Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 13-Jul-2022 | Report No: PIDC33883

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Parent Project ID (if any)	Project Name
Kazakhstan	P174995		Kazakhstan MSME Financing, Digitalization, and Greening for Sustained Productivity (P174995)
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
EUROPE AND CENTRAL ASIA	Nov 17, 2022	Feb 20, 2023	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	Baiterek Holding	Damu Entrepreneurship Development Fund	

Proposed Development Objective(s)

To assist the GoK in modernizing MSME credit and equity financing support programs to make them more market-based and effective, and to promote digitalization and greening of the program beneficiaries.

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	200.00
Total Financing	200.00
of which IBRD/IDA	200.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Bank for Reconstruction and Development (IBRD)	200.00

Environmental and Social Risk Classification	Concept Review Decision

Moderate	Track II-The review did authorize the preparation to continue

Other Decision (as needed)

B. Introduction and Context

Country Context

1. **Kazakhstan has experienced a rapid growth in the last three decades, but its growth model remains vulnerable because of the country's reliance on hydrocarbons and lacking economic diversification.** The concentrated economy poses risks to shared prosperity and fossil fuel dependence will draw increasing pressure from the international and domestic green transition. Recent economic downturns have demonstrated the vulnerability—namely the 2008 global financial crisis, the 2014 Russian economic crisis combined with the falling global oil prices, the 2020 COVID crisis and, most recently, the repercussion from Russia's invasion of Ukraine.

2. **The challenges posed by the existing economic model prompted the largest protests in the country's modern history, triggering a new wave of reforms**. In response, the government has announced its intention to tackle some key challenges stalling the country's progress and gradually lay the groundwork for more inclusive, private sector-led, and greener growth.

3. **A new, more diversified economic model requires massive and efficient capital reallocation, but Kazakhstan's financial sector does not allocate capital efficiently and firms are falling behind on the global digital and green transition**. With banking sector credit to GDP at 25 percent, Kazakhstan falls markedly behind its peers. Despite multiple government support programs, private sector credit to the real economy has been contracting in real terms in recent past due to banking and corporate sector weaknesses. The main driver of recent credit growth has been consumer and mortgage lending—the latter mostly fueled by state support programs.[1] To gain competitiveness and grow in non-extractive industries, firms need to embrace the need for digital and green transitions that climate change crisis, Covid crisis, and the repercussions from the Russian invasion of Ukraine reinforce.

Sectoral and Institutional Context

4. **The vast government financial support programs, while well-intended, have not been successful in tackling deeper structural challenges and hinder the reallocation of capital**—including by developing an ecosystem of diverse financial service providers. The GoK subsidized credit lines have unintended repercussions for the economy that distort the pricing of capital and its allocation. They can encourage adverse selection by banks of their less viable clients rather than a search for new promising clients. Indirect financial support such as through partial credit guarantees (PCG) is still evolving in its design and implementation, and while has grown in volume, it was not fully tested for viability and reach during the COVID crisis. The associated M&E frameworks fail to credibly capture socio-economic and fiscal impact of the programs. The targeting and conditionalities of these large programs do not help transform the MSME sector into a greener, more socially conscientious, and better governed part of the economy. The private equity (PE) and venture capital (VC) space has been dominated by state-sponsored equity channeled via multiple sovereign wealth funds/agencies, while private PEVC options for SMEs are limited. Government sponsored funds do not primarily target MSMEs for financing.

5. **The comprehensive institutional and policy framework has not been effective in propelling productivity growth and**

[1] During 2017-2019, consumer lending grew rapidly at a 15-27 percent rate. In 2021, the consumer and mortgage lending sped up again at 37 percent, becoming the main driver of total credit growth.

job creation among Kazakh MSMEs. The MSME contributions to employment and added value are about a half of those in OECD countries.[2] Importantly, Kazakhstan's formal MSME sector is very fragmented. It comprises many individual entrepreneurs and fewer medium-sized enterprises that concentrate in industries with relatively low added value. Several demand side factors continue to constrain MSME investability, access to finance, and thus much needed capital reallocation to productive businesses in non-extractive sectors. Namely, Kazakh MSMEs underperform on some critical capabilities such as financial, managerial, technological, and actuarial capabilities. The ability of Kazakh MSMES to undergo digital transformation and greening of their operations to elevate and sustain productivity is thus constrained. In this context, MSME public support programs need to focus on broader objectives such as promoting green strategies and digitalization to prepare firms for new growth opportunities.

