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The Small Enterprise Equity Development Program
The SEED Fund

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President Development Initiatives
Manila, Philippines

The Small Enterprise Equity Development Program

The SEED Fund

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EXECUTIVE SUMMARY

THE SMALL ENTERPRISE EQUITY DEVELOPMENT PROGRAM

THE SEED FUND

1. The Situation Addressed

There have been many assistance programs for the small and medium enterprise (SME) sector but these have only served to swell the ranks of numerous small enterprises, stagnating at a low level of production, unable to grow to the scale needed to produce at the volume and quality needed to compete effectively in the market, because of their inability to access additonal capital to actualize their growth potentials.

The root of the problem is the low savings base of the entrepreneurs which pre-determines the limits of the size of the enterprise he can operate, and the counterpart capital he can put up, generally required as a pre-condition for fund availment. While there may be sufficient capital to start up the business, by the time the enterprise has resolved its technical problems and gain market acceptability, entrepreneur reaches the limit of his savings base to raise the counterpart equity/security requirements of financing sources to access additional capital. It is at this point of growth that the enterprise needs substantial long term capital to transform to a larger scale operation. This is the situation that traps a broad mass of small enterprise that are unable to break out of this capital impasse.

The problem of low savings and under-capitalized enterprises is more acute in the countryside where whole towns providing sub-contracting capabilities to urban based exporters, are stagnating at a low level of production unable to acquire the production capabilities needed to penetrate the larger markets. Socially oriented "Livelihood Programs" and other SME assistance programs have provided small packages of capital assistance sufficient to start-up new enterprises but are not designed to respond to the relatively more substantial capital requirements of a growth enterprise for long term capital and technical assistance.

The end result is a critical gap in the SME development program, which requires a new approach to development financing and a new type of intervention.

2. The SEED Intervention

The SEED strategy is to selectively intervene in the SME sector, focussing on enterprises which are mature and have a demonstrated growth potential and providing them the necessary long term capital and technical services in order to graduate them to a larger scale enterprise that can produce and compete effectively in the market. The objective is to intervene at the point of enterprise take-off and graduate mature enterprises into a larger scale operation which can then create additional markets for itself and the smaller enterprises supplying its inputs. The strategy then is to use the growth enterprise as the anchor investment which will catalyze and multiply additional production and income to its rural based suppliers and subcontractors.

To do this SEED will establish an equity financing facility to address directly the issue of under-capitalization and low savings base of SME entrepreneurs. The facility will provide for their long term capital needs under terms and conditions mutually acceptable to the business interests and attitudes of entrepreneurs and investors in a developing country context. In addition SEED will provide a package of technical assistance to support the enterprise in coping with the demands of transforming into a larger scale operation.

A corollary objective of the Program is to mobilize investible funds for the SME sector by establishing a Fund mechanism and the institutional infrastructure that will evolve into a capital market for SME needs. This requires designing a SEED Fund with the appropriate mechanisms and financial instrumentation that reconciles the business interests and concerns of both the fund user, ie the entrepreneur and the fund supplier, ie., the investor.

3. Purpose/Benefits of the SEED Program

In sum, the SEED Program will provide the following strategic benefits:

a. The Program helps provide a direct solution to the root porblem of small scale enterpises which are unable to grow because of the entrepreneur's low savings or equity base.

b. The SEED helps to initiate the development of a fund mechanism to evolve a capital market for channeling long term capital and new types of financing to the SME sector.

c. The SEED Program could have a strategic impact on rural industrialization by utilizing Growth Enterprises as a delivery mechanism for multiplying income and employment in the countryside by providing additional markets and financing to its rural based suppliers and subcontractors.

d. The SEED Program presents a fresh approach to entrepreneurial development by providing a "nursery" for growth companies, wherein they can be provided the necessary cpaital and technical assistance to shorten the period for achieving a larger scale operation.

3. Components of the SEED Program

To accomplish its mission, the SEED Program has two basic components: (a) the SEED Fund and (b) the SEED Prgoram Support System.

3.1 The SEED Fund -- The Program will establish a SEED Fund which will serve as the vehicle to receive funds from Official Development Assistance (ODA) sources and organize investible funds from governmental and private sources. The Fund resolves the difficulty of large scale investors who do not want to be involve in the structure of numerous small companies, in that the investment or the concessional loan is made to the Fund and its portfolio rather than on individual projects. The pooled funds are then managed and its investments are supervised by a common program support system, thus enabling small lots of investible funds to participate, and spreading the overhead costs of managing the fund and the investments, and diversifying the risks to make the portfolio actuarially sound and stable.

3.2 The SEED Program Support System -- This consist of the institutional set-up, the organizational capabilities and network of linkages to: (a) source or market fund participation from investors; (b) manage the Fund; (c) identify, evaluate, present project investments for approval to Fund administrators; and (d) supervise/monitor investments and undertake enterprise building and entrepreneurial training services.

4. The SEED Fund

4.1 Structure

The SEED Fund is structured according to its uses described as follows:

(a) the Investible Funds -- these are the funds for investments into the growth enterprises in the form of equity and or unsecured transactional financing;

(b) the Fund Support Mechanisms --these are the funds to establish the financial mechanisms that will be utilized to secure investments and provide the incentives to mobilize investors to participate in the Fund;

(c) the Program Support -- these are funds to establish and maintain the institutional and organizational capabilities to provide the Program Support System.

Accordingly the structure of the SEED Fund will be as follows:

			PER CENT
1. INVESTIBLE FUNDS			75
1.1 Equity Investments	-----	60	
1.2 Transactional Financing	-----	15	
2. FINANCIAL SUPPORT MECHANISMS			10
2.1 Guaranty Reserve	-----	5	
2.2 Liquidity Mechanism	-----	5	
3. PROGRAM SUPPORT SYSTEM			15
3.1 Program Management	-----	5	
3.2 Enterprise Building Services	-----	10	
			100

4.2 Program Costs

The SEED Fund composition is approximated as described above on the basis of at least $5 Million, which is the targetted amount for the pilot launch stage. Subsequently the objective is to secure a $25 Million SEED Fund to fully operationalize the SEED Fund. At this level of operation, private sector participation may enter.

The program costs breakdown will then follow the percentage distribution of the given Fund structure. Note that components 2.1 and 2.2 may not be immediately necessary, if there is no participating private investible funds, which may well be the case at the pilot stage of the Fund. As the Fund demonstrates a portfolio experience, and ODA funds bolster the Fund's financial support components, private investible funds may come into the Fund.

5. Fund Demand and Supply Considerations

The design of the SEED fund and program is based on an analysis and experience with the users (ie the SME entrepreneurs) and their interaction with the suppliers of the fund (ie., the financial sector and investors).

On the demand side the following considerations were noted:

--The equity base of SME's are relatively small relative to the amount of capital infusion they need to achieve growth. Hence entry in the form of common stock will effectively overwhelm and take-over the ownersnip and control of the enterprise.

--SME entrepreneurs personally identify with the struggles and growth of their company and as such are averse to the dilution of their control and ownership thru the entry into the common stock of any external entity.

-- SME entrepreneurs would want to have a divestment scheme built-in to an investment agreement so that they have chance to regian full ownership and control of their company. This is the best incentive for them to perform and make the investments mutually profitable for themselves and the Fund/investors. The SEED financial instrument provides for a buy-back scheme over a period or at the option of the entreprneur.

--The size of demand for SME growth capital is quite large, estimated to be about P3.0 billion or $150 Million in 1986. This estimate of the mature, growth segment of the SME sector is based on the statistics on renegotiated loans or "evergreen loans" of the commercial banking sector. Bankers indicate that these are generally the loans of performing companies who inspite of their good performance need to pereniaily roll-over their loans because of their inability to accumulate enough cash, an indication of their under-capitalization. This represents at least one-third of their portfolios, which they would gladly endorse to another fund source since their funds are frozen in and can have better earnings opportunities. Thus the targetted amount for the operation of the SEED Fund of $25 Million, is minimal compared to the requirments.

--Enterprise growth to a larger scale operation brings in new pressures, changes in operations and costs which must be coped with if the capital infused is to be utilized effectively. This requires entrprise building support services to accompany the capital infusion, which is provided for by the SEED Program support system..

On the Supply side, following are the considerations noted:

--The investors' investment objective must be reconciled with the SME entrepreneurs in order to gain entry ie., the objective must be to gain a good financial return rather than to gain ownership and control.

