... Before long, Hysa, who had never been to a bank before, presented his project to ProCredit Bank Albania, a specialised financial institution that focuses on providing banking services to very small and small enterprises in Albania’s private sector. The EFSE supports ProCredit Bank’s agricultural loans with a dedicated credit line. By 2010, Hysa was working 135 acres of land and able to buy two more cows, and put a down payment on a second tractor.
EFSE – a responsible investor

The recent international crisis led to a dramatic fall in banking activity and foreign direct investment in emerging and developing economies. In this context, the EFSE’s mandate to support and serve as a catalyst for long-term micro and small enterprise (MSE) finance as well as home improvement credit, both in Southeast Europe and in the European Eastern Neighbourhood Region, takes on its full meaning.

MSEs are at the heart of the economies in the EFSE’s target region. They are the main engines of growth, income generation and job creation, and thus require dependable access to funding from the formal financial sector. The EFSE supports this mainly by providing funds for on-lending through local partner banks and specialised microfinance institutions, and undertaking investments first and foremost on the basis of their developmental impact.

The EFSE fulfils its mandate through innovative financial solutions tailored to its partners’ needs, e.g. medium to long-term senior loans in foreign or local currencies, subordinated loans, guarantees, and equity participations. The EFSE Development Facility, partially funded by the EFSE, finances capacity building services – in the form of technical assistance, consulting and training – to partner lending institutions, thereby strengthening local financial sectors as well.

Besides energising private sector growth by supporting the financial sector, the idea behind the EFSE was to create a framework for regional cooperation and integration, one that would bring the target region’s countries closer to the European Union, and help to achieve stronger coherence and coordination of development activities in the region.

As the first public-private partnership initiative of its kind, the EFSE strikes a balance between commercial sustainability and development impact. In other words, it promotes the double bottom line of generating both financial as well as developmental returns. To achieve this, it delivers targeted, rapid and flexible support based on Responsible Finance principles.

All EFSE bodies and service providers share a passion for their work and are highly attuned to the requirements of the target region. The EFSE’s commitment to, knowledge of and proximity to the region and its people make it an internationally recognised model for responsible and market-oriented development finance.

In 2010, the EFSE remained true to its role as an advocate of Responsible Finance and borrower protection by fostering financial literacy among users of financial services, and promoting responsible financial products and practices. 2010 marks another year in which the EFSE’s finance activities and capacity building support have consistently demonstrated that development finance delivers more than solid dividends.
The public-private partnership: a blueprint for development finance

The EFSE was initiated five years ago by KfW (The German Development Bank) as a public-private partnership. The EFSE’s innovative fund structure and groundbreaking financial architecture enable the leveraging of limited public budgets to attract private funding for private sector development in Southeast Europe and the European Eastern Neighbourhood Region. Today, the Fund’s public-private partnership model is being replicated around the globe.

As at the end of December 2010, the EFSE’s group of investors comprised 33 international financial institutions, donor agencies and private investors, all sharing a common commitment to development. In 2010, the EFSE raised its capital by EUR 30.3 million (4.2%) to EUR 758.4 million, with the share of private funds amounting to 64.8%.

Total capital: EUR 758.4 million

Private capital: 64.8%

Public capital: 35.2%
A strong regional presence

The EFSE’s Fund Advisor, Finance in Motion, is committed to maintaining a strong presence within the Fund’s geographic reach, which includes the Southeast Europe and European Eastern Neighbourhood Region. Through Finance in Motion’s extensive network of regional offices and locally based experts, the EFSE remains both close to the market and well-equipped to meet any challenges head-on.

At the end of 2010, approximately 25 professional staff managed the Fund’s day-to-day operations in the EFSE’s target region, supported by over 40 professional staff at Finance in Motion’s main office in Frankfurt am Main, Germany.
It has been a particular privilege for us in 2010 to act as Fund Manager to the EFSE, and celebrate the first 5 years of the Fund’s operations. Another challenging year has passed for our partners in Southeast Europe and the European Eastern Neighbourhood Region, one that allowed us to demonstrate the importance of the Fund in responsibly and effectively advancing the financial sectors to foster economic development.

After a year of portfolio consolidation, the EFSE resumed steady growth in 2010. With a total volume of EUR 255.4 million, this has in fact been the EFSE’s strongest year in terms of new committed investments since its inception.

The start of investment activities in the European Eastern Neighbourhood Region (ENR), which significantly contributed to this year’s growth, is an important highlight. Approximately 38% of the total committed investments during the year were for partner lending institutions (PLIs) located in the ENR. At the same time, the EFSE remains committed as ever to its traditional target region, Southeast Europe. Here, the year has seen further portfolio diversification, with Bosnia and Herzegovina now sharing its historically pre-eminent position with Serbia.

As several markets in the target region are still struggling in the wake of the global financial crisis, and some PLIs are seeing their institutional capacities stretched, the qualitative dimension of the EFSE’s commitment to the region takes on an important role. Our extensive network of regional offices and professionals on the ground kept a finger on the pulse of our local partners, enabling us to maintain close and constant dialogue. In addition, the EFSE Development Facility has provided substantial technical assistance (TA) and training to PLIs under strain. Here, it is important to emphasise the rapid response time in designing and implementing these capacity building measures. In some cases, just a few days passed between identifying actual needs and fielding a consultant team. The EFSE Development Facility has also been at the forefront of high-impact research: its studies on over-indebtedness of end-borrowers, for instance, are internationally recognised as best practice and contribute to setting new industry standards.

Throughout 2010, the Fund Manager and Fund Advisor teams have further optimised the EFSE’s capital structure to ensure more efficient use of available risk capital. This process was closely coordinated with the Board of Directors and the shareholders who strongly promoted this quantum leap to a new quality of risk capital. These outstanding results would not have been possible without the EFSE’s PLIs, its efficient governing bodies, and the team of service providers to whom we owe our gratitude. The past year yet again demonstrated that the principles of Responsible Finance, which also include promoting financial literacy, transparent lending practices and balanced growth, are key to the development of a healthy financial sector. We are committed to further emphasising these principles going forward.

We look to 2011 with confidence, eager to contribute towards fostering job creation and prosperity in the EFSE’s target region.

Sylvia Wisniwski, Managing Director, Finance in Motion
Elvira Leifing, Managing Director, Finance in Motion
Florian Meister, Managing Director, Finance in Motion
Standing (from left to right): Elvira Lefting, Florian Meister, Sylvia Wisniwski.
Seated (from left to right): Johann Will, Max von Frantzius, Claudia Ploß-Dambax, Detlef Kröger.

Max von Frantzius,  
Managing Director, Oppenheim Asset Management Services

Claudia Ploß-Dambax,  
Senior Associate, Oppenheim Asset Management Services

Johann Will,  
Vice President, Oppenheim Asset Management Services

Detlef Kröger,  
Senior Associate, Oppenheim Asset Management Services
When she turned the sign over to “Closed” that evening in 2008, Luda Gharibyan felt it was not just for the day but for the last time. They had come such a long way; she and her husband, from selling groceries in the countryside on a wooden cart. For years they had set money aside, though always putting the health and education of their two children first, and one day they were able to open their own little shop in Yerevan. Things were finally looking up, when Luda suddenly became a widow. Though she seemed to manage at first, interest payments soon threatened to put her out of business. Shortly after that evening in 2008, friends told her about a new kind of bank that also offered better terms, especially for small businesses like hers. It turned out that ARARAT-BANK, an EFSE partner lending institution, could do much more; they helped her to restructure her finances with manageable interest rates, and provided valuable advice on growing her business. Now her two children are getting an education, and she’s ready to hire a clerk. And Luda is not only repaying her loan – the shop is such a success, she’s looking to expand.