6. **On the supply side of finance, banks perceive lending to MSMEs as too risky, especially outside of the government programs because** (i) banks lack access to reliable information on borrowers also owing to the incomplete infrastructure for sharing credit history; (ii) banks don't use cashflow based lending approaches or alternative data for credit risk assessments, and rely on collateral; (iii) they require high loan collateralization in the absence of alternative financing instruments, (iv) unfavorable collateral valuation are prevalent especially outside large cities; (v) few suitable financial products for MSMEs exist beyond traditional bank loans. Banks compete for the same pool of eligible MSME borrowers—including by evergreening loans of unviable companies thanks to heavily subsidized government support programs. Indirect and market- support creating approaches such as public credit guarantees (PCGs) have been underutilized in Kazakhstan. For the MSMEs outside of this pool, access to finance remains a major challenge and face difficulties in accessing government support programs that should help them.

7. **In view of existing and rising global uncertainty, equity financing options for SMEs to fund investments are gaining importance—but such options are rather limited in Kazakhstan**. The private equity (PE) and venture capital (VC) markets have been dominated by state-sponsored equity channeled via multiple sovereign wealth funds/agencies, such as Kazyna Capital Management (KCM), Kazakhstan Investment Development Fund (KDIF); and Samruk Kazyna. KCM is the most active government fund of funds structure in the PE space, having invested in 15 PE funds, both external and captive, with 40 partners. Government sponsored funds do not primarily target MSME financing.[3] Unlike other countries such as Estonia or Ukraine, Kazakhstan has seen few highly successful technology startups. Key market impediments related to PEVC investment in SMEs are: (i) lack of investable deal opportunities; (ii) limited presence of experienced private fund managers; (iii) a weak private institutional investor base; and (iv) high exchange rate risk as well as uncertainty about investment policy and enforcement of investment rules.

Relationship to CPF

8. **The Project is consistent with the World Bank Group's Country Partnership Framework (CPF) for Kazakhstan for 2020-2025**, which highlights the country needs to diversify its economic base through improving competitiveness of its non-extractive sectors. The Project hence contributes to achievement of the CPF objective of private-sector-driven growth by supporting the Government of Kazakhstan in developing fair and competitive support for MSME credit and equity financing. In line with the CPF-endorsed approach, the proposed financing Project will substantially contribute to institutional strengthening of the MSME policy institutions, as well as to the inclusion/shared prosperity agenda by addressing inequalities in access to finance for MSMEs in the lagging regions and improving conditions to mobilize additional resources for MSMEs for greening and digitalization.

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[2] In 2019, MSMEs accounted only for 32 percent of the total added value and 37 percent of the total labor force in the economy.

[3] For instance, within its portfolio, KCM has invested only in two SME funds, both with similar investment strategies: (i) 25bn tenge KCM Sustainable Development Fund, which invests 1bn – 5bn tenge in SMEs focused on production and manufacturing; and (ii) 40bn tenge Baiterek Venture Fund which invests 1bn – 5bn tenge in SMEs focused on manufacturing. In addition, QazTech Ventures, a government fund of funds program (fully operational as of 2019), engages with several international partnerships focusing on venture capital and acceleration services for technology companies.

C. Proposed Development Objective(s)

9. Assist the GoK in modernizing MSME credit and equity financing support programs to make them more *market-based* and *effective*, and to promote *digitalization* and *greening* of the program beneficiaries.

10. The key results expected for the proposed Project are as follows.

- *Market-based* and *effectiveness* characteristics will be measured through the following indicators under the equity and credit financing comments:

  1) Seed and early-stage venture capital financing support: Share of MSME hybrid investment fund committed capital raised from private investors.

     The intermediate result indicators are: (i) Share of the MSME hybrid investment fund committed capital raised from private investors at first close[4]; (ii) Share of committed capital deployed at five-year horizon; (iii) Number of transactions at five years horizon; (iv) Share of small transactions (less than US$ 1 million); (v) Share of investee companies headed by women and/or headquartered in the underserved regions.

  2) Partial credit guaranty scheme for MSMEs: The share of guarantees that are priced (have a non-zero guaranty fee) in Damu portfolio increased.

The intermediate result indicators are: (i) Number of participating financial institutions under the new PCG scheme, which will be tracked separately for the second-tier banks and MFOs; (ii) Volume and (iii) Number of guaranteed loans disbursed to MSMEs for greening and digitalization purposes; (v) Share of MSME lending in the loan portfolio of banks and MFIs.

- The *greening and digitalization* characteristics will be measured through the following indicator:
  3) Partial credit guaranty scheme for MSMEs: The share of program beneficiaries that implemented green or digital milestones suggested by the Damu/WB self-assessment tool (baseline: ~X%; target: Y%).