--In lieu of tight control instruments which are never adequate nor fully effective, SEED Fund investments are more effectively protected by using the SME entrepreneur's self-interest to be the instrument or leverage of control. This can be built-in to the financial instrument for the investment which incorporates a system of incentives and penalty. The incentive is profit and growth while the penalty is conversion of the investments to common stock thus effectively taking over ownership and control of the enterprise.

--The Fund must provide a mechanism for liquifying investments since investors may not wish to be locked in for a long term, and would want a ready market that would buy back their investments. The Fund provides for this thru a Liquidity Reserve or Exit Mechanism which buys back private investment placements.

--Philippine investors are traditionally conservative and may want a guarantee on their return and principal in order to mobilize them to participate. The SEED fund provides a Guaranty Reserve which protects their principal and a fixed dividend rate with, provisions for income sharing.

--The Fund must be sufficiently large in order to be actuarially sound thru diversification of risks, and in order to recover the infra-structural costs of setting up the fund and its program support system. The targetted amount to have a reasonably sized pilot is P100 Million, or $2.5Million.

--The Fund is a kind of infra-structure and provides a common service support which are required to mobilize equity investments in small enteprises, and render these investments secure and profitable. The Fund provides the nucleus and the necessary foundation for the formation of a capital market for SME's. AS such these infra-structure and program support costs must be supported by grant funds, in order not to impair the returns to the investible funds. Otherwise the hurdle rate for the portfolio investments may become too high as to render the Fund unviable or unprofitable to attract private investors.

6. Financial Instrumentation

In response to the demand and supply considertions for an equity financing facility, The SEED Fund instrument for investing in growth SME's will be in the form of preferred equity shares with the following features: It will have a guaranteed or fixed annual dividend rate of 15% (targetted to regain at least cost of capital),cumulative. The stocks will have a mandatory divestment scheme to serve as an incentive to performance for the entrepreneurs and to assure them of the Fund's income orientation rather than control. Share will be non-voting, but convertible to common if there is a default on fixed dividends. When the preferred shares are repurchased, they are to be converted to common shares in order to effect the SEED Program objective of building up the equity base of the enterprise to achieve growth.

The Convertibility provision is the principal instrument of control and protection for the SEED Fund investment, as well as the self-regulating mechanism that pushes the entrepreneur to perform and act in the best interest of the investments. The SEED policy is to give the entrepreneur full autonomy, full support and full accountability. Fund presence in the company board will be purely monitoring and advisory in nature.

7. Financial Returns

Financial simulation studies on a typical growth company financial profile can generate a 35 % rate of return on investment, given that the company has a 15 to 20 per cent net income margin, and experiences a sales growth of 13 per cent.

The analysis shows that given a 15% net income margin, the the Fund's targetted return of 35% is achieved at a sales growth of 13 per cent. At this point the Fund will require a 52- 48% income sharing in its favor to secure its targetted return, and the entrepreneur suffers a drop in his absolute income share from a 1.16 return on equity to .65 return on equity. As sales grow by 50% from P4m to P6m, the entrepreneur's return on equity goes to 1.21 and the income sharing to generate the 35% Fund return is 37-63% between the Fund and entrepreneur respectively.

Given a 20% net income margin, the targetted return is also achieved at a sales growth of 13 %but the income sharing for the entrepreneur is improved to 40-60 for the Fund and entrepreneur respectively, with the entrepreneur earning a 1.06 % return on equity compared to his original 1.16. Given a 25 % sales growth, the entrepreneur's income reaches a 1.29 % return on equity and the Fund will share 35% of income while the entrepreneur's share is 65% , to generate the Fund's targetted rate of return of 35%.

This shows that the capital investments in growth SME's is fiancially profitable mutually for the SEED Fund investor and the entrepreneur, provided the growth does occur.

trivial statement

8. Fund Sourcing and Institutional Set-up

The fund sourcing which is inter-linked with the institutional set up, will evolve in three stages:

1. PHASE I--THE PILOT STAGE

SEED will be launched on a pilot basis with the initial funding coming from the sponsoring institutions, namely DBP and EDF.

Initially the DBP as the lead financial institution proposes to contribute funds to be drawn from the Bank's Window III, which is a special funding facility, that provides loans under concessional terms to support innovative development interventions in the SME sector and/or the rural sector. The Fund will then be set aside for the sole purpose of implementing the SEED Program. The targetted amount is P50 Million.

In a parallel effort, the EDF as the lead institution for the SEED program support system will likewise seek funding support from the DRDAP for the purpose of funding the cost elements in the SEED Program that require a grant or concessional loan source. This ODA fund source will support the Program support system and the financial support mechanisms, which are the infra-structure components of the program. The targetted amount is P25 Million.

The two fund contributions will be put together as a SEED Program fund to be managed jointly by DBP and EDF under a SEED Program Office. The application or investment of funds sourced from DBP may require confirmation by the DBP Board, because of DBP charter requirements, while those sourced externally specifically for the SEED Program will be governed by the SEED Program Board. The SEED Program Board may be composed of DBP, EDF, SEED Program Director, Department of Trade and Industry, and Private SME Sector Representative(s). See Chart IV-B-1.

In the meantime fund sourcing will be a joint effort, thru the SEED Program Office.Each organization will contribute to the technical capabilities required with the DBP concentrating on the credit evaluation and supervision aspects and EDF on the project generation and enterprise building aspects.In the meantime, UNIDO's assistance will be sought in the marketing of the Fund in order to secure the principal funding for the SEED Program from ODA sources.