Banking on solid fundamentals
Luda Gharibyan | Grocery store owner | ARARATBANK customer | Armenia

*Besides supporting a growing family with my own business, it’s being an important part of everyday life in our neighbourhood that gives me the greatest satisfaction.*

(Luda Gharibyan)
Highlights

More than 255,000 micro and small enterprise and home improvement loans since 2005
"We’re on our second greenhouse now and orders for our roses keep coming in! It starts with a passion, but making a dream come true takes hard work – and a good bank as partner."

Vardan Poghosyan | Flower grower | ARARATBANK customer | Armenia
2010 was an eventful year as well as an important milestone for the EFSE, marking five years of steady progress since its inception. The EFSE’s achievements in Southeast Europe and the European Eastern Neighbourhood Region point to a solid track record – and set the bar high for the future.
Highlights 2010

01 I December 2010
EFSE celebrates its 5th Anniversary in Vienna
By the end of December 2010, after just 5 years, the EFSE had facilitated more than 255,000 loans totalling EUR 1.3 billion to micro and small enterprises and private households – helping to secure and create some 265,000 jobs in the process. During this period, EUR 5.4 million were allocated to 141 capacity building, financial sector support and research projects.

02 I November 2010
EFSE wins G20 SME Finance Challenge Award
At the G20 summit in Seoul, US President Barack Obama, South Korean President Lee Myung-bak, and Canadian Prime Minister Stephen Harper presented the G20 SME Finance Challenge Award to the EFSE. A determining success factor of the Fund’s award-winning concept was its public-private partnership structure as one of the most effective models worldwide to catalyse private capital for micro, small and medium enterprises. The Fund’s entry won out of 345 submissions from 75 countries.

Highlights 2005 – 2009

2005 December EFSE incorporates in Luxembourg

2006 June EFSE Development Facility begins operations to support EFSE investment activities
Highlights 2010

03 I November 2010
First loan agreement in Georgia
The EFSE signed a US dollar 50 million loan agreement with the Bank of Georgia – the first to a Georgian financial institution for on-lending to micro and small enterprises as well as for home improvement loans.

04 I November 2010
Responsible Finance Conference in Tbilisi, Georgia
The National Bank of Georgia, KfW and the EFSE jointly hosted a conference on Responsible Finance and borrower protection in Georgia. Giorgi Kadagidze, the National Bank’s Governor, representatives of KfW and the EFSE, as well as noted finance professionals from the region all stressed the need for products, processes and policies that balance the interests of all stakeholders.

05 I June 2010
Initial investments in Belarus, Armenia and Azerbaijan
At its Annual Meeting in Ohrid, the EFSE reiterated its commitment to private sector growth in Belarus and the Caucasus region by signing loan agreements with two Belarusian banks, Belgazprombank and the Belarusian Bank for Small Business, and with Armenia’s Converse Bank, and Azerbaijan’s Bank Respublika.

2006 October EFSE establishes Advisory Group of Governors and Central Bank representatives

2007 February EFSE obtains LuxFLAG Microfinance Label

2007 March EFSE begins operations in Albania and in FYR Macedonia
06 | June 2010
4th EFSE Annual Meeting in Ohrid, FYR Macedonia
Over 250 guests from around the world gathered at the 4th EFSE Annual Meeting in Ohrid, FYR Macedonia. The key theme of Responsible Finance was addressed from the perspective of investors, commercial banks and microfinance institutions.

07 | May 2010
EFSE DF presents key agricultural finance study
The EFSE Development Impact Study on agricultural finance to farmers, agroprocessors and agrotraders covered six EFSE partner lending institutions (PLIs) in Albania, Kosovo and Moldova. One of the key findings was in stark contrast to the common belief that agricultural lending is risky: agricultural loans generally did not perform less well than loans to other sectors, and rural customers proved most committed and reliable. Over 80% of end-borrowers invested in fixed assets to improve productivity, which in turn increased profits and raised prosperity levels. It also showed that PLIs developed methods for agricultural loan analysis that do not require financial records and take into account non-traditional collateral.

08 | March 2010
Responsible Finance Conference in Tirana, Albania
The event, jointly hosted by the Bank of Albania, KfW and the EFSE, featured a panel discussion with financial sector experts, including the Bank of Albania’s Governor Ardian Fullani and Ridvan Bode, Albania’s Minister of Finance. The debate focused on customer protection in the financial services industry, and on the role of transparency and financial literacy in the relationship between banks and borrowers.
Investment operations in 2010

Ensuring continued access to finance for micro and small enterprises

2010 was the EFSE’s strongest year ever with regard to new commitments, underlining its strategy of maintaining access to finance for micro and small enterprises (MSEs). To many, uninterrupted funding was crucial in overcoming the persistent economic challenges in the wake of the global crisis. The EFSE signed 30 new investments in partner lending institutions (PLIs) totalling EUR 255.4 million – mainly for on-lending to MSEs as working capital or for investment purposes. Part of these funds went to private households as home improvement loans.

Focusing on balanced growth and employment generation

In view of the ever-growing importance of preserving current employment and creating new jobs, and the key role of MSEs in this process, the EFSE is dedicated to facilitating the provision of funding to MSEs on a large and regionally diversified scale as well as across all economic sectors. Whilst the manufacturing and service sectors continue to dominate with 49% of the EFSE’s MSE sub-loan portfolio, rural and agricultural lending now accounts for 17% of PLI onward lending. As economic development and job creation largely depend on reliable and long-term funding, the EFSE remains committed to providing attractive credit facilities. In 2010 the EFSE’s terms averaged 6 years for loans destined to MSEs and 7 years for those meant to private households for home improvement, with PLIs on-lending at 1 to 3 years to MSEs and at 5 years and more to households.

Accompanying MSE growth

With 83% of all sub-loans disbursed not exceeding EUR 10,000, the focus is on microfinance. Complementary to this, the EFSE continued to promote and aid the graduation process from MSEs to small and medium enterprises by working with PLIs, especially banks, to provide seamless finance solutions up to a sub-loan limit of EUR 100,000. In this segment, the EFSE registered higher demand in 2010 from PLIs for refinancing as well as specialised training support to both maximise growth opportunities and professionally address the multi-faceted challenges of growing enterprises.

Expanding into the European Eastern Neighbourhood Region

In addition to consolidating long-term relationships with PLIs, as evidenced by repeat investments and long-term technical assistance projects, the EFSE has been able to broaden its client base, adding 12 new PLIs in 2010. This was in line with the EFSE’s intended strategic expansion into the European Eastern Neighbourhood Region (ENR). A dedicated ENR finance window signed 17 investments totalling EUR 95.9 million and accounting for 38% of overall investment commitments in 2010.

Promoting local currency lending

The EFSE committed several local currency loans to assist PLIs in preventing foreign exchange risks, in particular to micro loan customers. The EFSE’s participation in the Currency Exchange Fund (TCX) enables the Fund to hedge local currency financing. Together with other stakeholders, the Fund is also looking into additional innovative instruments dedicated to local currency lending. For 2011, the EFSE intends to maintain the high investment volume whilst stepping up local currency funding and promoting rural and agriculture finance.

1 TCX was established in 2007 by a group of international financial institutions and investors, including the EFSE, to reduce foreign exchange risk in development finance through local currency financing.

