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# APPRAISAL REPORT ON SMALL ENTERPRISE EQUITY DEVELOPMENT (SEED) SCHEME IN THE PHILIPPINES

PREPARED FOR UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION, VIENNA (UNIDO)

BY

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1. The views contained in this reports are those of the author & not necessarily those of the UNIDO Secretariat.

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## INTRODUCTION

1. This UNIDO assignment (CLT 89/611) is to prepare an appraisal report on a proposal for establishment of a Small Enterprise Equity Development (SEED) Fund in the Philippines. The report is required to cover (a) basic issues in financing of Small Scale Enterprises(SSE), (b) SSE financing in the Philippines,(c) appraisal of the planned SEED Fund including its objectives, fund structure & resources,and programme of implementation of the SEED Fund Scheme, and comparative assessment in relation to similar equity financing scheme in other countries. The assignment envisaged about five days of field research in Manila, Philippines.

2. The detailed proposal for the SEED Scheme was required to be prepared by two national consultants in Manila, Mr. Arther Alvendia and Mr.Jose Ferro. Their consultancy assignment included an analysis of SSE financing,particularly in the Philippines,and assessment of past and present schemes, shortcomings in existing SSE financing facilities, the objectives of the proposed SEED Fund,the planned SEED Fund structure and its programme of implementation. The report of the national consultants was to be appraised by the undersigned.

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3. The undersigned proceeded from New York on Jan 4,1990, reaching Manila the same night. Detailed discussions were held with the two national consultants on Jan.5,together with meetings & discussions with senior representatives of the Development Bank of the Philippines (DBP) the Department of Trade & Industry (DTI) & the Philippine Chamber of Commerce & Industry (PCCI). These discussions extended over the next four days, till the afternoon of Jan 9,1990, when the undersigned departed from the Philippines. The meetings included two discussions with the Chairman & Vice Chairman of the DBI. The national consultants participated fully in all the discussions & were most helpful in arranging the various meetings. A meeting was also held with Mr. Christian Newman, UNIDO Country Director regarding progress of work on the assignment.

4. The national consultant Mr. Alvendia had earlier prepared a paper defining the rationale for a SEED programme. This earlier study which led to the UNIDO project for a more detailed analysis of the potential & implications of the SEED Scheme, also contained some project profiles of enterprises, which were assessed as having considerable potential but requiring substantial financing other than loan finance. The criteria for choosing the projects was that the enterprise should have a demonstrated growth potential,

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particularly an assured market, the enterprise should be a prototype project in a sector with considerable replicability,& that the equity financing to be provided would bring about substantial , increase in production & tecnnological capability.

5. It was expected that the national consultants would have finalised their final report prior to the undersigned's visit to the Philippines. This has not,however,been possible because of the dislocation & confusion caused by the attempted coup in Manila in Dec. 89. The report of the national consultants is presently in an advanced stage of finalization & should be available to UNIDO in the course of the next month. The views of the national consultants have, however, been fully incorporated in this report.

6. The meetings & discussions held by the undersigned with the national consultants & with the DBP,DTI,PCCI & other organisations in the Philippines clarified & led to considerable modidfications in the SEED concept & the institutional and administrative arrangements that were earlier contemplated. This appraisal report,therefore, not only reviews the concept & proposal relating

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to the SEED Fund Scheme, which was under contemplation,but also highlights the modifications & changes that would be necessary in this programme. The modifications would also be included in the report of the national consultants.

7. The present report is divided into three chapters following the terms of reference. The first chapter deals with various aspects of financing,including policies and institutional experience in various countries. The second chapter deals with SSE financing in the Philippines & the rationale, nature and manner of implementation of the proposed SEED scheme. The third chapter assesses the prospects & potential of the SEED Fund scheme as compared to similar equity financing for small-scale industries in other countries & the further requirements of technical assistance for the SEED programme in the Philippines.

8. The mission would like to express its appreciation & gratitude to the UNDP office in Manila,particularly Mr. Christian Newman, UNIDO Country Director & his staff for the arrangements made for the undersigned,& to the representatives of the Development Bank of the Philippines,the Department of Trade & Industry,the Philippines Chamber of Commerce & Industry & other organi-

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zations, who were kind enough to attend prolonged meetings & discussions even outside office hours. I should also like to convey my special appreciation & thanks to Mr. Arther Alvendia & Mr. Jose Ferro, national consultants for the SEED Fund Project, who provided all necessary information & facilities to the undersigned.

# CHAPTER-I

## ISSUES IN FINANCING OF SMALL ENTERPRISES

9. The growth of small-scale industries & enterprises is recognised as having a key role in the process of industrialisation & in the development of enterpreneurial, production & technological capability. Small-scale production not only constitutes a critical stage in the growth of particular enterprises which gradually expand to higher scales of production,but also provides critical links in production, marketing & supply of various inputs & services in different sectors.

