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Thailand.

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Two-step loan: a financial scheme for small & medium industry

by

Chintala Viseskul

Narongchai AKRASANE

Senior Specialist. Business Development Department
The Industrial Finance Corporation of Thailand

I. Thailand's small & medium industry (SMI)'s needs

About 70-80 per cent of the 80,000 registered industrial concerns in Thailand are classified as cottage and small scale enterprises employing less than 50 workers, while medium sized firms employing less than 200 workers account for about 15 per cent of the total. About 70 per cent of the enterprises are located in Bangkok and the Central Region.

The economic significance of SMI in Thailand may be gauged from their contribution to the total value of industrial output, employment, value added, which are as follows:

| | |
|-----------------------|-------------|
| Industrial output | 52 per cent |
| Industrial employment | 80 per cent |
| Total value added | 48 per cent |

SMI are engaged in a diverse range of manufacturing activities, ranging from production of consumer goods such as processed foods, wearing apparels, to furniture, construction materials and production of tools and equipment.

SMI's contribution to the value of Thailand's industrial exports has been found to be substantial in the case of processed foods, garments, leathergoods, metal products, plastic products, wood products and furniture, and in most cases the utilisation of domestic inputs are as high as 80 per cent of total inputs.

Notwithstanding the wide-ranging economic impact of SMI in Thailand, extensive researches on the situation of SMI firms since 1977 have identified the inherent weaknesses of SMI operations, disincentives for SMI development resulting from fiscal and industrial promotion policies. On the other hand public resources are marginal compared to the need to strengthen SMI into a more solid industrial base for the economy. Hence a strong argument for the acceleration of programmes for SMI promotion.

The problems of Thailand's SMI, in broad terms, are similar to their counterparts in other developing countries. Shortage of finance is generally an important, though not the only, constraint. Debt financing accounts for only 30% of total capital investment^{1/}. The low debt ratio indicates great difficulties by small enterprises in acquiring sufficient credits from institutional sources. From the viewpoint of commercial banks, which are the most important source of SMI credit, inadequate collaterals, poor record keeping and the risk of business failure, particularly among new enterprises, constitute greater lending risk. Higher transaction costs also reduce the profit potential in SMI lending, compared to larger loans.

It may also be said that financial problems of SMI are symptoms or results of managerial/technical weaknesses. IFCT's own experience with smaller clients on several occasions attests to this remark. Poor book-keeping, typical family

^{1/} Saroj Aungsumalin, Financial Structure and Credit Requirement for Small Industry, 1981.

management style, inadequate production control and inadequate marketing/technical knowledge, are among other deficiencies that result in financial difficulties. Limited financial resources also pose constraints in the acquisition of fixed assets and enterprise operation.

II. IFCT's SMI financing operation

The extension of financial support to small & medium scale projects is not new to IFCT. As a development finance institution which specialises in medium and long term financing for the acquisition of fixed assets, since its inception in 1959 IFCT has financed 382 small scale projects and 272 medium sized projects.^{1/} These constitute about 50 and 35 per cent respectively of IFCT's total projects. In terms of loan amount, small scale projects make up 8 per cent and medium-sized projects 25 per cent of the total

In 1984 a special loan unit for small scale projects was created to implement IFCT's current strategy to strengthen its promotion of small industry & regional development. The programme laid down operational targets and funding requirements, as well as the building up of branch network and the transfer of loan service functions in the project cycle to the unit.

As for the types of financial services offered, long-term fund for fixed asset acquisition is provided as well as short-term working capital loan. The target group of the small-scale financing facility are manufacturing and service businesses that have net fixed assets below US\$265,000, with a maximum long-term, loan requirement of US\$132,500. The interest rate on the loan is the same as that on IFCT's normal loan, which currently stands at 14.5 per cent per annum.

So far the loan facility has been extended to 104 clients totalling US\$10.5 million. The average loan per

^{1/} Small scale project is defined by loan size under US\$132,500, and medium scale project by loan size US\$132,500 - US\$755,000.

client is about US\$100,000. The clients are mainly engaged in food processing, construction materials, wood product & furniture making, and commercial farming activities.

Another major aspect of the programme involves the provision of technical assistance. Currently it covers a small number of client enterprises which have been found to face operational problems but may be possible to turn around if technical and/or management assistance is provided. The services are performed by IFCT's consulting subsidiary, the Industrial Management Co., Ltd.

III. Export modernisation programme: a financial scheme for small & medium enterprises.

IFCT is about to start a new financing programme for small & medium sized enterprises. The programme differs from the small industry lending activity described above in 3 major respects.