At a glance

New territories in 2010: Armenia, Azerbaijan, Belarus and Georgia

Number of investments signed in 2010: 30

Investment volume signed in 2010: EUR 255.4 million

Highlights

2007 June EFSE begins operating in the Republic of Moldova

2007 October Responsible Finance Conference in Belgrade, Serbia

2007 November EFSE enters Romania
Selected EFSE investments in 2010

Expanding micro and small enterprise lending in Georgia

In Georgia, where the economic recovery is still in the process of gaining traction, micro and small enterprises (MSEs) remain key to sustainable and employment-led growth.

The EFSE has partnered with the Bank of Georgia, providing EUR 21 million for on-lending to MSEs in urban and rural areas. The facility serves to address increased demand for longer term finance, and will enable the bank to branch out and deepen its MSE portfolio. While MSEs can borrow up to EUR 100,000 under this facility, average loan size is expected to be closer to EUR 20,000, which will benefit 3,500 MSEs over the life of the EFSE’s loan.

As one of the country’s leading financial institutions with an extensive branch network, Bank of Georgia is an established and efficient platform for MSE finance. With a balance sheet totalling EUR 1.7 billion in 2010, the Bank of Georgia accounts for approximately 36% of the domestic lending market.

Fostering local currency financing in the Republic of Moldova

Though exchange rate fluctuations are a strain for the economy, especially for micro and small enterprises (MSEs), local currency funding is still in short supply in the Republic of Moldova. Reducing the foreign exchange risk for MSEs, and thus their vulnerability to global economic fluctuations, is an integral part of Responsible Finance. Given the key role of MSEs in growing the economy, particularly in rural areas, access to local currency finance is crucial to achieving sustainable growth. In 2010, the EFSE provided a synthetic local currency (MDL) loan equalling EUR 5 million to ProCredit Bank Moldova (PCBM) for on-lending to MSEs. This loan followed a synthetic local currency facility equalling EUR 2 million as part of a syndication arranged by the European Bank for Reconstruction and Development in December 2009.

PCBM is expected to leverage 2,000 loans to MSEs over the facility’s lifetime, and to further bolster the financial sector by firmly implanting local currency funding. PCBM currently serves 10,500 very small and small enterprise borrowers.

Supporting microfinance institutions in Bosnia and Herzegovina

Both microfinance institutions (MFIs) and micro borrowers in Bosnia and Herzegovina have been particularly hard hit by the global crisis. Rising unemployment, declining household incomes, and only weak signs of an economic recovery as evidenced by high intra-company indebtedness, combine to make the prospects for micro enterprises all the more difficult. The country’s MFIs, crucial to providing access to finance to very micro entrepreneurs and marginalised parts of the population, also in remote locations, are helping borrowers to reduce debt and reschedule loans. Leading MFIs, including MI-BOSPO, Partner and EKI, have joined forces in setting up a debt counselling centre with the support of the EFSE and other sponsors.

While the crisis revealed the negative effects of increased competition for market share among MFIs, the need for financial services tailored to MSEs as well as for dedicated and specialised institutions to cater for them remains. It is even more pronounced now given the capital and loss absorption constraints faced by MFIs.

The EFSE, a significant lender to MFIs in Bosnia and Herzegovina, stays committed to strengthening the country’s financial sector through investments and targeted technical assistance. Mikrofin, the country’s largest MFI, for instance, received EUR 8.5 million for on-lending in 2010, with further funding in 2011.

2007 December
* EFSE Development Facility receives first private grant from German lessor VR Leasing

2008 January EFSE invests in TCX to promote local currency lending in target region

2008 May 2nd Annual Meeting in Sibiu, Romania
2010 remained a challenging year for banks and microfinance institutions (MFIs) in the EFSE’s target region: many were still struggling to reach pre-crisis profitability, improve loan portfolios, or simply to solve basic liquidity problems. True to its mission of institutional capacity building, the EFSE Development Facility (EFSE DF) focused on supporting partner lending institutions (PLIs) with preventative and corrective technical assistance (TA). MFI’s directly benefitted from hands-on consulting in credit and delinquency management, asset liability management (ALM) and business planning. In selected markets, the EFSE DF also spearheaded projects to support consolidation efforts in the MFI sector.

Responsible Finance remained at the top of the agenda throughout 2010. In Albania and Georgia, for instance, the EFSE DF and KfW – The German Development Bank – joined the central banks of these countries in organising conferences on Responsible Finance. One research project dealt with the risks of foreign currency loans, resulting in an educational booklet that has proved very effective in raising awareness among final borrowers. In one specific case, the EFSE DF helped secure funding for the Centre for Financial and Credit Counselling in Bosnia and Herzegovina. Finally, the very positive response to the EFSE DF’s study on over-indebtedness in Bosnia and Herzegovina on the part of the development finance community at conferences in Astana, Prague, Berne, and Washington only reinforced the added value the EFSE DF represents to the Fund and its investors. A similar study was launched in Kosovo at the end of 2010 to broaden the research scope and gain additional insights in another market.

In 2010, the EFSE DF approved 28 projects totalling approximately EUR 1 million for TA & training, research & development, and sector-specific activities in 2010. PLIs share in the costs: on average about 30% for TA projects. In terms of geographic scope, Bosnia and Herzegovina accounted for 46% of the total EFSE DF budget. MFIs were main beneficiaries, as they were hit hardest by the global financial crisis. No fewer than 500 staff members (including top and middle management as well as loan officers) at 13 PLIs directly benefitted from training and coaching as part of the EFSE DF’s capacity building measures.

The EFSE DF’s activities are financed by Fund profits and grants from the Danish International Development Agency (Danida), the Netherlands Development Finance Company (FMO), the Austrian Development Bank (OeEB), and the Swiss Agency for Development and Cooperation (SDC).

In 2011, the majority of EFSE DF projects will continue to focus on TA tailored to PLI needs. The plan is also to launch a series of research and development initiatives as well as selected sector support measures. The focus here will be on post-crisis institutional restructuring, Responsible Finance, foreign and local currency lending, rural and agricultural finance, consolidation and transformation as well as small and medium enterprise lending.

At a glance

- **Number of projects approved in 2010:** 28, including 4 studies
- **Total volume of projects in 2010:** EUR 1,024,096
- **Number of partner lending institutions supported in 2010:** 13, including 8 microfinance institutions and 5 banks

---

2008 July 1st investment in Bulgaria – loan agreement with ProCredit Bank Bulgaria

2008 September BN&P Good Growth Fund first retail fund to join EFSE as private investor

2008 September Investment portfolio passes EUR 500 million mark
Some EFSE Development Facility projects in 2010

Transforming microfinance institutions in Bosnia and Herzegovina

The recent financial crisis clearly demonstrated that sector consolidation among microfinance institutions (MFIs) through mergers or transformations is of key importance for securing a sustainable institutional platform to provide access for finance to micro enterprises. In Bosnia and Herzegovina, for instance, a number of MFIs have already taken steps to either undergo transformation or merge with other financial institutions. In 2010, the EFSE DF provided hands-on support to three major MFIs in Bosnia and Herzegovina with a detailed feasibility study on the possibilities of a merger and transformation. The EFSE DF also advised another MFI in assessing the possibilities of gradually transforming itself into a microfinance bank to enable the financial institution to provide deposit-taking services and tailor-made finance to growing micro businesses. A third project was launched in late 2010 to support one of the market’s smaller niche players in evaluating strategic development options available for achieving its mission while operating on a financially sustainable basis. These are only three examples of projects in the EFSE’s geographic area, but they effectively illustrate how the EFSE DF, by thinking and acting locally, is a pivotal component of the Fund’s strategy to foster local financial sectors and institutions. By strengthening institutional capacities, the EFSE DF ultimately helps to make the process of providing comprehensive financial services to micro and small enterprises much more transparent and effective.