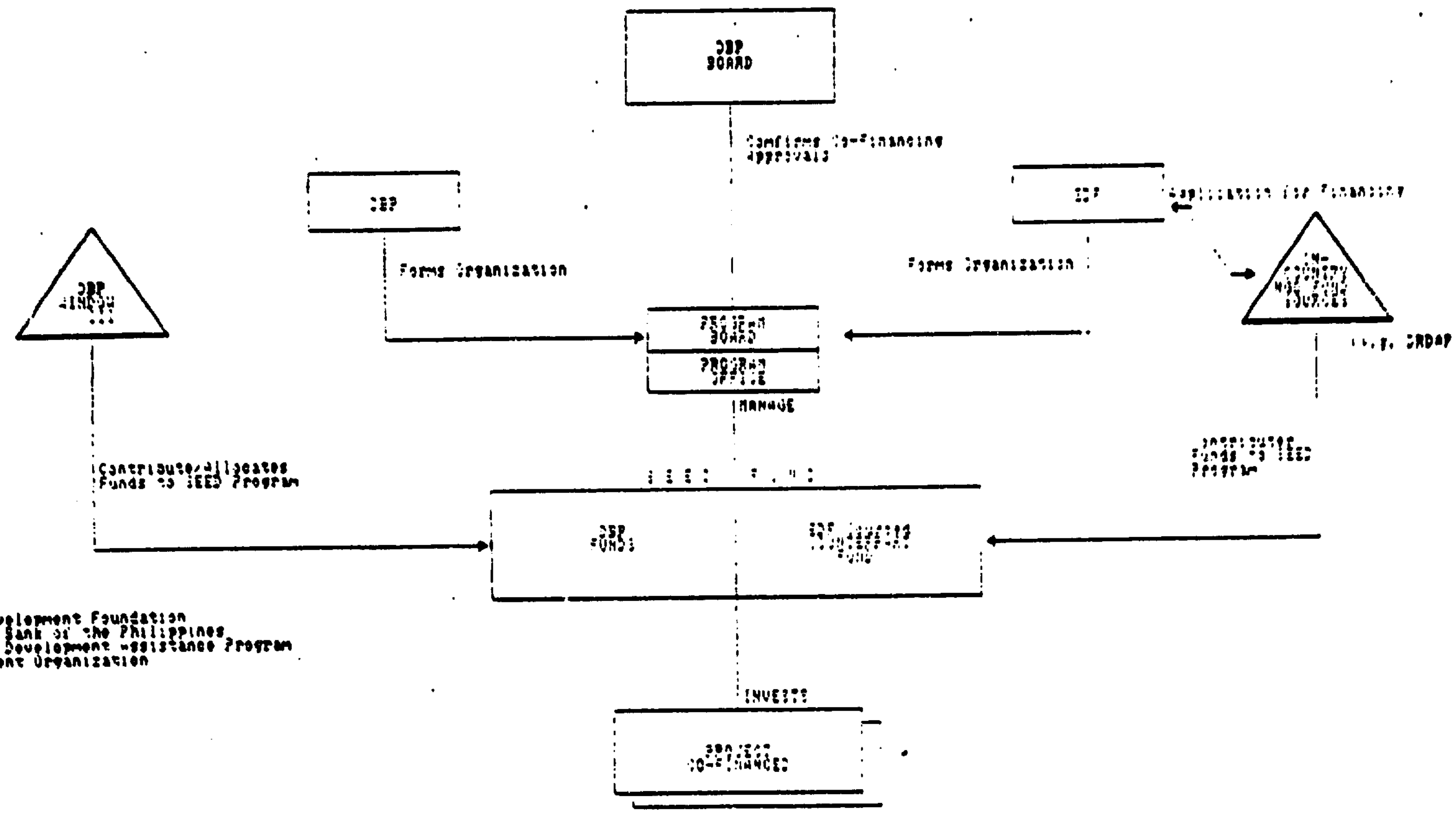
2.PHASE II -- ODA FUND MOBILIZATION /ESTABLISHMENT OF THE SEED FOUNDATION

Parallel to the pilot launch, efforts will be undertaken to source the principal funding of the SEED Program from ODA sources with the assistance of UNIDO offices in different donor country sources. Once the funds are received, the institutional plan for the program will go into full swing with the formal establish of the SEED Foundation as the development institution chartered to implement the SEED Program.

The institutional arrangement proposed here provides for a combination of the advantages of both a governmental and a private development institution. This is summarized in Chart IV-B-2, which shows the establishment of the SEED Foundation as an NGO, chartered to lead the implementation and management of the SEED Program. The Foundation will source its own development funds, from donor sources who do not require a governmental entity to be the fund administrator, and contribute it into the SEED Fund. For this tranche of the SEED Fund, the SEED Foundation Board is the approving authority of the investments or disposition of the funds.

CHART IV-B-1

SEED FUND/INSTITUTIONAL SET-UP
PILOT STAGE



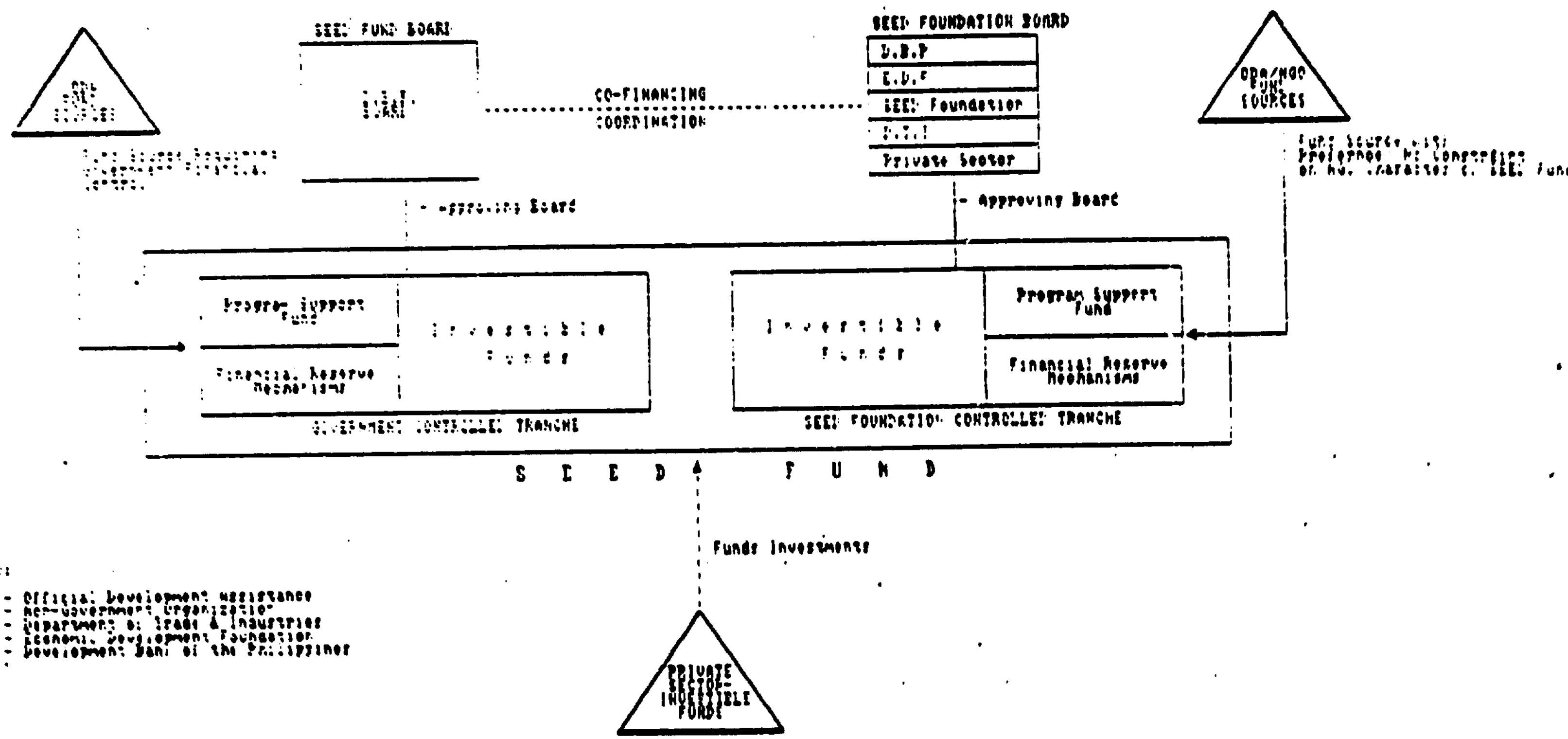
LEGEND:

EDF - Economic Development Foundation
DBP - Development Bank of the Philippines
DRDAP - Dutch Rural Development Assistance Program
NGO - Non-Government Organization

CHART IV-B-2

SEED FUND/INSTITUTIONAL SET-UP

PHASE II AND III



LEGEND:

ODA - Official Development Assistance
NGO - Non-Government Organization
DTI - Department of Trade & Industries
EDF - Economic Development Foundation
DBP - Development Bank of the Philippines

At the same time the DBP as co-sponsor of the program, together with the SEED Foundation, will likewise seek ODA funds from donors who do require governmental ownership or control of the funds and likewise pool these into another tranche within the overall SEED Fund. Investments of this fund will be approved by either the DBP Board or its subdsidiary.

DBP will take the lead in sourcing the funds from Official sources in behalf of the SEED Program. As ODA funds, the national government will be the recipient or borrower of the funds which are then on-lent to the DBP for re-investment in SME's under the SEED Program. While the national government is the borrower or grantee as the case may be, the credit risk remains with DBP which means that in the event of default, the Bank must repay the national government which in turn is responsible to repay the donor source. This financial arrangement has many precedents in DBP's operations and is in fact the arrangement currently in force with DBP's bilateral credits that it is now administering. On the other hand the DBP has the option to handle the funds as a trust fund or use one of its subsidiaries as its fund administrator, in tandem with the SEED Program manager.

It is important to note that administration of the funds by DBP does not preclude the bank from working with a private development institution such as the SEED Foundation as the Program Manager or as a sub-borrower of the funds. While the funds are conduited thru DBP, the SEED Foundation will maintain its role as the institutional manager of the SEED Program which it will coordinate and undertake co-financing activities with its own funds with DBP.

3. PHASE III --MOBILIZATION OF PRIVATE SECTOR INVESTMENTS INTO THE SEED FUND / MUTUALIZATION OF THE SEED FUND

A principal objective of the SEED Program is to mobilize private investible funds for the SME sector thru the SEED Fund since the investment gap in the sector is beyond the resources of any institution or program. As SEED gains a portfolio track record and the program gains public confidence with the participation of international development institutions, the Fund can be opened to the public by unitizing the investments in the Portfolio and offering its own financial instruments to investors, and using its liquidity fund mechanism as a market exchange mechanism.

Chart IV.B-2 likewise shows the integration of the this third source of fund contribution into the SEED Fund. As a private contribution these funds may be lodged with the tranche under the administration of the SEED Foundation.