The intermediate target is the number of MSMEs that conducted self-assessment of digital and green capabilities on the DAMU/KCM hosted assessment tool and developed by the World Bank.

Numeric values for the baseline and target indicators will be developed during the Project preparation stage.

11. The Project is expected to achieve broader impacts not entirely captured by the above indicators by contributing to a shift to indirect market-friendly state support programs and improving their wider economic impact to support more equitable access to finance for MSMEs across regions and the green, resilient, and inclusive development.

D. Concept Description

12. The proposed Project has four components.

Component 1: Seed and early-stage venture capital financing support for MSMEs.

13. **This component will aim to establish a hybrid (public/private) MSME investment fund to** (i) improve the access of

[4] A milestone signifying completion of a first phase of raising capital, after which the fund can start investing.

startups and young, innovative SMEs (less than 5 years) to seed and early-stage venture capital (VC) finance; and (ii) support the development of the seed and early-stage VC industry by serving as a forerunner of a series of hybrid VC funds managed by private fund managers to mobilize early-stage private financing for startups and young SMEs in the country[5] . This component consists of two sub-components, which will finance: (1) equity in KCM Hybrid MSME Fund and its downside risk protection and small investment facilities; and (2) institutional capacity building of KCM.

Subcomponent 1.1: **Equity in KCM Hybrid MSME Fund with downside risk protection and small investment facilities**

14. **This subcomponent shall finance the first Fund in a series of hybrid early-stage investment funds, which will be launched by Kazyna Capital Management (KCM) and managed by a competitively selected private fund manager(s)**. The overall development objective of the Fund would be to improve the access of startups and young, innovative MSMEs (less than 5 years) to seed and early-stage venture capital finance. The secondary development objective of the Fund would be to support the development of the seed and early-stage venture capital industry in Kazakhstan by serving as a forerunner of a series of hybrid seed and early-stage venture capital funds managed by a private fund manager (FM) to mobilize early-stage private financing for startups and young SMEs in the country. The ESG framework of the Fund would be based on the World Bank ESS9 that applies to investment funds as non-bank financial intermediaries.

15. **Fund Facilities:** Under this Project's Component, the Government would establish two facilities to support Fund implementation.
    - *The Downside-Risk Protection Facility (DRPF)* would provide first or second loss protection for private investors in the Fund, including the private arms of multilateral and bilateral financial institutions.
    - *The Small Investment Facility (SIF)* would provide small grants to the Fund manager for the structuring and follow-up of small transactions, in particular with investee companies headed by women and in disadvantaged regions, subject to a set of KPIs. The terms of SIF would be defined in the Fund Technical Note of the FM Tender dossier.

Subcomponent 1.2: **Institutional Capacity Building at KCM**

16. **This subcomponent will support institutional capacity building at KCM in two specific areas**:

    - *KCM as sponsor of hybrid funds.* Capacity building will focus on the capacity of KCM to select private fund managers for hybrid funds based on the best international procurement practices. Specifically, KCM will be provided with training and technical advisory services in the following areas: (i) preparation of pre-qualification (PQ) documentation, including fund description and PQ evaluation grid; (ii) management of pre-qualification selection process; (iii) preparation of tender documentation, including fund term sheet, fund technical note, fund manager terms of reference, and draft fund management contract; (iv) management of the tender selection process; and (v) negotiation of the fund management contract with the selected fund manager.

    - *KCM as limited partner of hybrid funds.* Capacity building will focus on the capacity of KCM Directors to represent KCM on the Advisory Committee (AC) of hybrid funds. Specifically, KCM will be provided with training and technical assistance to exercise its role as limited partner in AC sub-committees, including the investment policy committee, the oversight committee (conflicts of interest, anti-corruption, and AML/CFT), the audit committee, and the impact committee.

[5] Annex 1 provides more details on the rationale for government investment in early-stage finance funds, international experience, and best practices.

Component 2: Market-based partial credit guaranty (PCG) scheme for MSME greening and digitalization.

Subcomponent 2.1: **GRID and market-creating partial credit guaranty pilot.**

17. **This subcomponent will aid Damu in re-designing and scaling up its nascent *market-based* credit guaranty and encouraging greening and digitization of MSME beneficiaries while addressing regional disparities in MSME access to finance.** Specifically, under this subcomponent the Project will finance: (i) capitalization of Damu and (ii) technical assistance to Damu to enhance design, pilot, scale up, and evaluate a new market based PCG program supporting the greening and digitizing of MSMEs.