On the frontline of applied research in finance

The EFSE Development Facility’s applied research activities are central to the EFSE’s role as a pioneer in development finance. The insights gained in micro and small enterprise (MSE), agricultural and small and medium enterprise (SME) finance, as well as in the area of Responsible Finance, not only serve to measure the Fund’s impact, but also to identify new trends and opportunities. In 2010, for instance, the EFSE DF conducted an innovative study on over-indebtedness of microcredit clients in Bosnia and Herzegovina, one of the first studies to document debt levels among low-income bank customers. Recognising the importance of this issue, the study was expanded to Kosovo in late 2010, and a similar study is planned for Azerbaijan as well. The EFSE DF tackled another hot topic: the risk of foreign exchange lending. In November, the EFSE won the G20 SME Finance Challenge Award, with much of the credit going to the EFSE DF for its findings on MSE to SME graduation patterns. In 2010, the EFSE DF also published its third EFSE Development Impact Study, this one on the effects of agricultural finance on farms and other agricultural MSEs in Kosovo, Moldova and Albania. This type of finance is also important for development in other countries, such as Ukraine, and the EFSE DF will conduct a similarly comprehensive study there in 2011.
Metalika Volf, founded 140 years ago and run by the 4th generation of Volfs, brothers Zoran and Goran, is a thriving, ISO-certified manufacturer of carbon, graphite and metal products. The company prides itself in offering job security and the best workplace conditions. However, Metalika Volf’s business had been affected by the global financial crisis. Customers were defaulting on payments, while suppliers of crucial raw materials insisted on punctual payments.

The market situation was at its worst when, in 2009, the Volfs happened to open an account with Komercijalna Banka. The bank, as the first EFSE partner lending institution in Serbia, was providing the type of micro and small enterprise finance that was scarce at the time of the crisis. As the conversation turned to the Volfs’ business, it became clear that all the company needed was a loan to tide it over – just the kind of credit facility the EFSE and Komercijalna Banka were cooperating on. Very soon, Metalika Volf was back on track and growing at a rate of 30% per year.

Building on a tradition of growth
Zoran and Goran Volf | Manufacturers of carbon and metal products | Komercijalna banka Beograd | customers | Serbia

Weathering the financial crisis was one thing, preserving jobs was quite another. Not only did we manage both – we actually started hiring again, too.

(Zoran Volf)
At the core of strong performance and high impact: sound governance and execution.
"I used the loan for a new sewing machine, and now I’m able to provide a better life for my family."

Nejira Hasić | Tailor shop owner | MI-BOSPO customer | Bosnia and Herzegovina
Over the last 5 years, the EFSE has been in a constant learning mode, driven by rapid economic, political and societal change in the region, and by growth from a four to a fourteen-country fund. The EFSE’s unique experience, specialisation and strong governance create an opportunity, but also an obligation, to remain innovative and dynamic in terms of the Fund’s development mission, and maintain its attractiveness to investors.

This section looks back at the changes and challenges the EFSE faced in 2010 at the level of the sub-borrowers of the Fund, i.e. MSEs and private households, at the level of its PLIs and its investors. It provides the perspective for properly shaping the Fund’s operations going forward as well as leveraging, in every sense of the word, its expertise, capital, position and impact. As this requires transparent and responsible decision making, this section also highlights the essentials of the EFSE’s governance.

At the sub-borrower level
Traditionally, the EFSE target region has shown high levels of unemployment, with Bosnia and Herzegovina as well as Kosovo taking the lead with an official jobless rate exceeding 40%. The financial and subsequent economic crisis further exacerbated this situation. In parallel, the enterprise sector has undergone important changes in recent years. Overall, there has been a strong increase in the number of enterprises, reflecting a (still) significant portion of informal sector activities. Concomitantly, the small enterprise sector has shown dynamic growth across the EFSE’s target region, including a considerable number of micro enterprises that have graduated into small and medium sized enterprises (SMEs). The Fund mirrors these developments in that the sub-loan portfolio generated by its PLIs shows that more than 84% of all loans disbursed to MSEs continue to be for amounts below EUR 10,000, yet the share in volume terms of loans above the micro threshold of EUR 10,000 and up to EUR 100,000 increased to 65% by year-end 2010. Given that SMEs are considered important job creators, the Fund’s increasing support in this area is essential. The EFSE’s Development Facility recently commissioned an SME access to finance study to obtain further insights into the dynamics of the different sub-segments of the EFSE’s enterprise target group, and the ways in which the EFSE could further support economic growth and employment creation.

In line with other leading international research, a notable effect on reducing high unemployment is expected in the years to come if
SMEs are properly supported through finance. While lack of access to finance is mentioned by many SMEs as a main impediment to their business activities, the well-developed microfinance sector led to a massification of microcredit to micro enterprises but also to private households. More than 130 microfinance institutions (MFIs) are operating in the EFSE’s target countries, serving around 2 million clients. Bosnia and Herzegovina, Azerbaijan and Armenia lead the region by portfolio size and number of customers. Strong growth of the microfinance sector in terms of portfolio volume and client outreach, however, has also started to show its downsides. Aggressive competition in already well served markets has led to lax credit checks, in some instances, cross-lending and ultimately over-indebtedness, whilst areas of rural finance, agricultural finance and needs-based enterprise finance versus supply-based enterprise finance\(^1\) have not yet sufficiently been addressed. The EFSE has been a pioneer in researching the topic of over-indebtedness and demand analysis to facilitate a corrective action plan for the sector. It is noteworthy that the portfolio at risk over 30 days ratio for the entire sub-loan portfolio of the EFSEs MFI partners capped at 8.3% in 2010 and is progressively coming down, indicating adequate responses and measures by the MFIs as well as substantial write-offs. Furthermore, the EFSE has been active in promoting preventive strategies, e.g. by launching financial education campaigns in several countries in close partnership with PLIs. The EFSE also helped to establish the first debt counselling centre in Tuzla in Bosnia and Herzegovina, and will continue to support similar initiatives on mitigating the effects of over-indebtedness as well as dealing with some of the contributing causes, for example by assisting with the establishment or improvement of credit bureaus, and advancing on MFI sector consolidation.

**At the PLI level**

By 2010 the economies in Southeast Europe and the European Eastern Neighbourhood Region had recovered only slightly from the sharp contraction in 2009, when GDP declined by an average of 3.4% in the region, spiking at 14% and 15% in Armenia and Ukraine, respectively. Accordingly, demand by enterprises and private households for loans from financial institutions remained at a low level in 2010, while financial institutions generally coped with deteriorating loan books, leading to both increased risk aversion as

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\(^1\) Supply-based finance: here, the terms and conditions of financing provided to sub-borrowers and the delivery mechanisms for it are driven by MFI constraints and limitations rather than by the actual nature of demand.
well as a structural review of target clients and product offerings. In
2010 loan portfolios of the Fund’s PLIs increased by 6.5% on aver-
age, with MFIs showing a 19% decrease versus a 16.5% increase
in bank lending volumes. Increasing intra-company indebted-
ness, disrupted payment cycles in the public and private sectors,
over-indebtedness of households driven by excessive consumption
finance – these are phenomena that both MFIs and banks had to
and still have to deal with. This also applies to the EFSE. An ever
stronger correlation between the difficult state of most economies
and the financial sector is becoming evident. It has implications for
ratings and financial strength assessments, and consequently on
refinancing options for banks and MFIs. In this context the Vienna
Initiative, a decisive cross-boarder crisis resolution framework
to ensure that parent banks commit to maintain their exposures and
recapitalise their subsidiaries, proved its vital importance, as did the
regional coordination of National Banks.