Firstly, the programme has a more specific objective. It is intended to enhance the competitiveness of export-oriented manufacturing through modernisation of production facilities, improvements in product quality, work and management systems.

Secondly, in order to achieve the above objective, the programme will have to link the provision of technical assistance with the provision of financing, not just in the project implementation phase, but throughout the project cycle. That is, from the project concept phase to the operation phase.

Thirdly, since about US\$22 million in foreign and local currencies will be available for lending and technical assistance, which is not a large sum, it is preferable that the programme concentrates in selected priority export sectors rather than any export manufacturing project. The heterogeneity of small & medium enterprises is obvious even within one sector. Thus narrowing down the target groups to a few sectors will not put too extensive requirements on the provision of technical assistance, in view of the resource limit.

III.1 Description of the programme

Having outlined the programme framework, this section will discuss the relevant features of the programme in more detail.

III.1.a Sources of fund

While the local currency financing requirement will be met by IFCT, a two-step loan of approximately US\$17 million, at concessional terms, will be provided by the OECF (Organisation for Economic Cooperation Fund - the Japanese aid agency), with about US\$1.0 million ear-marked for technical assistance expenses.

III.1.b Type of financial assistance

To provide medium and long-term financing for the modernisation of plant and equipment, which will enable manufacturers to improve production efficiency, product quality, including the development of new product lines, so as to increase the competitiveness of their products in the international markets.

IFCT's normal working capital credit facility will also be available to enterprises in the programme.

III.1.c Eligibility of borrowers

As the target groups are small and medium sized export manufacturers in priority sectors, the eligibility criteria are defined in terms of firm size, export sale ratio, and industrial sector, as follows.

1. Firm size. Small & medium enterprises are defined as those with a maximum net fixed asset size of US\$1.85 million.

2. Export sale ratio. An export sale ratio of at least 30 per cent per annum within a 3-year period is required. This is in line with the definition adopted by Thailand's Board of Investment.

3. Industrial sectors. The sectors are selected with regards to their export performance potential, modernisation needs, predominance of small & medium sized operations, and priority in the national export promotion plan. Altogether 8 sectors are included: processed foods, garments, wood products, footwear, metal products, toys, rubber goods, and electronics.

It is envisaged that assistance under the programme will be extended to about 30-40 enterprises in the first round of programme implementation. Since the maturity of the OECF fund will be longer than the expected maturity of IFCT's loans to the borrowers, repayments will be placed in a special revolving fund which will be utilised in the same manner.

III.1.d Technical assistance

As the target group of the programme will be firms in the process of modernisation to compete in the international market, it is envisaged that they will be from the upper range of the small scale group, and that they will have some understanding of management requirements and have

relatively more managerial experience than those in very small scale enterprises. The target's profile is mentioned here because, to be effective, the levels of technical assistance have to be appropriately geared to their needs.

The nature of technical assistance services may be categorised as follows.

1) Basic market research to identify business/product opportunities.

2) The preparation of project studies to comply with the requirements of IFCT, and government agencies if necessary.

3) Production management assistance, including product design, quality control.

4) Operational management assistance, such as financial management and marketing of products.

The services will be provided for 2 years from the commencement of the programme.

IV. Arrangements for the Programme Approach

It is already mentioned that technical assistance should be linked to financial assistance, not only at the project operation phase as is normally the case at IFCT. Thus the implementation plan provides for the collaboration between technical service consultants and lending officers from the stage of project identification through to project operation. Lending officers will be informed of the scope of technical assistance services so that they can refer individual cases to the consultants for opinion and advice.

The costs of technical assistance are bound to be high. IFCT's experience indicates that SMI entrepreneurs are often reluctant to make use of the services if they have to pay for the full services cost. But if the services are provided free of charge, they may have little perceived value to the entrepreneurs and will also quickly become a strain on the agency's budget, which usually is quite limited. In view of these considerations, the arrangements for this particular export modernisation programme are that borrowers do not have to pay additional fee for the services relating to operation review, problem identification and analysis, and recommendations for improvements by the consultant. However if borrowers agree to proceed to implementing any of the recommendations which may involve the consultant's time and other expenses, this portion of technical service costs will be borne directly by the borrowers.

It is expected that assistance under the programme will be provided to about 30-40 enterprises. Though the number of firms involved are small, the aim of the programme loan approach is the qualitative improvement in technical and management practices, the quality of which is one of the most important factors that combine to make smaller enterprises successful in international competition.