10. Small & medium enterprises have been encouraged & promoted in most industrialised countries, such as the USA, Japan & several West European countries and programmes of assistance ranging from industrial parks & other infrastructure facilities to provisions for financing on concessional terms,have been extensively undertaken over several decades. The continuing & expanding programme of the Small Business Administration in the USA for providing funding to small business investment companies (SBICs) which,in turn,provide and supplement the flow of private equity capital & long-term loan funds to small business concerns is an example of the priority still being accorded to such enterprises.

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11. The development of small and medium industries & enterprises is of vital importance in most developing countries. With small, internal markets, combined with paucity of financial resources and enterpreneurial skills, investment & production activities have often to be limited to relatively low or medium scales, particularly during initial stages. Such enterprises can, however, grow rapidly in size & levels of production & either extend their operations to external markets in the same or similar fields of production or diversify and expand their activities in different directions.

12. A wide range of programmes are being implemented in a number of developing countries for the promotion & stimulation of small enterprises. Such enterprises are differently defined in various countries, the usual definition being ceiling levels in fixed investments and the number of employees/ workers. In certain countries, small & medium enterprises are accorded similar benefits & concessions. The specific fields of assistance range from technical assistance, guidance & training for prospective small-scale entrepreneurs to provision of infrastructure facilities such as industrial estates and parks with common equipment or service facilities; provision of finance, usually on concessional terms; supply of scarce

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raw materials; assistance in marketing of products & specific tax & fiscal incentives for such enterprises. In some countries, such as India where over 50% of industrial production takes place in the small-scale sector, a number of subsectors & products are reserved for production only by enterprises falling under this category.

13. While various types & forms of promotional assistance are required for small enterprises, the most crucial requirement is supply of adequate finance at various stages in the life & growth of such enterprises. Access to finance is essential not only at initial stages of plant installation & production, but for working capital and, equally importantly, for subsequent stages of expansion & outputs and of production capacity.

## ISSUES OF FINANCING

14. The financing of small-scale enterprises poses several issues & implications. These include (a) definition of enterprises to be covered, (b) requirements of finance, both longterm & by way of short-term working capaital at initial stage, (c) contribution of sponsoring small-scale entrepreneur, including by way of guarantees & collate-

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ral,(d) requirements of finance for expansion of production or output,(e) forms of long-term finance, (f) institutional arrangements for supply of different types of finance &(g) implications of equity financing.

15. The enterprises to be covered can range from micro or cottage industries to small & medium enterprises with fixed assets or asset size which may extend to $ 1 million or more & having 100-300 workers. Provision of funds for micro or cottage enterprises are either provided by banks or by special financial institutions dealing with this category. Finance is provided primarily by way of concessional loans against collateral to the extent available. Generally, such collateral includes hypothecation of equipment purchased such as a lathe or sewing machine. In the case of small & medium enterprises, loan finance both for loan term & working capital, is provided either by commercial banks or by specialized institutions such as finance corporations & development finance institutions in several developing countries.

16. Financial requirements would need to be assessed in much greater detail in the case of small & medium industries than for micro enterprises where the loan is generally confined to the cost of the equipment item with a small provision

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for working capital. For small & medium enterprises, however, fairly detailed assessment of the viability of the project & the SME entrepreneur's capacity to repay, is necessary. While commercial banks perform such functions in a large proportion of cases, long term loans are generally required to be fully covered by collateral security, while working capital loans are assessed on the basis of inventory requirements from time to time. In the case of development finance institutions, including finance & investment corporations set up specifically for promotion of small & medium enterprises, the principles followed are similar as in the case of commercial banks, through development finance institutions tend to be less rigid. The requirements of finance of SMEs are, however, primarily met through loans, both for investments & for working capital.

17. The SME entrepreneur is generally required to contribute a certain percentage of the initial investment. This can range from 10% to 40%, depending on the norms of the financed institution concerned. Besides, collateral is required to cover the cost of most, if not entire, loan amount required, apart from guarantees that have to be pledged by the entrepreneur.

18. Financial requirements of SMEs at the stage of expansion of output or production pose greater difficulty. Where such expansion involves increased fixed investment, including machinery & equipment, the collateral base of the enterprise also increases & provides a cover for increased loan finance. In cases, however, where there is no appreciable increase in fixed assets, the SME entrepreneur may be required to provide additional collateral & this can constitute a severe limitation.

19. The form of long-term finance provided to SMEs is primarily in the form of loans. Participation of financial institutions in the equity base of small & medium enterprises is rare and undertaken only in certain countries & by specific types of institutions. One difficulty may arise from the structure of the SME, which may be a proprietory or partnership concern & not a company with equity holdings. There may also be considerable reluctance on the part of SME entrepreneurs to invoke participation of financial institutions in the equity base of their enterprises. There may also be equal reluctance on the part of financial institutions to participate in the equity structure of SMEs. This would undoubtedly involve greater involvement, & even commitment of such enterprises in particular SMEs, including in management operations. While the administration of loan finance is a normal banking function, participation in equity involves a different type

of involvement for which most financial institutions may not be prepared.