Given the above, the increase of portfolio at risk over 30 days in
the region’s financial institutions overall and the Fund’s PLIs is not
surprising, peaking at an average of 11.7% for 2010. At the same
time, we see a significant portion of restructured loans, averaging
7.5% for the Fund’s PLIs. Setting aside the efforts of financial
institutions to minimise impairment losses and hence pressure
on capital, we can see a clear tendency on the part of banks and
MFIs alike to stand by their borrowers, enabling them to handle
cash flow problems induced by worsening payment discipline
and limited demand. Such a strategy, however, eventually requires
additional capital as well as stable and patient funding sources for
the long term. This is particularly true in times when capital has
either withdrawn completely or its availability is both very limited
and short-term in nature. These developments have contributed
to the EFSE realising its strongest year ever, with EUR 255.4 mil-
ion of new funding committed in 2010 alone, and disbursements
reaching EUR 196 million. As demand from small companies
recovered faster, and banks were able to restart lending sooner,
the Fund allocated a predominant share of its funding in 2010 to
this purpose. For 2011 the expectation is that leading MFIs will
be able to consolidate their position to adequately meet the micro
enterprise demand in terms of structure and scope of funding
required. The Fund will focus on such MFIs and continue to assist
sector consolidation by providing tailored technical assistance to
the respective stakeholders involved.

An important task for the Fund and its Advisor team has been to
work with a small number of PLIs where the financial and/or insti-
tutional strength came under significant pressure. In these cases
a comprehensive approach is required to safeguard the Fund’s
assets, protect the value of the institution and respect the interests
of other stakeholders involved. The Fund’s Advisor team has
worked hand in hand with the Fund’s Investment Committee and
its Development Facility to tailor a strategy for assisting each PLI in
overcoming its difficulties, and to coordinate action with other debt
providers where applicable. The Fund and its Advisor team will
continue to play a leading role in such restructurings where needed
and is cognisant of the importance of its proximity to PLIs and the
markets to be successful.

In line with the previous year, demand for technical assistance
provided by the EFSE Development Facility has further increased
among PLIs in 2010, especially in the areas of risk management
as well as in overall business and strategy planning and product
development. To support the progress of PLIs and that of
the financial sectors overall, the EFSE will continue to address sector
and regional issues with a special focus on over and cross-indebt-
edness of enterprises, enabling agriculture finance, Responsible
Finance, and client education and the link between employment
creation and SME finance.

At the investor level
As a consequence of the financial crisis, investors have become
much more aware and sensitive with regard to transparency to
correctly assess the risk-return profile of their investments. The
EFSE has always applied Responsible Finance practices with its
investments, operating in a very transparent manner and promot-
ing the highest standards in managing its investor relations. In
recent years, the EFSE has participated in all relevant industry ini-
tiatives to enhance the Fund’s credibility among investors. Since its
inception, the EFSE regularly reports to Mixmarket and participates
in the annual CGAP MIV and Microrate surveys. The EFSE was
also among the first Luxembourg microfinance investment funds
to obtain the LuxFLAG label, and among the first signatories of the
SMART campaign.

Representatives of the Fund Advisor participated in international
work groups on harmonising social performance criteria, which are

2009 December Responsible Finance Conference in Sarajevo, Bosnia and Herzegovina

2009 October 1st investment in Ukraine – loan agreement with MEGABANK
Shaping and leveraging the new reality

The key to successfully shaping the new reality resides in strengthening the financial institutions that fuel growth through credit as well as the framework in which they are operating.

What are the EFSE’s key success factors?
For one, its public-private partnership structure: scarce public funds are used in a revolving manner and serve at the same time to mobilise private capital. It so effectively leverages public sector contributions that it's become a blueprint for many other funds. Regional diversification, scale and our broad investor base also make us more robust in times of turmoil. Specialisation in micro and small enterprise finance, with strong links to local stakeholders, further adds to our robustness. Then there is the EFSE’s comprehensive approach: institutional capacity building is just as important as funding.

What differentiates the EFSE from other development funds?
Our extensive network of regional offices, for instance, and the fact that our staff speaks the same language as our partners. We also have shareholders from our target region, and the EFSE's Advisory Group strengthens economic cooperation and provides valuable guidance for our activities. Most important, certainly, is the EFSE Development Facility whose activities are financed through public and private funds. It provides hands-on support in capacity building to our partner lending institutions, and promotes Responsible Finance and positive change at the sector level. Its applied research arm tracks our performance but also informs our investment decisions. The Facility is highly effective in increasing outreach to micro and small enterprise borrowers and mitigating investment risks.

How does the EFSE promote Responsible Finance?
Since its inception five years ago, the EFSE has striven to set the example in Responsible Finance. We focus on good governance and avoid businesses that are questionable, be it environmentally or socially. We organise conferences on Responsible Finance throughout the region, and work on enhancing financial literacy and raising credit risk awareness with end-borrowers. Transparency is key, naturally, and information on all of the EFSE’s activities is readily available on our website.

Monika Beck, Member of the EFSE Board of Directors and Investment Committee, Chairwoman of the EFSE Development Facility and Head of Financial and Private Sector Development, KfW Entwicklungsbank

now internationally referred to as environmental, social and corporate governance principles (ESG principles). In order to enhance transparency, the EFSE has further expanded its quarterly reporting to shareholders and noteholders. Furthermore, the EFSE regularly offers on-site investor tours at each EFSE Annual Meeting to afford a hands-on look into the EFSE’s markets and partners. With the aim of continuously improving the Fund’s structure and operations, the shareholders, after one year of preparation, approved an optimised capital structure at the end of 2010. This marks a quantum leap towards a more streamlined and efficient use of risk capital, and underlines the EFSE Board of Director’s and the Fund Management team’s joint commitment to constant innovation. Implementing the highest standards of good corporate governance has been a key element in attracting investors over the years.

A comprehensive approach towards energising development finance

2009 December Geographic scope expanded to Armenia, Azerbaijan, Belarus and Georgia

Monika Beck, Member of the EFSE Board of Directors and Investment Committee, Chairwoman of the EFSE Development Facility and Head of Financial and Private Sector Development, KfW Entwicklungsbank
They had the contacts, some savings, and that was how Ina Melniciuc and Alexandru Gheletea got into business for themselves and founded Mirsan Ltd. fifteen years ago in Chisinau, Moldova’s capital. The niche they had identified was in sourcing and trading wood for local furniture makers. One day, while holidaying in Austria, the solid yet economical furniture in her hotel room got Ina thinking that they could also manufacture furniture, instead of just trading in wood. She ran the idea by Alexandru, and soon enough their business experienced its first major step change. Their relationship with Moldova Agroindbank was excellent, but until then there had been no need for significant credit, and getting into the manufacturing business was surely going to require capital. As an EFSE partner lending institution, however, the bank was in a perfect position to accompany and support Mirsan in this new chapter of its growth. And there would be more to come. Today, Mirsan still trades in wood. It also manufactures wooden furniture and doors as well as kitchens, and now also iron gates and fences. From initially a staff of two, they are now up to 20 – and growing.

Growing with the local market
Ina Melniciuc and Alexandru Gheletea
Furniture manufacturers
Moldova Agroindbank customers
Moldova

“The great thing about creating your own business and having a financial partner is being able to seize new opportunities when they arise – and see it all become a success.”