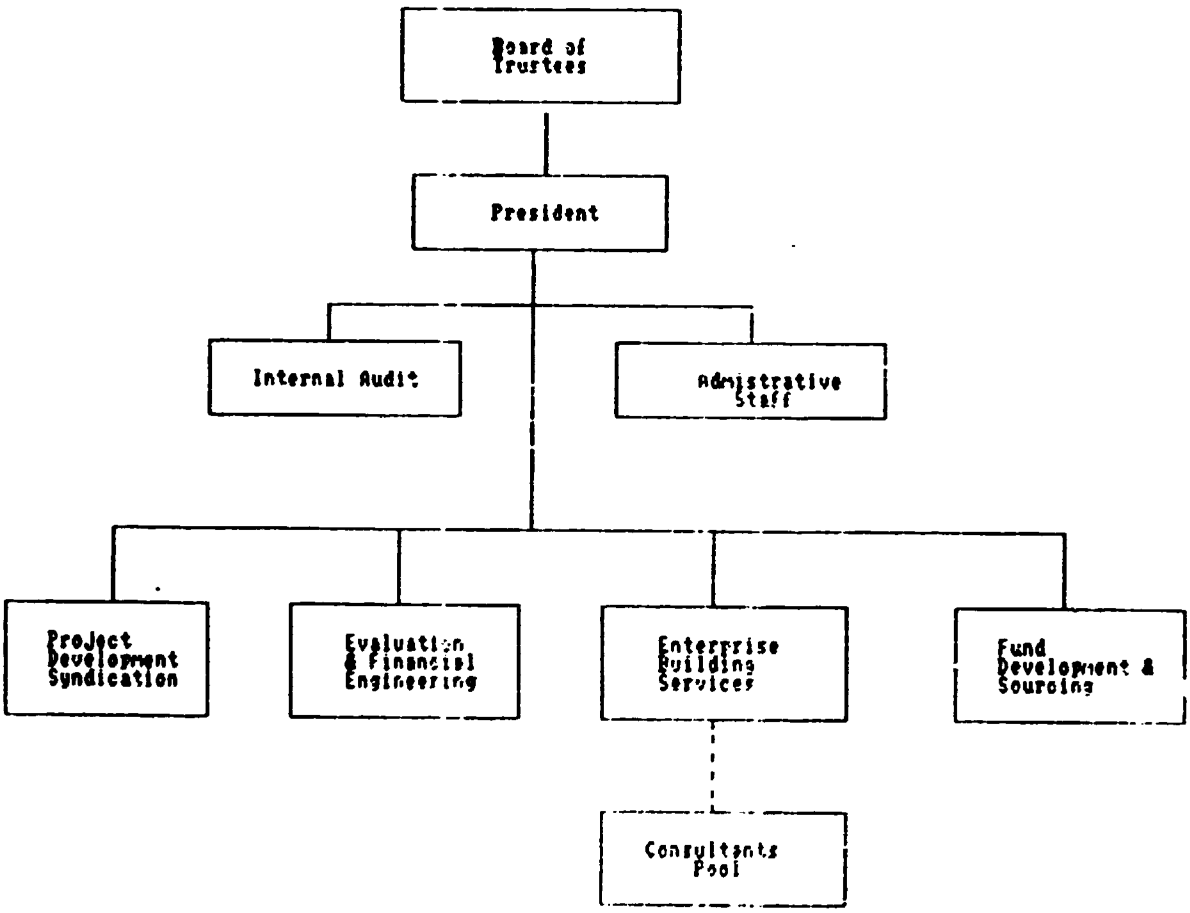
9. The SEED Foundation

The pioneering nature of the SEED equity financing program calls for a specialized private development institution that will develop a profit oriented investment and fund mobilization mechanism while maintaining the primacy of the development objective of the SEED Program. The institutional plan calls for the establishment of a SEED Foundation grafted to the capabilities of existing institutions ie., DBP and EDF. Chart IV.C.1 indicates the structure and the capabilities that have to be built up by the Foundation to cope with the program needs.

10. The Need for Grant Funds

The nature of the funds to be sourced for the SEED Program is a critical issue because it affects the viability of the SEED Fund. The Program Support System and the financial mechanisms need to be supported by Grant fund sources while the investible funds can be obtained in the form of long term concessional loans. The grant is needed to support the infra-structural costs of establishing the SEED Program/Fund which are substantial and essentially non-revenue generating. Saddling the investible funds with these costs will seriously undermine the profitability of the Fund and raise its hurdle rate for investments so high as to be unfeasible.

SEED - ORGANIZATION



THE SMALL ENTERPRISE EQUITY DEVELOPMENT PROGRAM
THE SEED FUND

I. THE SITUATION ADDRESSED

A. Rationale for the SEED Program

There have been many small and medium scale industry financing programs, and so the question raised is what is the need for one more. What is the difference and contribution of the Small Enterprise Equity Development (SEED) Program?

The difference and strategic value of the SEED program lies in: (1) SEED addresses a critical gap in the SME (small and medium enterprise) development program; (2) SEED's strategy of selective intervention; (3) the type of intervention undertaken; (4) the strategic impact of the program on the capital market of a developing country; (5) the strategic impact of the program on entrepreneurship within the context of low savings; and (6) the SEED program represents a new approach to the development of enterprises in the countryside.

The following elaborates these significant points of departure from traditional SME (small and medium enterprise) financing programs, and provides the rationale for the SEED Program.

1. SEED ADDRESSES A CRITICAL GAP IN THE DEVELOPMENT PROGRAM STARTEGY FOR THE SME SECTOR

Despite the myriad of SME assistance programs, the mass base of Philippine enterprises has remained small and uncompetitive in a world market where quality and supply reliability requires that an enterprise attain a critical economic size of operations and capital base.

The fundamental problem of the Philippine SME sector is still the limited savings or capital base of Filipino entrepreneurs which substantially pre-determines and delimits the size and capability of the enterprise he can put up.

They require capital infusion, but are unable to access additional capital in the form and at the time they need it most. because of the basic pre-condition for fund availment of all SME assistance programs, that is -- the entrepreneur must put up counterpart equity capital or collateral assets as security. This is possible for start-up companies wherein the entrepreneur may have some limited savings or asset base with which to start the company. But as the company grows and needs more capital, the enterpreneur exhausts his limited ability to put up the required counterpart as he reaches the the limit of his savings base.

By the time the enterprise has resolved its initial technical and marketing problems, the entrepreneur reaches the limit of his savings base to raise the counterpart equity/security requirements of SME financing sources. Failing this he is unable to actualize the growth potentials of the enterprise he has developed.This is the situation that traps a broad mass of small entrprises that are unable to break out of this capital impasse.

It is at this time -- the point of growth, that substantial capital infusion (in the appropriate form and terms) is needed to transform the enterprise into a larger scale enterprise and establish its position in the market. This is the point of intervention for which the SEED program has been designed. to break the capital impasse rooted in the entrepreneur's limited savings base and enable the mature SME with a growth potential to actualize that growth.

The problem of smallness as brought about by undercapitalization is a serious sectoral problem which works against the growth not only of the enterprise, but also of the whole SME product sector. The smallness of the enterprise limits its ability to compete effectively specially in the export markets where a minimum economic size is required in order to produce large volumes and attain product standards. As a result sales volume remains at a low level, capital and cash generation is limited, and there is a perennial roll-over of debt to maintain the operations level. Consequently the savings or equity base of the enterprise remains small.

This is the vicious cycle of smallness that besieges the SME sector of a developing country: being a poor country implies limited savings base for the mass of entrepreneurs, low savings begets small enterprise, implies limited access to capital, limits growth of the enterprise, limits ability to compete and generate higher sales levels,perpetuating the smallness of the equity and savings base.

This is a problem that has long been unattended. Instead SME financing assistance programs have merely poured in more funds into the sector creating new entrants into the sector who eventually reach the same dead-end size/operations level due to the entrepreneur's limited savings base. As a result the number of small undercapitalized firms continues to increase, overcrowding the product sectors,competing for the same limited market. Buyers tend to exploit this situation, pitting one supplier against another, squeezing further profit margins, limiting growth opportunities even more. Very few graduate to larger sized enterprises, which if assisted to grow larger could create additonal markets to be serviced by the smaller enterprises.

This issue of overcrowding, exploited by international buyers to the detriment of the whole sector has been the subject of many complaints by the different industry associations, such as the Philippine Chamber of Commmerce and Industry, the Philippine Chamber of Handicraft Industries. The answer does not lie in providing more of the same type of financing under the same basic availment conditions. The SEED Program provides the focussed funding approach designed to respond to this situation.