20. The institutional arrangements for supply of finance to SMEs are, as mentioned earlier, commercial banks and a number of specialised financial institutions created specifically for providing finance to such enterprises, often at concessional rates. The various types of financial institutions are discussed in the next subsection. Most of these institutions, however, deal only with loan finance for SMEs. Participation in equity is provided mainly by two types of financial institutions. Firstly, institutions such as the Small Business Investment Companies (SBICs) in the USA participate both by way of loans and equity participation. SBICs in the USA may be set up with initial minimum capitalisation of $ 1 million and are required to obtain a licence from the Small Business Administration. This enables SBICs to borrow funds at favourable rates from the Federal Government upto a ceiling of $ 35 million in most cases. These sums can be invested in small business concerns, including through purchase of equity securities of such concerns. The SBIC cannot, however, become a general partner in any unincorporated small business concern or become liable for the general obligations of an incorporated business enterprise.

21. Another institutional arrangement for equity participation in small enterprises is provided by the Islamic Development Bank (IDB) based

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in Jeddah. The IDB provides lines of credit to national development finance institutions (NDFIs) to finance the equity of small enterprises where the amount of financing is below the minimum limit required for direct financing by IDB. Though equity participation in small enterprises, was undertaken by NDFIs in certain Islamic countries in the late 1970s & early 1980s, the IDB's emphasis in recent years has shifted away from equity financing, because of the difficulties experienced with the projects financed through equity financing.

22. Equity financing has also taken place through some other development finance institutions. In most of these cases, this has taken place because the scope for loan finance had been exhausted.

## IMPLICATIONS OF EQUITY FINANCING

23. The implications of equity financing in small & medium enterprises relate, firstly, to the essentiality of such investments in particular cases; secondly, to the selection of enterprises where such participation may be appropriate ; thirdly, to the degree of involvement in day-to-day management that such equity financing may necessitate, and finally, the institutional arrangements in the financial institution which would become necessary if equity participation is adopted as a regular means of financing SMEs.

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24. Equity investments may become necessary if the scope for loan finance become exhausted, because of lack of additional collateral or matching contribution by the SME sponsors &, at the same time, the SME has considerable potential for growth. Such financing may also be appropriate in priority sectors where SME entrepreneurs are desirous of obtaining equity participation from initial stages, either because of the nature of the project or the need for assured support by one or other governmental agency. Several small enterprises with major potential either for export or to meet growing internal demand are unable to expand because of non-availability of additional resources or collateral, and equity participation by financial institutions could serve as a critical source of financing.

25. Equity participation would undoubtedly involve a high degree of selectivity in choosing the SME in which such equity partici-pation would take place.There should not only be adequate growth potential, but the financial institution should also be able to have necessary confidence in the SME & its owners as a result of demonstrated ability on the part of the latter. The purpose of equity participation should be to meet a financial & resource gap & since such participation would be far more risk-prone than loan finance,confidence in the SME constitutes an essential pre-requisite.

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26. It is important that the financial institution concerned does not become unduly involved in day-to-day management of the concerned SME. While some involvememt may become necassary, such as participation in the Board of Directors or prescription of detailed reporting requirements, the management of the SME should, as far as possible, be left to the SME entrepreneur. From this viewpoint,it may be desirable for equity participation to take the form of preferred, non-voting shares rather than common equity holdings on the part of the financial institution.

27. It would be necessary for the financial institution to develop specialized expertise to deal with equity participation proposals. More detailed and qualitative assessment of feasibility studies & techno-economic viability of projects would be necessary. It would be desirable to induct, to the extent possible,persons with experience of SMEs in the management echelons of financial institutions to deal with proposals for equity participation.

## TYPES & NATURE OF FINANCIAL INSTITUTIONS

28. The financing of small-scale enterprises has posed major policy issues in most developing countries. Apart from loans for working capital, requirement of machinery and other fixed capital expenditure are also met primarily through loans from banks and speicalised financial institutions. Loan capital requires, on the one hand, collateral security which can be provided by sponsors of such enterprises only upto certain levels, and on the other creates a growing debt burden which may extend beyond the capacity of repayment by

such units. The most durable package of financial assistance in such situations is to arrange a combination of equity participation and loan capital . This is, however, very difficult to implement, largely because of the reluctance of banks and financial institutions for equity participation in most countries.