(Ina Melniciuc)
* 03
Operational results and development impact

265,000 jobs secured and created since 2005
“Going into business on our own wasn’t easy, but development funding helped to make it a success. Today, we’re creating jobs and making a profit. And my father is very proud.”

Givi Gachechiladze I Metal parts manufacturer I Bank of Georgia customer I Georgia
## Balance sheet

*In EUR as at 31 December 2010*

### Assets

<table>
<thead>
<tr>
<th>Description</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross loans to partner lending institutions</td>
<td>660,039,388</td>
<td>573,735,608</td>
</tr>
<tr>
<td>Un-amortised discount</td>
<td>-7,088,800</td>
<td>-10,789,389</td>
</tr>
<tr>
<td>Impairment allowances</td>
<td>-5,673,000</td>
<td>-394,941</td>
</tr>
<tr>
<td>Loans to partner lending institutions</td>
<td>647,277,588</td>
<td>562,551,278</td>
</tr>
<tr>
<td>Interest accruals on loans</td>
<td>7,044,148</td>
<td>6,985,510</td>
</tr>
<tr>
<td>Cash at bank</td>
<td>21,447,265</td>
<td>59,049,751</td>
</tr>
<tr>
<td>Equity investments</td>
<td>4,345,304</td>
<td>4,350,584</td>
</tr>
<tr>
<td>Other receivables</td>
<td>1,773,321</td>
<td>141,016</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>681,887,626</strong></td>
<td><strong>633,078,139</strong></td>
</tr>
</tbody>
</table>

### Liabilities

<table>
<thead>
<tr>
<th>Description</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes</td>
<td>101,508,129</td>
<td>169,039,711</td>
</tr>
<tr>
<td>Payables resulting from interest on notes</td>
<td>590,050</td>
<td>277,817</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>4,193,392</td>
<td>2,311,671</td>
</tr>
<tr>
<td>Distribution to holders of redeemable ordinary shares payable</td>
<td>6,859,010</td>
<td>7,173,133</td>
</tr>
<tr>
<td>Withholding tax payable</td>
<td>1,716,158</td>
<td>1,687,585</td>
</tr>
<tr>
<td>Other payables</td>
<td>18,428,638</td>
<td>749,119</td>
</tr>
<tr>
<td><strong>Total liabilities excluding net assets attributable to shareholders</strong></td>
<td><strong>133,901,638</strong></td>
<td><strong>181,239,036</strong></td>
</tr>
<tr>
<td>A Shares</td>
<td>209,192,023</td>
<td>152,711,174</td>
</tr>
<tr>
<td>B Shares</td>
<td>88,645,135</td>
<td>88,645,135</td>
</tr>
<tr>
<td><strong>Net assets attributable to holders of redeemable ordinary shares (A/B Shares)</strong></td>
<td><strong>297,837,158</strong></td>
<td><strong>241,356,309</strong></td>
</tr>
</tbody>
</table>

**Equity (C Shares)**

<table>
<thead>
<tr>
<th>Description</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net assets attributable to holders of redeemable ordinary shares (A/B Shares)</strong></td>
<td><strong>297,837,158</strong></td>
<td><strong>241,356,309</strong></td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td><strong>681,887,626</strong></td>
<td><strong>633,078,139</strong></td>
</tr>
</tbody>
</table>
### Income statement

In EUR as at 31 December 2010

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income on loans</td>
<td>27,810,418</td>
<td>33,694,887</td>
</tr>
<tr>
<td>Interest income on deposits</td>
<td>128,133</td>
<td>437,792</td>
</tr>
<tr>
<td>Net change in discount amortisation</td>
<td>3,700,588</td>
<td>4,133,881</td>
</tr>
<tr>
<td>Realised and unrealised gain on derivatives</td>
<td>1,613,750</td>
<td>1,497,594</td>
</tr>
<tr>
<td>Realised and unrealised gain on exchanges</td>
<td>5,249,388</td>
<td>1,377,428</td>
</tr>
<tr>
<td>Other income</td>
<td>2,903,042</td>
<td>2,303,232</td>
</tr>
<tr>
<td><strong>Total investment income</strong></td>
<td>41,405,320</td>
<td>43,444,814</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense on notes</td>
<td>2,481,914</td>
<td>6,642,010</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>11,543,061</td>
<td>10,329,535</td>
</tr>
<tr>
<td>EFSE Development Facility</td>
<td>1,067,495</td>
<td>1,113,431</td>
</tr>
<tr>
<td>Realised and unrealised loss on derivatives</td>
<td>3,362,792</td>
<td>1,670,947</td>
</tr>
<tr>
<td>Realised and unrealised loss on exchanges</td>
<td>4,528,903</td>
<td>2,990,518</td>
</tr>
<tr>
<td>Loan loss allowance</td>
<td>5,278,059</td>
<td>394,941</td>
</tr>
<tr>
<td>Other expenses</td>
<td>554,475</td>
<td>620,625</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>28,816,699</td>
<td>23,762,007</td>
</tr>
<tr>
<td><strong>Operating profit before tax</strong></td>
<td>12,588,620</td>
<td>19,682,807</td>
</tr>
<tr>
<td><strong>Withholding tax on interest income</strong></td>
<td>1,108,173</td>
<td>2,664,832</td>
</tr>
<tr>
<td><strong>Increase/decrease in net assets attributable to holders of redeemable ordinary shares and equity from operations</strong></td>
<td>11,480,447</td>
<td>17,017,975</td>
</tr>
<tr>
<td><strong>Other comprehensive income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net gain/loss on available-for-sale financial assets</td>
<td>-5,280</td>
<td>418,259</td>
</tr>
<tr>
<td><strong>Total comprehensive income for the year, net of tax</strong></td>
<td>11,475,167</td>
<td>17,436,234</td>
</tr>
</tbody>
</table>
# Cash flow statement
In EUR as at 31 December 2010

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating profit before tax</strong></td>
<td>12,588,620</td>
<td>19,682,807</td>
</tr>
<tr>
<td><strong>Adjustments for:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Un-amortised discount</td>
<td>-3,700,589</td>
<td>2,443,146</td>
</tr>
<tr>
<td>Impairment allowances</td>
<td>5,278,059</td>
<td>394,941</td>
</tr>
<tr>
<td><strong>Operating profit before working capital changes</strong></td>
<td>14,166,090</td>
<td>22,520,894</td>
</tr>
<tr>
<td><strong>Loan agreements</strong></td>
<td>-86,303,780</td>
<td>-51,223,642</td>
</tr>
<tr>
<td>Net increase/decrease in other accrued income</td>
<td>-58,638</td>
<td>2,060,768</td>
</tr>
<tr>
<td>Net increase/decrease in other receivables</td>
<td>-1,632,305</td>
<td>1,273,846</td>
</tr>
<tr>
<td>Net increase/decrease in accounts payable and accrued expenses</td>
<td>2,193,954</td>
<td>243,619</td>
</tr>
<tr>
<td>Net increase/decrease in other payables</td>
<td>17,679,002</td>
<td>486,566</td>
</tr>
<tr>
<td>Withholding tax on interest income</td>
<td>-1,079,600</td>
<td>-977,247</td>
</tr>
<tr>
<td>Distributions paid to holders of redeemable ordinary shares</td>
<td>-10,820,493</td>
<td>-11,892,011</td>
</tr>
<tr>
<td><strong>Cash flow used in operating activities</strong></td>
<td>-65,855,770</td>
<td>-37,507,207</td>
</tr>
<tr>
<td><strong>Cash provided by financing activities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash received on notes issued</td>
<td>2,651,740</td>
<td></td>
</tr>
<tr>
<td>Cash paid on notes redeemed/matured</td>
<td>-67,531,582</td>
<td>-</td>
</tr>
<tr>
<td>Cash received on shares issued</td>
<td>120,030,516</td>
<td>55,099,074</td>
</tr>
<tr>
<td>Cash paid out on shares redeemed</td>
<td>-24,852,428</td>
<td>-</td>
</tr>
<tr>
<td><strong>Cash flow provided by financing activities</strong></td>
<td>27,646,506</td>
<td>57,750,814</td>
</tr>
<tr>
<td><strong>Net increase/decrease in cash and cash equivalents</strong></td>
<td>-38,209,264</td>
<td>20,243,607</td>
</tr>
<tr>
<td><strong>Opening cash and cash equivalents</strong></td>
<td>59,049,751</td>
<td>38,806,144</td>
</tr>
<tr>
<td><strong>Closing cash and cash equivalents</strong></td>
<td>20,840,487</td>
<td>59,049,751</td>
</tr>
</tbody>
</table>
Both the number and volume of subloans were down for the year due to the post-crisis drop in lending by partner lending institutions. However, subloan portfolio performance began to improve in the last two quarters.