2. SEED STRATEGY OF SELECTIVE INTERVENTION: THE GROWTH SSE

An important difference of the SEED Program Strategy is that it addresses a specific segment of the small and medium enterprise sector -- ie., the enterprise which are mature and ready to expand into a medium or larger scale enterprise, but the entrepreneur has reached the limit of his savings base,which prevents him from infusing or accessing additional capital to actualize the enterprise's growth potential. For purposes of this study, this segment is called the "Growth SSE", ie (small scale enterprise), or "Growth enterprise".

(Note that the term "small scale" here is a relative term referring to that which is of a smaller scale and can become bigger or larger scale. Hence the use of the term small scale here does not refer to an enterprise of a particular asset size as the term is traditionally used. The growth SSE may in fact be a medium scale enterprise (under the asset size definition of medium scale) with the potential of becoming larger in scale.

The Growth SSE is the enterprise that is operationally mature,has solved its start-up problems in production, technology, product standards, has gained market acceptability and consequently are faced with prospects or actual opportunities for larger sales. It is at a stage of take-off into a larger scale of operation, but requires infusion of additional long term capital to provide the additional inventory levels required by a larger volume of production, or it may need additional production facilities, plant expansion to service the additional volumes.

It is at this point of take-off that the enterprise is ready for growth if capital is made available. But because of the long period of enterprise debugging or development, and given the limited capital base, the entrepreneur's savings resources is exhausted. He cannot come up with additional counterpart collaterals or equity as required by SSE financing programs, that will trigger the infusion of external capital. The inability of the entrepreneur to resolve this financial impasse finally results in the market opportunities being passed up and the firm stagnates at a low level of production.

Existing SME financing programs tend to treat the enterprises as a homogeneous mass, all requiring financial assistance, without discriminating at what stage of development the enterprise may be. The design of SME financing programs must be adjusted to the absorptive capacity of an enterprise and the nature of its financial and operations needs which changes depending on the stage of development of the enterprise.

The government SME programs tend to have a populist bias favoring the small start-up enterprises and micro-enterprises, as the ones needing help. While from a social standpoint this may extend financial relief, and provides good political mileage, it is doubtful that these clientele could lead to substantive industry growth, and could in fact militate against sector growth as the same sized market is divided further among a larger number of SSE's.

This is not to discount the worthiness of economic relief to poverty groups through socialized lending programs. The point made is that financial interventions in the SME sector must be diversified and deliberately selectively to provide direct assistance to "growth enterprises" which can be the catalyzers or multipliers of income opportunities to other smaller enterprises and workers. Selective intervention, ie., targetting Growth SSE's could lead to penetration into new and larger markets, catalyze immediate backward and forward linkages within the industry, generate sustained employment, and lead to a higher return on investment.

From a capital programming standpoint,capital infusion in Growth SSE's are optimal points of intervention. They are optimal users of scarce capital resource, because of the high economic benefit to cost ratios and the immediate impact they have. In the case of a growth enterprise, additional capital is infused on an existing base of capital and an effective and experienced producer with a definite market share that is in fact due for expansion. Hence capital is used more effectively, profitably and with immediate results.

Thus from the point of view of the economic planner, programming scarce capital resource and investors looking for the most profitable investments, the strategy of selective intervention focussed on mature enterprises ready for take-off -- would lead to the highest socio-economic and investment returns.

3. SEED UNDERTAKES A NON-TRADITIONAL FORM OF INTERVENTION -- EQUITY FINANCING AND TECHNICAL/MANAGMENT SERVICE PACKAGE

The financial impasse faced by Growth SSE's, calls for the infusion of equity infusion which the SEED Program will undertake thru an equity financing facility -- ie., the SEED Fund.

Given the conservatism of loan fund sources which compel the putting up of counterpart equity or collaterals as a pre-

-condition for fund availment, the entrepreneur has nowhere else to source funds but from equity sources. There are sources of unsecured loan financing from informal sources but the terms of maturity are short term and the cost of financing prohibitive. The default of the commmercial banking system to respond to the needs of these undercaptilized, highly leveraged growth enterprises, has created a good market opportunity for these informal lenders, who regard these growth SSE's as prime clients because of their business performance although they may not have the counterpart equity or collateral base. Growth SSE's who are compelled to grab at any capital to keep on going, go to informal lenders inspite of the high cost of money. At present where the bank lending rates are at 24% per annum, the informal lender's rate ranges from 36% to 60% per annum for three to six month money.

Equity financing is the answer to the needs of the highly leveraged capital structure of the growth SSE's, in order to develop the equity base of the enterprise, and increase its absorptive capacity for additional capital infusion. However transformation into a larger scale operation also requires internal changes in the management, financial,production systems and organizational culture of the growth enterprise. This then requires including a package of technical and management services to guide the transformation of the company as well as to monitor the use of the capital infused.

4. SEED STRATEGIC IMPACT ON THE CAPITAL MARKET FOR MOBILIZING INVESTIBLE FUNDS FOR THE SME SECTOR

The mobilization of equity investments on a large scale for SME's presumes the establishment of the appropriate funding mechanisms that reconcile the goals and interests of both the investors and the entrepreneurial owner recipients of the equity funds. Moreover, it assumes the existence of the institutional support systems to organize and manage the funds, select and screen the investment risks, and service and secure the investments.

The launching of the SEED Program as an equity financing facility will then require the establishment of the necessary financial and institutional infrastructure to mobilize the inveestment funds needed in growth SSE's. The design of the SEED Fund mechanism and the institutional support system will likewise take into consideration the demand (entrepreneur-user) and supply (investor) of the funds. The SEED Fund vehicle once established will serve as an infrastructure and a market mechanism for others funds to be mobilized and support the capital requirments of SSE's. The SEED Program will serve not only as a provider of capital funds for SSE's but also as a mobilizer of savings and develop the capital markets for SSE's needs. This is discussed in greater detail in section I.B.

For the larger scale enterprises, there is a stock exchange market mechanism to mobilize investments in industrial and commercial establishments, and the mining and oil companies. However there is no such exchange for the small and medium scale enterprises, that can be a source of long term capital.

There have been no successful equity financing facility for SME's in the Philippines although one signficant attempt that failed was the establishment of venture capital corporations. This failure may be the result of a simplistic application of Western or developed country type venture capital concepts to the equity requirements of the SSE's in a developing country setting. The concept of operation of the Western style venture capital corporation (VCC) is to enter into the common stock of a company it invests in, and makes its profits by awaiting the appreciation of the value of the company shares in the stock market.

The absence of a stock market for SSE's in a developing country and the aversion of the SSE entrepreneur to sharing ownership and control of the enterprise to common stock investors has caused the failure of VCC's in the Philippines. A number of VCC's were established in 1980 but they have all stopped operation since then. The VCC's did not undertake long term investments but rather concentrated in transactional financing. Their capital base were likewise too small to diversify their investment risks and support the service requirements of their project investments.

5. SEED : A NEW APPROACH TO ENTREPRENEURIAL DEVELOPMENT

While there are always stories of heroic entrepreneurs who made their success thru innovation and hard work, the mass of entrepreneurs in a developing country are severely handicapped by their low savings base which bring them to the dead-end point where further growth is limited by this fundamental constraint. Allowing the natural course of the market mechanism a few may eventually hurdle this impasse and in time, at least ten years accumulate enough or get a profit break that enables them to grow.

The SEED Strategy is to shorten this transformation period from small to large by providing as it were a "nursery" for entrepreneurs who have a demonstrated potential for growth. The SEED Program would select the growth SSE with the potential, and provide the necessary financial, management and technical service support during this critical period of transformation to a larger scale operation. Aspiring entrepreneurs who may be starting their company, are given hope f overcoming this fundamental constraint, provided they can demonstrate their worthiness as a company that has a real growth potential.

As such the SEED Program represents a new strategy in entrepreneurial development, in that it actually works with entrepreneurs to directly address the operative constraints that prevent their success. The Development Bank of the Philippines which has projected itself as the institutional champion of Philippine entrepreneurship, is then the appropriate proponent of the SEED Program.

6. SEED: AN ALTERNATIVE MECHANISM FOR RURAL INDUSTRIALIZATION

The problem of low savings and undercapitalized enterprises is particularly acute in the countryside towns as evidenced by the stagnation of these towns where export products are frequently subcontracted and supplied to urban based export enterprises.