29. In a number of countries, specialised financial institutions have been set up to deal with the financial needs of small & medium enterprises. Among industrialised countries, the most successful experience has been that of the small Business Investment Companies (SBICs) under the Small Business Administration in the U.S.A. In West Europe,the Netherlands set up a bank for Small and Medium Business over 50 years ago. In developing countires, a number of such institutions have been set up. In the Republic of Korea, two institutions were established,the Small and Medium Industries Bank in 1961 to provide long-term & short- term finance for such enterprises and the Citizens National Bank (CNB) in 1963 to provide various financial & other services for small industries.In India,State Finance Corporations and the Small-Scale Industries Corporation have been providing various forms of loan finance and technical & other assistance to small-scale Industries. In Pakistan, the Industrial Development Bank of Pakistan provides financial assistance to Small & Medium Industries, besides larger industrial enterprises. The Grameen Bank of Bangladesh which was started in 1976, has concentrated successfully on agricultural & micro non- farm

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enterprises in rural areas,& has had an excellent recovery rate so far. In Turkey, the Halk Bank has extensive financing operations for small-scale industries. In Columbia, the Corporation Financiera Popular (CEP) was set up specifically for small & medium industries & has provided industrial long-term finance to such enterprises.

30. Experience of such specialised institutions for small & medium industries has been mixed. While these institutions have served their basic objectives of meeting credit needs of small & medium industries, only loan finance has usually been provided & cost of transactions & operations has tended to be high. The problem of financing small- scale units when they graduate to larger enterpris- es also creates difficulties.

31. As pointed out in the earlier section, equity finance to SMEs has been provided only in certain countries and by certain types of institutions. The SBIC programme in the U.S.A. is the most extensive facility, providing venture capital to small business firms. SBICs can only invest in qualifying small business concerns or short-term Government instrunents. In India, a National Equity Fund Scheme has been formulated in 1987 jointly by the Government and the Industrial Development Bank of India (IDBI) to provide equity types of support to small entrepreneurs & for rehabilitation of 'sick' small-scale units. The scheme is confined to units in the rural areas or in small towns and seed capital

assistance in the form of loan to meet the gap in equity is provided upto 15% of project costs, within a ceiling of Rs. 75,000/ per project. The seed capital is required to be refunded in 7 years, including a moratorium of 3 years. No security, including collateral, need be provided for seed capital. Refinance facilities are provided by IDBI.

32. Apart from such specialised financing institutions development finance institutions(DFIs) also meet credit and loan requirements of small and medium industries in several countries. Resources channeled to small industries through DFIs have, however been limited, even where special units or departments have been set up by such institutions. In Asia, measures have been initiated by the Development Bank of the Philippines, the Industrial & Financial Corporations of Thailand, the Bangladesh Shilpa Bank and the Developement Finance Corporation of Sri Lanka. In Africa also,several DFI's have undertaken special lending programmes for small and medium industries. The Development Bank of Zambia set up a Small- Scale Enterprise Promotion Limited in 1983 to provide equity, loans & technical assistance to small and medium industries. The Kenya DFC established the small Enterprise Finance Company in 1984. In Botswana, the two DFI's set up TSWELOLO Ltd. in 1984 to provide loans to small and medium units.

33. Most DFI's have not been particularly successful in financing small scale industries. Repayment records have been poor because of high debt burdens , & transaction costs have been high. There has generally been much greater preference to lend to larger industrial units.

## CHAPTER II

## FINANCING OF SMALL AND MEDIUM ENTERPRISES IN THE PHILIPPINES

34. The manufacturing sector in the Philippines registered an average annual growth rate of 6.5% during 1967-80 which was higher than the 5.8% growth rate for GDP. During 1981-86,however,there was a sharp decline and gross valueadded reflected negative growth of (-).9%. Since 1986, there has been gradual and sustained recovery. In general, industries oriented towards exports performed much better than those dependant on the domestic market.

35. In recent years, growing emphasis has been given to the growth of small and medium enterprises (SMEs) in the Philippines. It is increasingly recognised that such SMEs would play a vital role in the country's industrialization and in the develpment of national enterepreneurial, and technological capability. The role of such enterprises would be particularly significant with respect to capital formation and creation of employment opportunities; the utilization of domestic factor resources; the conservation of foreign exchange, the development of local entrepreneurial capability and developing a techno-cultural base for further industrialization.

36. Small and medium enterprises in the Philippines are defined with respect to number of employees and value of total assets. Thus, small enterprises are those with less than 100 employees and having

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total assets of between P.500,000 to P. 5 million. Medium enterprises are units with 100-199 employees and having assets from P. 5 million to P.20 million.