18. **Under this Project subcomponent, the *"Optima Plus" Loan Guaranty Program* will be developed and piloted with Damu.** The main principles and features of this new PCG will incorporate some of the successful elements of the existing Optima program design, while addressing its major shortcomings, and will envision the following major enhancements to the program
    1. Simplification of the program design while assuring its market-based principles.
    2. Increased loan exposure coverage.
    3. Reduced collateral requirements for guaranteed loans.
    4. Reflecting benefits of PCG in loan pricing.
    5. GRID-promoting incentives.
    6. Digitalization of DAMU's operational procedures.
    7. Enhanced product marketing including through supporting consultancy companies.

Subcomponent 2.2: **Co-investment in Green and digital capabilities of beneficiaries across regions.**

19. **The provision of co-investment under this subcomponent aims to boost the entrepreneurial capabilities of beneficiary MSMEs for digital upgrading and greening of their operations**—and help them overcome the fixed cost of accessing better (digital and greener) technologies and management skills. In the implementation, the participating financial institutions and Damu will facilitate the development of a project pipeline, supported by the tools developed and operationalized under this subcomponent. Initially, credit officers at the participating financial institutions would evaluate prospective MSME borrowers, including their potential for digital and green enhancements. As a next step, the pre-qualified potential MSME borrowers would go through a diagnostic (self-assessment) to assess where they stand in terms of digital technology adoption and resource efficiency (green) practices. As a result of this assessment, MSMEs would receive standardized reports with recommendations on how to improve the use of digital technologies and resource efficiency of their operations, considering their geographical location and sector of activity. Based on the individual firm results, Damu will provide vouchers to MSMEs to partially cover the costs of the pre-approved consultancy services to help them implement the recommendations. This is expected to enable MSMEs to overcome the fixed cost of accessing better (digital and resource-efficient) technologies and management skills.[6]

Subcomponent 2.3: **Institutional capacity building of DAMU.**

20. **This subcomponent will support implementation of a capacity building program for Damu based on the ongoing assessment against the World Bank Principles for Public Credit Guarantee Schemes for SMEs.** The capacity building

[6] The set of services covered by Damu/KCM can include business training aiming to improve managerial practices; consulting services – executed by DAMU's preapproved list of local private consulting companies or local institutional partners and provided to individuals or groups of similar firms; etc.[6] The local consultancy industry will also become part of the outreach and advocacy for greening and digitalization and help identify creditworthy MSMEs that want to green or digitize.

program will be aimed at enhancing the role and additionality of Damu via strengthening its partial credit guaranty scheme, expanding industry and regional access of MSMEs to Damu programs, and greening Damu's operations. Provisionally, under this component the Project would finance, inter alia: (i) the design of a corporate governance and risk management strengthening plan for DAMU; (ii) design and implementation of a monitoring and evaluation strategy to measure the effect of access to credit within final MSME borrowers; (iii) revision of a product mix policies, and (iv) design and implementation of an environmental and social management system and standards for Damu operations.

Component 3: Performance-Based Conditions to improve MSME access to finance.

21. **To strengthen the potential for achieving expected results and sustained impact, a financing component may be contemplated with several performance-based conditions (actions) that can be implemented by Baiterek.** The proposed conditions were developed based on the policy recommendations from the Kazakhstan MSME finance diagnostic and policy and regulatory obstacles identified during the Project's technical design preparation. They will aim to make the government financial support more market driven, indirect and better targeted, with the gradual reduction of market-distorting public support measures such as some untargeted and fiscally costly subsidies.

Component 4: Project Management.

22. **This component will focus on supporting the Project Implementation Unit (PIU) to effectively execute the Project.** Baiterek will establish a PIU that will be responsible for, inter alia, (i) coordinating the implementation of the Project; (ii) ensuring compliance with fiduciary and environmental and social safeguard requirements; and (iii) monitoring and evaluating the Project results.

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

CONTACT POINT

World Bank

Martin Melecky, Katerina Levitanskaya, Mariana Iootty De Paiva Dias
Lead Economist

Borrower/Client/Recipient

Baiterek Holding
Nuraslan Baltemir

international relations department
n.baltemir@baiterek.gov.kz

Implementing Agencies

Damu Entrepreneurship Development Fund
Murat Bapayev
International relationship department director
murat.bapayev@fund.kz

FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: http://www.worldbank.org/projects

APPROVAL

Task Team Leader(s):	Martin Melecky, Katerina Levitanskaya, Mariana Iootty De Paiva Dias

Approved By

Practice Manager/Manager:		
Country Director:	Sascha Djumena	05-Aug-2022