A prominent example of this is the town of Paete in Laguna, about ninety kilometers from Metro-Manila. The town specializes in wood carved products and papier-mache which has a large export demand either from exporters or direct buyers. Virtually every household is an enterprise. Inspite of the great demand for their products, the enterprises have remained small, the profit margins are squeezed to the limit as the entrepreneurs vie for the buyers. Their production technologies and facilities remain crude, as there is not sufficient capital accumulation to acquire the specialized equipment needed to upgrade production volumes and quality standards to the levels required by the export markets. As a result the town enterprises have remained at a low level of production and the town has remained poor with no chance to grow.

Growth SSE's particularly those in export manufacturing have a network of material suppliers and component sub-contractors in the countryside. This is because of the cheap labor and material supply provided by the rural areas. Development programs have often targetted the expansion of these SSE's in the countryside as the nucleus of rural industrialization. SSE financing programs recognize the continuing need of these SSE's for financial assistance. However the absorptive capacity of these SSE's for additional financial assistance is limited by their inability to penetrate larger markets.

Assisting the Growth enterprise would then catalyze an income and employment multiplier effect in the countryside thru its network of suppliers. The SEED Program could go one step further by providing direct financial assistance to sub-contractors, provided their markets are secured by the client growth SSE's of the SEED Program.

In this way, the SEED Program represents a "two step" approach to livelihood development in the countryside. The growth enterprise functions as a direct delivery mechanism for capital, technical and marketing assistance to the smaller enterprises in the rural areas.

B. DEMAND AND SUPPLY CONSIDERATIONS FOR THE SEED PROGRAM DESIGN

The Situation Addressed calls for the establishment of an equity financing facility which will respond to the capital requirements of growth enterprises in the SME sector.

The design of such a Fund and its institutional support system, requires an appreciation of the following Demand and Supply considerations in order to respond effectively to the requirements and interests of both the Fund users and the Fund suppliers.

B.1. USERS OF THE FUND-- DEMAND CONSIDERATIONS

In designing the Fund the following considerations have to be inputted from the point of view of the users of the Fund:

1. Aversion of SSE entrepreneurs to sharing ownership and control with new partners particularly at the point of growth -- SSE Entrepreneurs identify personally with the struggles and growth of their company, and are very jealous of their prerogatives to manage their company without external interference. They also express fear that an external institutional partner may take-over what they have built. This is a principal reason why they would rather remain small than yield their autonomy to new investors, who could provide the capital to grow.

In terms of Fund Design -- this calls for a "user friendly" equity investment -- ie one that is after income returns rather than control or ownership of the enterprise. This likewise calls for the intervention of a "development oriented" Fund manager such as the SEED Foundation, that will ardently seek to foster the growth of the enterprise and limit the commercial appetite of investors to take over a growing enterprise. The involvement of a developmental institution will likewise serve to remove the threatening posture of external investors and enable the entrepreneur to cooperate with the SEED Program objectives.

2. Divestment Provision -- To assure entrepreneurs of SEED's disinterest to takeover their business, a provision for divestment should be included in the agreement to invest in the enterprise. The divestment could be programmed but could be acclerated at the option of the entrepreneur, if he is able to repay the capital infused.

The divestment terms must be considered in establishing the rates of return to be obtainewd for the SEED Fund investment. The entrepreneur must retain sufficient income so as to redeem the share pruchased by the Fund investment, and still maintain an interesting entrepreneurial return for his work.

3. Small Equity Base -- The capital structure of the Growth enterprise is characterized as having a small equity base, relative to its debt thus becoming highly leveraged. It is likewise small relative to the required capital infusion to realize its growth potential.

The Fund design implication of this structure is that-- the entry of the capital invested can not come in the form of common stocks or it will dilute or effectively take-over the common stock ownership of the enterprise. Infusion in the form of preferred shares is the considered solution to remove the threat of equity take-over.

4. Type of Funds needed -- The capital requirement of the growth SSE need not be all in equity form, but could be a mix of equity and debt financing. Equity infusion will increase the absorptive capacity for additional debt as debt-equity ratios are improved, and there is an increase in asset holdings, as operations expand anew. These can then be the basis for the provision of additonal debt financing.

In particular Growth SSE's could make use of transactional financing which may be unsecured, working capital requirements to service large orders. Financing would be needed to bring up inventory levels to support higher level of production.

5. Size of Demand: The Growth Enterprise -- The SEED Program will be selective in its intervention in that it will invest only in enterprises that are experiencing growth or have a strong potential for transformation into a larger scale enterprise.

The term "small" in the acronym SEED is used in a relative sense that is we are referring to an enterprise which may be called a small or medium scale enterprise in terms of asset size but has the potential to transform into a larger scale enterprise, if its capital impasse can be resolved. Thus the universe of the SEED clientele is the small and medium scale enterprise which are enterprises which have assets of P5million or $250,000 up to P20Million or $1 Million.

There is no formal or statistical identification of the growth segment of the sector, but the identity of these growth enterprises are well known to the banking sector, the suppliers of materials particularly the bonded trading firms who handle the importation of materials used in export products, to international buying offices who have an extensive network of "performing" export suppliers; and to the industry association itself.

One statistic that can be used to estimate the size of this Growth segment is the amount of "renegotiated loans" in the portfolio of commercial banks. It has been noted that growth enterprises tend to pereniallly roll-over their debts because of their continuing need for capital which can no longer be met from internal sources. This is then refelected in the portfolios of commercial banks as loans that are continuously renegotiated and labelled as the "evergreen loans". Banker interviewed this could easily comprise about 25 per cent of their portfolios. A 1986 World Bank study of the financial sector estimates the renegotiated loans to be about P3billion.

6. Fund Infusion to result in sales expansion/ cost reductions --

The capital infusion must result in substantial expansion of sales to justify the investments and generate the rate of returns high enough to justify the unsecured investment. This will be a principal criterion for the investment of the SEED Fund. Financial simulations are undertaken in a subsequent section to illustrate this point.

A substantial portion of this capital infusionwill be used for permanent working capital since much of the equipment requirement will already be in place. Expansion will entail funds for special equipment that upgrade production standards and, or to increase production volume; and funds for production space to accomodate the increase in production activities and inventory storage. The infusion of interest free long term capital will have an immediate effect on the net income margin over sales, since financing charges will be kept at the current level or lowered, while the sales level will be expanded.

7. Enterprise Building Service Support ---

The transformation to a larger scale enterprise brings about a whole range of changes in the financial and operating systems, the organization, and decision-making requirements/structures of the enterprise. These changes must be anticipated and prepared for in terms of enterprise building reforms and frank discussions with the entrepreneur, in order to cope with the changes brought about by the demands of a larger scale of operations. This can not be over-emphasized.

The transformation into a larger scale enterprise must then include enterprise building services to ensure the effective use of capital. The transformation will necessarily entail upgrading personnel, as "levels of incompetence" are reached by the original work force who may be adequate for lower scale operations, but require higher planning and technical skills in an expanded operation. Systems will have to be upgraded if not installed for the first time, in areas where rudimentary methods previously sufficed. The areas of financial planning, cost controls, inventory planning, production planning are the critical areas that will require upgrading.

The SSE entrepreneur himself must realize that transformation into a larger scale operation will require a whole new organizational culture affecting not only his work force but also himself as he relates to an external institutional investor.Particularly in the area of decision-making on major expenditures and financial discipline, the entrepreneur must be ready to accept the transformation into a more formal corporate form, since he must appreciate the obligations and implications of having an external institutional investor. Specfically this means learning to work as a team with a corporate Board which may include representation from the Fund; professionalization of the management team; more formal financial planning. reporting and disposition of funds.

To be successful, the fund design must provide for the financing of these enterprise building costs which must accompany every equity investment. This cost component must be sourced from grant sources or concessional loans in order not to impinge on the returns of the investible funds, which will have a detrimental effect on the returns to investors and thereby delimit entry of investors into the Fund.

B.2 INVESTORS IN THE FUND -- SUPPLY CONSIDERATIONS

In designing the Fund, the following considerations must likewise be inputted from the point of view of the suppliers of or investors in the Fund.

1. Investor objectives: Returns not Ownership --- The entry of the investor into the SEED Fund must be premised on pursuing a good financial return rather than on securing control or ownership of a growth enterprise. These objectives must be acceptable to the investor in order to be compatible with the SSE entrepreneur's objectives in accepting external equity participation. This is a sensitive point, non-consideration of which has led to the failure of venture capital corporations in the past.