37. A number of institutions and programmes provide a wide range of assistance to SMEs. These extend from schemes for technical assistance of various types to programmes for financial support by way of loan finance. The Productivity and Development Centre of the Developing Academy of the Philippines, for example has undertaken several projects to improve productivity in these enterprises. The department of Trade and Industry(DTI) implements a programme for Medium and Small Scale Industries Co-ordinated Assistance (MASICAP) and another to provide Marketing Information and Direct Assistance (MIDAS). Information is supplemented by training courses for entrepreneure and marketing assistance teams which serve as buyers and sellers in particular fields. The Small Business Assistance Centres of DTI provide a variety of information and support to SMEs, particularly in food manufacturing, garments, metal working and furniture enterprises which, together with handicrafts, dominate this sector of production. The Bureau of Small and Medium Business Development(BSMDB) in DTI aims at strengthening technological development in this sector. It provides technological information and facilitites technology transfer services. It also provides a package of assistance programmes, which include the Industrial Guarantee and Loan Fund (IGLF), the Guarantee Fund for Small and Medium Industries (GFSME) the Export Industry Modernization Programme and the Agro-Industrial Technology Transfer Programme(AITTP). A Council has also been set-up for micro-cottage and small/medium industries(MICSMEC).

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38. There is, therefore, a wide range of programmes to assist SMEs in the Philippines. The functional assistance provided, largely through (DTI) range from extension services provided through small Business Centres in various regions to facilities for entrepreneurial training and for marketing through trade fairs and supply of marketing information. A programme for industrial estates and infrastructure facilities is being developed through the Regional Industrial Centres. In recent years, there has also been growing policy emphasis for industrial decentralization away from the metropolitan area of Manila and for country -side development. The development of livelihood 'multipliers', which are designed to extend employment and economic growth to rural areas, has been accorded considerable priority. A policy environment is being sought to be created through modifications of laws and regulations which would contribute towards greater industrial decentralization through small and medium enterprises. While sectoral emphasis and programmes have continued in fields such as food products, agro processing, garments,furniture handicrafts and housewares,there has been a growing shift of priorities to integrated industrial programming for geographical regions, which would be implemented through small and medium enterprises. The SMEs have therefore, assumed a key and pivotal role.

39. Despite the growing emphasis on SMEs however, there continue to be serious shortcomings with respect

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to finance, which is emerging as a major and critical constraint for a large number of such enterprises. Apart from the financing of micro enterprises (upto P.50,000), which is undertaken directly by DTI, industrial financing has been largely left to the banking sector. While substantial loan funds are available with financial institutions, it is often not possible for SMEs to avail of such facilities, primarily because of their low capital base and limited collateral security. The approach of financing institutions, as in most other countries has been traditional and conservative, with supply of finance to SMEs being limited to continuous rollover of loans or additional loan finance against adequate collateral or adequate matching resources raised by the entrepreneur.

40, There has been very limited venture capital or equity financing even for SMEs with obvious growth potential. Though some venture capital companies were started in the Philippines with capital of P.5 million these were not successful, often because local SMEs were not keen on outside equity partners. These companies are now mostly confined to transactional finance.With resource availability primarily in the form of loan finance, most SMEs in the Philippines have tended to have a low equity base and a growing debt burden, which becomes increasingly difficult to meet. Ironically, it is often at the stage of rapid potential growth, including export-oriented production, that the problem of inadequate financial resources, particularly loan finance, tends to become

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most pronounced. While it is usually possible, at initial stages of production, for SMEs to raise loan finance against collatoral, including capital equipment,this becomes more difficult at subsequent stages of increased production or substantial expansion, when the entrepreneur faces considerable difficulty in mobilising additional equity capital or arranging additional collateral for increased loan finance. At such stages, the need is also often for increase in share capital rather than on additional loans.

41. The inadequacy of the capital market in the Philippines for SMEs, therefore, poses a major constraint. While this problem is common to most developing countries, the issue gets further accentuated in this country because of the reluctance of SMEs entrepreneurs to raise equity capital from outside sources. This is partly a cultural constraint reflecting the desire of the local entrepreneur to retain autonomy and control,but is also largely the result of weakness in the local capital market to meet the non-loan needs of such enterprises..

42. An anamolous position is thus tending to develop where available loan funds cannot be utilised by SMEs because of their capital base and collateral, resulting in their growth being stifled and their financial need not being met.Additional funding in the form of loans, even if regulations and practices relating to collateral are significantly relaxed, would not necessarily meet the problem, particularly of on-going enterprises having substantial growth prospects. The solution lies in providing capital

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participation in the expanded capital base of such enterprises in a form acceptable to such enterprises and to the financing agency.

43. The rationale of the Small Enterprise Equity Development (SEED) programme in the Philippines stems from the growing need to provide a financial facility which would enable capital inflow and infusion to SMEs which are otherwise unable to raise financial resources because of lack of increased collateral or matching funds on the part of SME entrepreneurs. Since the Fund would draw heavily on external investment finance, as also from Philippines investors, it should however, ensure reasonable returns on its investments.