<table>
<thead>
<tr>
<th>Subloan portfolio outstanding by product</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subloan portfolio to end-borrowers (EUR millions)</td>
<td>434</td>
<td>446</td>
</tr>
<tr>
<td>Micro and small enterprise loans – urban/rural</td>
<td>334</td>
<td>350</td>
</tr>
<tr>
<td>Housing loans, including housing energy efficiency loans</td>
<td>100</td>
<td>96</td>
</tr>
<tr>
<td>Number of active end-borrowers</td>
<td>104,450</td>
<td>115,590</td>
</tr>
<tr>
<td>Micro and small enterprise loans – urban/rural</td>
<td>93,811</td>
<td>104,061</td>
</tr>
<tr>
<td>Housing loans, including housing energy efficiency loans</td>
<td>10,639</td>
<td>11,529</td>
</tr>
<tr>
<td>Average subloan amount outstanding (EUR)</td>
<td>4,152</td>
<td>3,862</td>
</tr>
<tr>
<td>Total subloan volume disbursed (EUR millions)</td>
<td>275</td>
<td>352</td>
</tr>
<tr>
<td>Micro and small enterprise loans – urban/rural</td>
<td>245</td>
<td>330</td>
</tr>
<tr>
<td>Housing loans, including housing energy efficiency loans</td>
<td>30</td>
<td>22</td>
</tr>
<tr>
<td>Total number of subloans disbursed</td>
<td>40,802</td>
<td>68,477</td>
</tr>
</tbody>
</table>
Subloan disbursements by economic sector in 2010 – micro and small enterprise (MSE) loans

Year to date as at 31 December 2010

Agriculture, industry and production still represent the main customer base for micro and small enterprise finance.

Throughout 2010, the EFSE maintained its focus on facilitating micro and small enterprise loans.

Subloan disbursements by product in 2010

Based on volume of subloans disbursed

Year to date as at 31 December 2010

Based on number of MSE subloans disbursed

Based on volume of MSE subloans disbursed
Subloan disbursements by loan purpose in 2010 – micro and small enterprise (MSE) and housing loans

Based on volume of subloans disbursed
Year to date as at 31 December 2010

The share of micro and small enterprise (MSE) subloans for mixed purposes was up in 2010, raising the average amount of MSE subloans.

Subloan disbursements by loan size in 2010 – micro and small enterprise (MSE) and housing loans

Year to date as at 31 December 2010

Subloan amounts to micro and small enterprises (MSEs) trended upward compared to 2009. In contrast, average loan size of rural MSE loans dropped slightly over the same period.

Subloan portfolio outstanding by currency

Based on volume subloan portfolio outstanding
As at 31 December 2010

While 62% of subloans were disbursed in euros, 38% were on-lent in local currency. The latter’s share is expected to increase over coming quarters due to increased local currency lending in the target region.
Despite the scope and severity of the global financial crisis, development funding picked up at the first signs of recovery. This resulted in stronger investment portfolio growth for the Fund.

The portfolio distribution by financial instrument remained basically unchanged compared to the previous year.
Investment portfolio outstanding by country
As at 31 December 2010

Southeast Europe (SEE)

- Serbia: 20% (EUR 134.6 million)
- Bosnia and Herzegovina: 10% (EUR 68.5 million)
- Montenegro: 9% (EUR 58.9 million)
- Kosovo: 7% (EUR 49.4 million)
- FYR Macedonia: 5% (EUR 35.3 million)
- Albania: 5% (EUR 32.6 million)
- Bulgaria: 4% (EUR 29.0 million)

European Eastern Neighbourhood Region (ENR)

- Moldova: 8% (EUR 51.0 million)
- Georgia: 4% (EUR 25.3 million)
- Belarus: 2% (EUR 14.9 million)
- Ukraine: 1% (EUR 7.5 million)
- Armenia: 1% (EUR 5.2 million)
- Azerbaijan: 1% (EUR 1.5 million)

Supra-Regional: 3% (EUR 19.0 million)

Compared to 2009, 2010 saw further portfolio diversification in geographic terms due to the start of investment activities in Belarus and the Caucasus region. Bosnia and Herzegovina and Serbia are still the two largest, equally strong foci of EFSE funding.

Investment portfolio outstanding by product
Based on volume of investment portfolio outstanding
As at 31 December 2010

- Micro and small enterprise loans (urban): 74%
- Micro and small enterprise loans (rural): 4%
- Housing loans: 21%
- Housing energy efficiency loans: 1%

The majority of the EFSE investment portfolio remains targeted at micro and small enterprises.
The share of US dollar investments increased significantly due to strong investment activities in the European Eastern Neighbourhood Region, where several markets are largely dollarised.
EFSE continued the long-term partnerships with its partner lending institutions (PLIs) and welcomed 12 new institutions in 2010, holding 65 active PLIs in its portfolio.

### Southeast Europe

**As at 31 December 2010**

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Albania</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Credins Bank, Banka Kombetare Tregtare</td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>ProCredit Bank Albania</td>
</tr>
<tr>
<td>Microcredit organisations</td>
<td>Opportunity Albania</td>
</tr>
<tr>
<td><strong>Bosnia and Herzegovina</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Fima Banka, Intesa Sanpaolo Banka Bosnia and Herzegovina, NLB Tuzlanska Banka, NLB Razvojna Banka, Nova Banka Banja Luka, Raiffeisen Bank Bosnia and Herzegovina, UniCredit Bank, Volksbank Bosnia and Herzegovina</td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>ProCredit Bank Bosnia and Herzegovina</td>
</tr>
<tr>
<td>Microcredit organisations</td>
<td>MCC Mikrofin, MCC Sinergija Plus, MCF EKI, MCF MI-BOSPO, MCF Mikra, MCF Mikro Aldi, MCF Sunrise, Partner MCF</td>
</tr>
<tr>
<td><strong>Bulgaria</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Raiffeisenbank Bulgaria</td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>ProCredit Bank Bulgaria</td>
</tr>
<tr>
<td><strong>Kosovo</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>NLB Prishtina, Raiffeisenbank Kosovo</td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>ProCredit Bank Kosovo</td>
</tr>
<tr>
<td>Microcredit organisations</td>
<td>FINCA Kosovo, KEP Trust, KRK</td>
</tr>
<tr>
<td><strong>FYR Macedonia</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>IK Banka, NLB Tutunska Banka, TTK Banka</td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>ProCredit Bank Macedonia</td>
</tr>
<tr>
<td><strong>Montenegro</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Crnogorska Komercijalna Banka, Erste Bank Podgorica, NLB Montenegrobanka, Hipotekarna Banka</td>
</tr>
<tr>
<td>Microcredit organisations</td>
<td>Alter Modus, MFI AgroInvest</td>
</tr>
</tbody>
</table>
### Romania