Equity infusion must not pose a threat or disincentive to the entreprenuer's drive for profit and identity, which is the basic engine of growth of the enterprise and the best insurance for the investor's return of capital. The balancing of the control requirements of an investor and the autonomy objectives of the entrepreneur are factored into the financial instrument used by the SEED Fund, (discussed below).

2. Using the Entrepreneur's Self Interest as the Control Mechanism to Protect the Investor's Interest. ---

The Philippine financial sector is known for its extreme conservatism, which accounts for its unyielding requirement for collateral security for all its loans, and strict mechanism of financial control when they get involved in investments. Hence business performance alone, no matter how good has not been sufficient justification for a loan exposure. The wave of financial defaults that the country has just emerged from, has only served to strengthen this conservatism. It is within this environment that the SEED financing approach of investing on the basis of business track record and growth potential,without guarantees or securities, is ushered. This is a radical departure from the traditional basis for lending or investment.

The next issue is the control mechanism to protect the investments and secure the usage of the funds. The traditional practice in this regard is representation in the Board and assignment of a comptroller who will act as a co-signatory to all disburesements. The experience with this mechanism has not been favorable. It is observed that this frequently leads to ineffective decision-making and blaming of each other when the enterprise gets into trouble. This is understandable since, assigned representatives are not full time to the company and may not be as committed as the entrepreneur, resulting in an absentee key decision-maker. In fact, in a position of comptrollership, the assigned representative may actually result in a virtual take-over as chief executive of the company.

This runs against the market oriented philosophy of the SEED Program whose thesis is that the entrepreneur is in the best position to decide and should be solely accountable for his business decisions. The SEED Fund design protects its investments thru a system of incentive and disincentive to the entrepreneur worked into the terms of investments of the Fund in the enterprise. The incentive for performance is divestment of the Fund or regained full autonomy by the entrepreneur and the penalty for non-performance is conversion to common shares of the Fund's investments thus effecting a take-over of the company. This serves as a self-regulating mechanism to ensure that the entrepreneur works to the best interest of the company and himself which is linked by design to the Fund's interest.

It is important that SEED maintains his autonomy in decision-making since the consequence of financial non-performance will cause him to lose his controlling interest in the company. It is important to maintain the workings of the market mechanism and utilize the entrepreneur's self-interest as the regulating force to make the investment work. The balance between control and supervision on one hand and the support and monitoring system, must be ruled by this guideline.

3. Investor's need for Exit Mechanism. -- In the absence of a stock exchange for investments in small and medium scale enterprises, the SEED Fund must provide for a mechanism to ensure investors a ready market for the liquidation or recovery of their investments. These applies particularly to private investible funds which may not want to be locked in with the fortunes of a small scale enterprise. The establishment of an exit mechanism to service investments in SSE's will be the first such financial infrastructure in the Philippines that could cause the mobilization of investible funds into the small and medium scale industry.

4. The SEED Investible Fund must be sufficiently large -- The Fund must attain a minimum economic size in order to be actuarially sound, enable the diversification of investment risks in its portfolio, as well as to recover the overhead or infrasturctural costs of investing in SSE's. The experience of the first venture capital corporations are noted in this regard, which were capitalized with five million for investments. A number of such VCC's were established by the Philippine government together with private banks. It was subsequently realized that the fund was too small to absorb the risk of one or two investments getting sour, such that the VCC's limited their investments to small short term transactional financing, avoiding long term investments altogether.

5. The Need for a Fund -- While there may be investors willing to invest in growth SME's there is a need to establish a financial service facility that performs the following:

(a) Serve as a conduit thru which investments in SME enterprises can be made without requiring the investor to be involved with each enterprise that his funds are invested in.

(b) pool together funds to achieve an economic or critical size portfolio of investments in SME's that will be diversify the risks, and be profitable;

(c) Provide the common services required by the pool of funds and the individual investments and achieve economies of scale in performing this function.

(d) In the absence of a capital market or a stock exchange for SME's, the Fund will serve as a substitute market mechanism to organize and service the demand and supply of investible funds into the SME sector.

6. Investible Funds Require an Infrastructure - Investments in growth SSE's have costs in terms of enterprise building services, project development, evaluation, and monitoring costs. These may be called the program support costs. Another group of

infra-structure costs are the financial mechanisms within the Fund itself to service particular concerns of the investors, such as an exit or liquidity mechanism to enable the investor to find a ready market or a mechanism for liquifying his investments in the Fund. Or it may be a guarantee reserve to motivate a financial sector known for its conservatism to participate in the Fund because there is a guarantee scheme to cover the principal of his investment.

Such infra-structure costs have to be budgeted as a vital part of the delivery mechanism for investing in SSE's. These are either pure costs or nominal revenue generating, but this must be front-ended otherwise the high returns expected from the investible funds will not be realized.

Again the mistake in the initial venture capital corporations (VCC's) set-up was a failure to take into account the need for these delivery overheads and providing an adequate budget for these costs. This attitude is likewise evident from discussions with ODA fund programmers, who argue that since the SEED Fund is expected to generate high returns on investments, it should not be entitled to grant funds. This fails to appreciate the heavy front end capital costs of the infra-structure that must first be laid down. The heavy capital costs of such an infra-structure will eat into the returns of the investible fund portion and produce a low return such that the viability and incentive to investors to participate is lost, and the whole Fund collapses. In fact in the absence of grant funds to finance the initial infra-structure costs, the Fund may become marginally viable and render it ineffective to mobilize investors to participate in building up a capital market for SME's. This infra-structure once provided will enable even smaller un-economic sized lots of investible funds to participate in the investments of a Fund built on this infra-structure.

II. THE SMALL ENTERPRISE EQUITY DEVELOPMENT PROGRAM

A. DIMENSIONS OF THE PROBLEM

SEED is a development program designed to respond to the multi-faceted problem of stagnation of an ever-increasing number of under-capitalized, uneconomic sized small scale enterprises unable to grow into a larger scale operation inspite of growth potentials. This is due to the SME's inability to break out of a capital impasse that is fundamentally rooted in the entrepreneur's limited savings or capital base, and the conservatism of a financial sector unwilling to provide unsecured investments in small and medium scale enterprises.

It is a complex inter-related problem, requiring an integrated approach to the situation. The dimensions of the problem are as follows:

1. Gap in the SME Sectoral Development Program -- Inspite of the many SME assistance programs, a large segment of the sector is stagnating at a low level of production, unable to access additional capital needed to grow to a competitive scale, overcrowding in limited markets, squeezing further profit margins, preventing the growth of enterprises and the sector as a whole.

2. The Problem of Under-capitalization and Low Savings Base- The root of the problem is the low savings base of the entrepreneurs which pre-determines the limits of the size of the enterprise he can operate and the counterpart capital he can put up needed as a pre-condition for fund availment.

3. Stagnation of Rural Industries -- The problem of low savings and under-capitalized enterprises is more acute in the countryside where whole towns that provide sub-contract capability to urban based exporters, stagnate because of their limited ability to tap capital to attain production levels and standards required.

4. The Absence of an Equity Financing Source for SME's --- While it is clear that equity financing is the appropriate response to the SME sector and rural industries needs, there is no program or market mechanism to organize investible funds, and provide an investment mode or financial instrument that is acceptable to both the SME entrepreneur and the investors.

5. Institutional and Financial Infra-structure Needed for an Equity Financing Facility --- Mobilization of investments for the SME sector requires, establishment of a minimum economic size Fund in order to be actuarially feasible and profitable, with the necessary technical and financial support systems, and the front-end funds to finance the facility's support systems, and demonstrate to a traditionally conservative financial sector, the viability and profitability of this pioneering financing approach to the SME sector.

6. Transformation of Enterprise to Larger Scale Operations Brings in Radical Changes -- Expansion to a larger scale operation introduces new demands on the operating systems, level of organizational competence and culture, that must be supported along with the infusion of capital to ensure effective utilization and transformation to a higher level of operation.

B. PURPOSE OF THE SEED PROGRAM

The SEED Program is an equity financing program which addresses specifically small scale enterprises which have the potential for growth and transformation into a larger scale enterprise but are constrained by the limited equity and savings base of the entrepreneur and the conservatism of a financial sector that does not provide long term capital without counterpart securities and equity.

As premised on the Situation addressed, the purpose of the SEED Progam are likewise multi-dimensional as enumerated below:

1. To selectively intervene in the SME sector, focussing on enterprises which are mature and have a growth potential, and providing them the necessary long term capital and technical services in order to graduate them to a larger scale enterprise that can produce and compete effectively in the export market.