44. The discussions with representatives of DBP, DTI and the PCCI & with the National Consultants highlighted the need for an institutional facility in the Phillippines which can participate in the capital base of selected small industries besides providing transactional financing including by way of other unsecured credits for purchase, packing etc. for such enterprises. It is considered important, however, that such institutional capital participation should not adversely affect the role & initiative of small scale entrepreneurs. It is also essential that such an institutitonal facility should be flexible in its approach & not be bound by bureaucratic rules & procedures. The purpose hou d be to provide venture capital for small enterprises on the one hand &, at the same time, provide dynamic support for the growth

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of such enterprises. This would necessitate close linkages with the private sector, in the operations of such an institutional facility. The creation & development of such a facility would cover an impor- tant gap in the financing of small-scale enterprises having growth potential.

45. In the light of the discussions with concerned departments & institutions in the Philippines & after appraisal of the implications of capital participation in selected small-scale enterprises, the following recommendations are made for the implementation of the SEED programme in the Philippines.

INSTITUTIONAL FACILITIES PROPOSED.

46. A small Enterprise Equity Development(SEED) Programme should be undertaken in the Philippines, comprising of the creation of (a) SEED Fund,as a trust fund by the Development Bank of the Philiphines(DBP) which would participate in the capital of small & medium enterprises(SMES) in the Philippines & provide transactional finance to such enterprises, & (b) a SEED Foundation, a non- profit body which would be responsble for the management & operations of the SEED Fund and the SEED Programme. The objectives of the SEED Fund and Foundation would be not only to meet the financial requirements of selected small-scale enterprises but to provide managerial & technical guidance to enable such enterprises to expand rapidly & sucessfully.

47. The creation of both the SEED Fund & Foundation would be initiated by Development Bank of the Philippines (DBI) which would initialy allocate

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P.50 million to the SEED Fund. DBP would seek the participation in the SEED Fund of external donors & institutions, besides private investors in the Philippines & abroad. The resource target for the SEED Fund if the proposal is implemented by March,90 should be set at P.500 million (U.S.$ 25 million) by March, 1991. The Fund would also provide Guarantee facilities to private funders and a liquidity/ Invester Exit Mechanism, both of which would yield fee income,apart from returns on preferred stocks.

48. While the principal objective of the SEED Fund should be to provide development finance to both small and medium enterprises (SMEs), it would also be necessary to ensure adequate returns on investments made by the Fund in particular SMEs. The two approaches, while not necessarily contradictory, do pose issues that need to be reconciled and harmonized. From the viewpoint of the SME enterpreneur, the Fund should ideally provide adequate finance at a concessional rate, without recourse to collateral.This could either take the form of an unsecured loan, which may not be prudent or acceptable for most financial institutions,or be in the form of preferred,non-voting stock with guaranted rate of return which would be lower than the prevailing market rate for intermediate or long--term loans. A third alternative of participation in increased common stock of the SME would also be practicable except in cases where the volume of funds required would be such that the financial institution would acquire majority equity holdings. or where there would be resistance from the SME

entrepreneur to equity participation. Common stock equity participation by a financial institution would tend, however to be less welcome even if these were limited to minority holdings. From the viewpoint of the fund,however, participation only in preferred stock with guaranteed returns which are substantially lower than market rates, would represent considerable financial disadvantage. This could pose a serious problem in inviting investment participation in the SEED Fund from local private investors and from external sources. The solution may lie, either by the Fund's participation in the form of minority, common-stock holdings upto, say, 40% of total such holdings and the balance being retained as preferred stock with a fixed return, or to limit stock participation to preferred stock but to provide for profit-sharing be the Fund above a certain level of dividends and after providing for a Sinking Fund for redemption of the funds preferred stock holdings.

49. The details of the Fund's stock participation in particular SMEs would have to be determined on a case to case basis. The guiding principle should to be meet the capital requirements of the SME on terms acceptable both to the Fund and to the SME. For the purpose of definition of the SEED Fund Programme, it would suffice to say that the Fund's participation shall normally be in the form of preferred, non-voting stock, with a guaranteed return to be prescribed by DBP at the time of their purchase of stock and with a share in the profits of

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the enterprise above a prescribed level of dividends for common stocks of the enterprise concerned. The quaranteed return on preferred stocks for the first year of operations may be set by DBP at around 12%.

50. In the event of the Fund contributing to the capital of a SME through preferred stock, such preferred stock shall be redeemable by the SME at par value at any time, subject to a maximum period of 10 years from the date of purchase of the Fund's preferred stock. The SME shall be required to pro-vide suitable arrangements for redemption of the preferred stocks within such maximum period, to the satisfaction of the Fund.

51. The Fund's preferred stock in a SME shall be convertible at the same value to common-stock equity at the option of the Fund in the event of any default in the payment of the guaranteed return agreed upon, at the close of each financial year. This shall be clearly stipulated in the agreement between the Fund & SME prior to capital participation by the Fund. The fact of such a provision would be an important deterrent against default. At the same time, there is the undoubted likelihood of preferred stocks being converted to common-stock holdings, atleast in a certain proportion of cases, involving the Fund's managers in direct management operations of these enterprises.