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>68.5</td>
</tr>
<tr>
<td>Banca Comerciala Carpatica, Banca Transilvania</td>
<td></td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>ProCredit Bank Romania</td>
</tr>
<tr>
<td>Microcredit organisations</td>
<td>Opportunity Microcredit Romania</td>
</tr>
<tr>
<td>Non-bank financial institutions</td>
<td>BT Leasing</td>
</tr>
</tbody>
</table>

### Serbia

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>134.6</td>
</tr>
<tr>
<td>Cačanska Banka, Komercijalna Banka, Privredna Banka, Banca Intesa Beograd</td>
<td></td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>Opportunity Bank, ProCredit Bank Serbia</td>
</tr>
<tr>
<td>Non-bank financial institutions</td>
<td>ProCredit Leasing</td>
</tr>
</tbody>
</table>

### European Eastern Neighbourhood Region

**As at 31 December 2010**

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>5.2</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Converse Bank, Araratbank</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>1.5</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Bank Respublika</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>14.9</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Belgazprombank</td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>Belarussian Bank for Small Business</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>25.3</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Bank of Georgia</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moldova</td>
<td>51.0</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>FinComBank, Banca Sociala, Moldova Agroindbank</td>
</tr>
<tr>
<td>Microfinance banks</td>
<td>ProCredit Bank Moldova</td>
</tr>
<tr>
<td>Microcredit organisations</td>
<td>MFO Microinvest</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>7.5</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Megabank</td>
</tr>
</tbody>
</table>

### Supra-Regional

**As at 31 December 2010**

<table>
<thead>
<tr>
<th>Country/Partner lending institution</th>
<th>Investment portfolio outstanding (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supra-Regional</td>
<td>19.0</td>
</tr>
<tr>
<td>Non-bank financial institutions</td>
<td>ProCredit Holding, TCX</td>
</tr>
</tbody>
</table>
Investment portfolio outstanding by type of partner lending institution

Based on volume of investment portfolio outstanding
As at 31 December 2010

- 12 Commercial banks (large) 38%
- 23 Commercial banks (small and medium) 30%
- 10 Microfinance banks 18%
- 16 Microcredit organisations 10%
- 4 Non-bank financial institutions 4%

The share of commercial banks in the EFSE’s investment portfolio increased throughout 2010.
**Funding**

**Committed funds from investors**
As at 31 December 2010

The solid growth shows the strong commitment and trust from investors.

**Investor commitments by investment class**
As at 31 December 2010

EFSE continued to expand its investor base: 4 new private institutional investors joined the Fund in 2010.

<table>
<thead>
<tr>
<th>Investment class</th>
<th>Volume (EUR millions)</th>
<th>Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes</td>
<td>102</td>
<td>13 %</td>
</tr>
<tr>
<td>A Shares</td>
<td>294</td>
<td>39 %</td>
</tr>
<tr>
<td>B Shares</td>
<td>95</td>
<td>13 %</td>
</tr>
<tr>
<td>C Shares</td>
<td>267</td>
<td>35 %</td>
</tr>
<tr>
<td>Total</td>
<td>758</td>
<td>100 %</td>
</tr>
<tr>
<td>Subscribed</td>
<td>649</td>
<td></td>
</tr>
</tbody>
</table>
**Investors by type of investment class**

As at 31 December 2010

**Notes**
Deutsche Bank, Sal. Oppenheim, Omidyar-Tufts Microfinance Fund, ESPA VINIS Microfinance, other private investors

**A Shares – Senior Tranche**
KfW, IFC, OeEB, FMO, EIB, EBRD, NORD/LB Horizont Fund, The Waterloo Foundation, BN&P-Good Growth Fund, other private investors

**B Shares – Mezzanine Tranche**
IFC, FMO, EBRD, KfW, EIB, OeEB, Finance in Motion, BN&P-Good Growth Fund

**C Shares – Junior Tranche**
Government of Germany (BMZ), European Commission (with European Investment Fund and KfW as Trustees), Republic of Albania, Government of Switzerland (SDC), Government of Austria (ADA), OeEB, Government of Denmark (Danida)
The EFSE Development Facility, founded in 2006, supports the EFSE’s partner lending institutions through capacity building projects. Projects in 2010 focused on credit risk and delinquency management, promotion of Responsible Finance, transformation of microfinance institutions, business and product development, risk management and asset-liability management, and agricultural finance.
Since 2006, the EFSE Development Facility has carried out a total of 141 capacity building, financial sector support and research projects with 37 different partner lending institutions, in 10 target countries.

Since the EFSE Development Facility’s inception in 2006, a substantial share of its financing has stemmed from the Fund’s profits.
In 2010, Joni Mamasakhlisi was making plans to acquire a second building for additional machinery to make plastic window frames, hiring his fifth employee, and looking to buy a lorry to speed up deliveries. The business is doing so well that Mamasakhlisi can donate windows and doors to churches, send his two sons to a school where they can learn English, and provide more attractive payment terms to some of his customers. The latter is no doubt due to the fact that he can empathise: barely five years earlier Joni Mamasakhlisi had returned from Russia, disillusioned because of the lack of job opportunities. There was no business then, just him, a shack with a band saw, and the burning desire to do right by his young family – and a skill for making window frames. His work soon earned him a solid reputation, and with that came greater demand for his products. And to continue meeting it, he needed to expand. The Bank of Georgia, an EFSE partner lending institution, has been at Joni’s side every step of the way. The bank, specialised in development funding of the type Joni requires, is playing a pivotal role in fostering prosperity in Georgia.
Organisational structure

EFSE Development Facility

Initiator and Lead Investor

General Shareholder Assembly
- Board of Directors
- Advisory Group
- Investment Committee

EFSE Development Facility Committee

Fund Management
- Management of the EFSE Development Facility

Custody and Fund Administration

Citi

Qualified Partner Lending Institutions
- Commercial Banks
- Microfinance Institutions
- Others

Regiona Offices
- Investment
- Transaction Management
- Technical Assistance/Training

Micro and Small Enterprises

Private Households
EFSE Network
www.efse.lu

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Liebchen + Liebchen GmbH (www.lplusl.de)

Photographs
Peter Großlaub, www.trendshots.com
EFSE Advisory Group

The EFSE Advisory Group to the Board of Directors comprises representatives from Central Banks in the target region. The Advisory Group provides EFSE with better linkages to local markets, shares local experiences and makes recommendations to the Fund Management and the Board of Directors with regard to Fund policies and operations.

The Advisory Group is comprised of representatives from the following Central Banks:

- Central Bank of Bosnia and Herzegovina
- Central Bank of Montenegro
- Central Bank of the Republic of Armenia
- Central Bank of the Republic of Azerbaijan
- Central Bank of Kosovo
- National Bank of Albania
- National Bank of Georgia
- National Bank of Moldova
- National Bank of the Republic of Belarus
- National Bank of the Republic of Macedonia
- National Bank of Romania
- National Bank of Serbia
- National Bank of Ukraine

Investment Committee

From left to right: Michael Neumayr, Monika Beck, Syed Aftab Ahmed, Karlo de Waal.

EFSE Development Facility Committee

- Monika Beck
- Kristin Duchâteau
- Hans Ramm
- Marit Vet/Raymond Wever
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June 2011

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