52. Apart from capital participation as envisege-ged above, the Fund can provide transanctional finance to selected small enterprises including by way of unsecured credits for specific purposes such as purchase, packing etc.

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53. The selection of enterprises to be financed by the SEED Fund shall be in accordance with specific criteria to be prescribed by DBP. Such selectivity would be a key element of the Fund's operations. The selected enterprises may be engaged in priority growth sectors or in export-oriented production and shall include,in particular,on-going enterprises with growth potential : with assured or potential markets.

## TECHNICAL AND MANAGERIAL ASSISTANCE

54. The SEED Fund shall also provide the selected enterprises with technical & management services as may be deemed necessary by the SME concerned.

## MANAGEMENT OF THE SEED FUND

55. Various alternatives are possible for the managment of the SEED Fund. One alternative would be for DBP to take up such management either directly or through one of its subsidiaries, such as the DBP's Management Service Corporation. Other alternatives could range from entrusting the managment to an experienced private sector organisation to setting up a separate Foundation for the Fund's management.

56. Of these alternatives, the most suitable approach would appear to be set up a separate, specialised Foundation, comprising of persons with knowledge & experience of finance, as also of SME operations. This is necessary because of the unique

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and non-traditional approach to SME financing that the Fund would need to adopt and implement. While DBP would have considerable interest & say in the Foundation's creation & growth, its operations should be left flexible & not restricted by rules and procedures of traditional loan financing to SMEs.

57. It is accordingly recommended that the SEED Fund should be managed by the SEED Foundation, which should be a non-profit body to be specifically created be Charter for this purpose. The Foundation should have a Board of Trustees, comprising initially of 7 members. The Chairman and one or two founding members of the Board of Trustees shall be nominated for this purpose be DBP. The remaining members should include nominated representatives of major contributors to the Fund. Detailed Charter provisions relating to the Board of Trustees including its composition and provision for chanages, its powers and functions etc would be drawn up by DBP.

58. There shall, in addition to the Board of Trustees, be a Management Committee which shall be responsible for the day to day administration and management of the Fund. The Management Committee shall be appointed by the Board of Trustees and shall be subject to policy directives issued by the Board the Trustees from time to time.

59. Funding for the SEED Fund and Foundation shall be initially provided by DBP. However,as contributions from donor bodies and institutions and from private investors became available,DBP

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would limit its holdings in the Fund to a minority.

60. DBP should provide, on secondment, management personnel for the Foundation from DBP's organisation. The cost of such personnel shall be borne initially by DBP till such time, within a maximum period of 18 months, as such staff are absorbed by the Foundation or reverted to DBP.

61. The emoluments of Foundation personnel, together with terms and conditions of service should be determined by the Board of Trustees.

62. It is vital to ensure that the Foundation is managed not only in accordance with high standards of efficiency but of knowledge and experience of SME business operations. Capital participation in SMEs involves different capabilities than management of loan finance and irrespective of the degree of involvement in management of particular SME's, the Foundation must ensure that its decision making is based on sound knowledge of operations of SME;s and the problems that these may encounter. It is necessary, in this context to induct such experience from the initial stages of the Foundation's activities. This can be done by bringing in one or two persons with extensive practical experience of SMEs in the Board of Trustees of the Foundation from the time of formation of the Foundation. Since DPB will be responsible for setting-up the Foundation, one or two such persons should be inducted by DPB as founding members of the Board. It would be

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desirable, in the interests of continuity & to retain the philosophy of the SEED Fund to provide that such founding member of members will have a tenure of atleast 5 years and can be removed during this period only on account of bankruptcy or misconduct. An alternative approach could be, as stated earlier, to entrust the initial management of the Foundation to a competent private sector organisation, with specialised experience in the field. It would however, be preferable to have a separate Foundation. With the Fund's essentially unique development trust & its non-traditional financial operations, it is important that the management of the Foundation should be insulated, as far as possible, from political changes, including changes in institutional leadership. The concept of founding members would ensure necessary continuity in the design & philosophy of the SEED programme.

## RESPONSIBILITIES OF DBP.

63. It would be seen from the above summary structures of the Fund & Foundation that the DBP will have the principal responsibility for setting up both these organisations.At the same time,DBP must increasingly involve not only external donor agencies & institution but private investors from the Philippines through investments in the Fund & grants or other forms of participation in the activities of the Foundation. To do this, DBP should gradually dilute its holdings, both in the Fund and the Foundation to a level not exceeding 49% within a period of 5 years or less. It is important

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to emphasize that, in the initial period of operation of the Fund & the Foundation when DBP shall have the principal operational responsibilities, such operations are guided by a flexible & dynamic approach and based on private sector management techniques. This will necessitate the induction of specially-selected persons in the Board of Trustees & the Management Committee.

64. The implementation of a programme for capital participation in small-scale enterprises will not be easy. While loan finance presents relatively less problems, particularly if collateral is available , non-loan participation in such enterprises has to be handled with considerable practical knowledge of business operations, & tact & sensitivity in dealing with SME enterprises. At the same time, the needs of such enterprise both financial & managerial, have to be effectively met & the Foundation's success would be judged by the extent to which this basic objective is adequately achieved.

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## CHAPTER III

## PROSPECTS AND POTENTIAL OF SEED FUND SCHEME

65. The SEED Fund proposal, as elaborated in the last chapter, is undoubtedly a fairly novel proposal for providing non-traditional financial participation in SMEs in the Philippines. It is designed for intervention in selected small and medium enterprises which have substantial growth potential. The development of these enterprises is important and critical in the Philippines, not only for industrial growth through nationally-owned enterprises but for decentralisation of industry to the rural sector outside Greater Manila, which is an important objective of Government policy. Such enterprises can also effectively serve as livelihood multipliers in various sectors and regions.

66. It must be stressed that the SEED Fund, which would be set up a trust Fund by the DBP, is intended to primarily serve development objectives and to meet an important gap in the financing of SMEs in the Philippines. At the same time, the scheme as revised envisages substantial inflow of resources into the Fund from the private secter and from external sources. It must be ensured, therefore, that the scheme is also viable from the viewpoint of yielding reasonable returns on investments in the Fund. For this purpose, it has been recommended that the Fund should be managed by an independent Foundation to be created by DBP, with persons having knowledge and experience of SME operations and financing in the Philippines. These would constitute important safeguards.

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67. It would be useful to compare the SEED Fund project with equity finance programme for small industries in other countries. As pointed out in the first chapter, most SMEs in developing countries receive only loan finance, adding to the debt burden of these enterprises and constituting a major constraint when additional collateral and matching contribution cannot be provided by the SME entrepreneur. In the cases where equity finance has been provided, these have largely been either for rehabilitation of weak units which cannot provide additional collateral or matching contribution or for a wide range of small enterprises without distinguishing those with special and demonstrated growth potential. In this respect, the SEED Fund represents a market improvement, since it concentrates only on those SMEs which have clear and well-defined growth prospects. The exercise of selectivity in choosing the SMEs to be financed through equity participation is an important and basic feature of the SEED Fund project, which could significantly protect the Fund from unduly risky investment participation.

68. The form of participation i.e. through preferred stock, is also a feature which would distinguish the SEED programme from the few other equity particpation schemes operating in developing countries. Preferred stock participation would enable the SME entrepreneur to take necessary management initiatives, without interference by the Fund, with the Fund's option to convert the preferred stock to common stock only being exercised in the event

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of default in the paym... of guaranteed divident on preferred stock. Though such option would be rarely exercised, it would be important for the Fund to be prepared for such an eventuality and the management structure of an independant Foundation for the Fund would be very valuable from this viewpoint.

69. The concept of a Foundation as Manager of the Seed Fund also marks an important difference with other equity participation schemes in developing countries. If the Foundation is manned by experienced and knowledgable persons in SME financing, this would provide for induction of specialized personnel for the management of the Fund's investments, which would be significantly different from traditional loan finance.

70. Thus, the SEED Fund scheme is substantially different from other equity investment programme for SMEs in developing countries. In view, however, of the limited experience of such investments, there is relatively little material for really useful comparison.

71. The SEED Fund scheme has certain elements of similarity with the SBIC programme in the USA. Both are essentially venture-capital schemes for SMEs, with SEED Fund concentrating more on developmental aspects, while the SBIC programme is primarily commercial in character. At the same time, both provide alternative forms of equity finance to SMEs and both are designed to be self-sustaining and to yield reasonable returns.

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72. Any programme of equity financing in SMEs involves a certain element of risk, which may be greater than in loan finance. At the same time, several safeguards have been built into the SEED Fund programme, ranging from selectivity of the SMEs in which the Fund would participate to the management structure envisaged for the Fund. These safeguards should ensure that the Fund's operations prove to be viable and successful, and at the same time, cover an important financing gap for SMEs in the Philippines.

73. Several follow-up measures would be required if the proposal for the SEED Fund is taken up for implementation. One important aspect would be the mobilisation of external resources for the Fund. This would require the preparation of suitable documentation for distribution to external donor agencies and institutions as also to private investors. It would also be necessary to follow-up the matter with major donor agencies in several countries. At the same time, guidelines and criteria would have to be drawn-up for selection of SMEs in the Philippines which could be considered for participation under this programme. Norms would also have to be prepared on various other aspects of functioning of the Fund. These responsibilities would largely devolve on the DBP, which may require further technical assistance from UNIDO for another 6 months or so till the SSED Fund programme is effectively under implementation.