2. To establish an equity financing facility to address directly the issue of under-capitalization and low savings base of SME entrepreneurs.The facility will provide for their long term capital needs under terms and conditions mutually acceptable to the business interests and attitudes of entrepreneurs and investors in a developing country context.

3. To operationalize a new countryside development approach by financing Growth enterprises and utilizing them as a delivery mechanism to provide capital, technical, and additional markets to their suppliers/sub-contractors in the rural areas.

4. To operationalize a new approach to entrepreneurial development by establishing a nursery for entrepreneurs with a growth potential and providing the necessary capital and technical assistance they need, with a view to shórten the gestation period for their transformation into a larger scale operation.

5. To mobilize investible funds for the SME sector by providing a Fund vehicle that can pool, manage investible funds and supervise its investments, and provide the portfolio track record to demonstrate the profitability of investing on the basis of an enterprise's growth potential (rather than securities it can offer) and thus overcome the traditional conservatism of the financial sector.

C. COMPONENTS OF THE SEED PROGRAM

The SEED Program needs two basic components in order to accomplish its mission. These are as follows: (a) The SEED Fund and (b) The SEED Program Support System.

1. THE SEED FUND --- The SEED Program will establish a SEED Fund which will serve as the vehicle to receive developmental funds from Official Development Assistance (ODA) sources and organize investible funds from governmental and private sources to support the objectives of the Program.

It is noted that one of the principal reasons why investors or fund donors are averse to undertaking equity financing is the direct involvement in the enterprise's capital structure and supervisory implication of such an investment. There may be policy constraints for governmental or donor institutions to be involved in the equity structure of numerous small scale enterprises. The SEED Fund vehicle resolves this difficulty in that the investment or concessional loan is made to the Fund and its portfolio rather than on individual projects. The Fund enables the pooling of funds and thus making it feasible for small lots of investible funds to participate. The pooled funds are then managed and its investments are supervised by a common program support system, thus spreading the overhead burden of managing the funds and the project investments. Actuarially, project returns are more stable and sound, as risks are diversified thru a larger portfolio of investments.

2. The SEED Program Support System -- This consists of the institutional set up, the organizational capabilities and network of linkages to: (a) source or market investors participation in the Fund; (b) to manage the Fund; (c) identify, evaluate, approve and supervise investments of the Fund in growth enterprises; and (d) undertake enterprise building and entrepreneurial services for the Fund supported enterprises.

The SEED program support system will be undertaken by a SEED Foundation, a non-stock, non-government development organization (ie., an NGO) which will be the specialized institution to carry out the SEED Program mission. The SEED Foundation will manage the Fund and serve as the preserver of the development philosophy and framework of the SEED Program. The SEED Foundation will provide the professional management corps to develop, evaluate and manage investments in growth SSE's. The approval authority of the investments will depend on the terms and conditions governing the fund contributions to the SEED Fund. This will be discussed in the section on institutional arrangements governing participation in the SEED Fund/Program.

III. THE SEED FUND

A. THE FUND STRUCTURE

The SEED Fund is structured according to its uses described as follows:

(a) the Investible Funds -- these are the funds for investments into the growth enterprises in the form of equity and or unsecured transactional financing;

(b) the Fund Support Mechanisms --these are the funds to establish the financial mechanisms that will be utilized to secure investments and provide the incentives to mobilize investors to participate in the Fund;

(c) the Program Support -- these are funds to establish and maintain the institutional and organizational capabilities to provide the Program Support System.

Accordingly the structure of the SEED Fund will be as follows:

			PER CENT
1. INVESTIBLE FUNDS			75
1.1 Equity Investments	-----	60	
1.2 Transactional Financing	-----	15	
2. FINANCIAL SUPPORT MECHANISMS			10
2.1 Guaranty Reserve	-----	5	
2.2 Liquidity Mechanism	-----	5	
3. PROGRAM SUPPORT SYSTEM			15
3.1 Program Management	-----	5	
3.2 Enterprise Building Services	-----	10	
			100

The SEED Fund composition is approximated as described above on the basis of at least $5 Million, which is the targetted amount for the pilot launch stage. Subsequently the objective is to secure a $25 Million SEED Fund to fully operationalize the

SEED Fund. At this level of operation, private sector participation may enter. Note that components 2.1 and 2.2 may not be immediately necessary. if there is no participating private investible funds, which may well be the case at the pilot stage of the Fund. As the Fund demonstrates a portfolio experience, and ODA funds bolster the Fund's financial support components, private investible funds may come into the Fund.

B. THE FUND COMPONENTS

1. INVESTIBLE FUNDS: Equity Capital and Transactional Loans

The investible funds will service the capital requirements of the selected growth SME's. The capital requirements are anticipated to be both short and long term, and unsecured except partially by the project assets expended for. Hence the SEED Fund investments are in the form of equity capital to account for the long term capital needs and transactional financing for the short term requirements. The entry of equity capital will raise the ceiling on the absorptive capacity of the enterprise for loan financing. Hence once the SEED equity funds are infused into the enterprise, these capital resources may further be augmented by debt financing from the commercial banking sector.

2. INSTRUMENTATION OF SEED EQUITY INVESTMENTS

The investment entry mode into the growth enterprise's capital structure is a sensitive issue and there is need to reconcile both the investor's and the entrepreneur's business interests and concerns related to the investment. The financial instrument to cover the investment into the enterprise must give due consideration to the "demand (user-entrepreneur)" and "supply (Fund investor)" considerations as discussed in Section I.B and I.C, otherwise the investment scheme will not work. The financial instrument designed by SEED brings both the investor and the entrepreneur into a "win-win" situation rather than a zero-sum game.

The financial instrument to be used by the SEED Fund for its equity investments will be in the form of Preferred stocks, with the following features:

(a) a guaranteed annual dividend return.

(b) in addition to a guaranteed dividend rate, the preferred shares will share with common shares a negotiated percentage of profit participation.

(c) The stocks will have a divestment scheme spread over a period of five to ten years but redeemable at any point in time that the entrepreneur can return the capital invested by the SEED Fund.

(d) the preferred stocks will be non-voting, although the SEED Fund may have representation in the Board.

(e) the preferred stocks is convertible to common shares, in the event of default on the guaranteed dividend rate.

(f) upon redemption of the Fund owned preferred shares by the entrepreneur owners, the preferred shares will be converted into common stock.

The purpose for these features are as follows:

(a) The equity instrument is a preferred share in order not to dilute the ownership and control of the owner. Many of these SME's have a small equity capital base relative to the capital requirement of the company to be infused by the SEED Fund. Hence infusion in the form of common stocks will dilute if not effectively take-over the ownership and control of the company. As pointed out earlier, dilution is a sensitive cultural or behavioral issue that in the past has caused entrepreneurs to shy away from venture capital offers if only to preserve their ownership and control prerogatives.

Entry in the form of preferred shares likewise avoids the thorny issues of valuation of common stock par values and goodwill in order to place the value of the capital being infused by the SEED Fund.

(b) The guaranteed dividend rate in effect guarantees the investor at least a minimum rate of return on his investments approximating market prime interest rates. Currently this may be set to about 15 per cent. At the same time, the guaranteed dividend rates, gives the entrepreneur a performance target for which he is accountable to the investor, failing which the preferred shares are converted to common causing the take-over of his enterprise by the Fund. It is actually a minimum demand on the entrepreneur since, the fixed dividend rate is even lower than the interest charges he normally pays for debt capital (backed up by securities) that he is using. It is only proper that he at least pays the prevailing cost of capital.

This imposes a self-regulating mechanism that will ensure that the entrepreneur will exert his best effort to make the company earn and utilize the invested funds to the best interest of the company so that it can generate the guaranteed dividends of the Fund and divest the investments of the Fund. Hence besides providing a guaranteed income return, the guarantee becomes an instrument of control for the investor without having to be present day to day in the enterprise's activities.

(c) The profit participating feature of the preferred shares enables the investor thru the SEED Fund, to gain investment returns that are higher than normal interest rates, and thus justify the risks that he is taking in this unsecured investment. It is thru this profit participation that the Fund/investor will realize its objectives of generating the level of returns that venture capital makes. Thru this feature, the Fund hopes to demonstrate to investors that investing in growth SME's is a profitable proposition and cause them to invest in SME's thru the SEED Fund.

In Section III.D, financial simulations are undertaken to analyze the levels of investment returns feasible in growth companies. The results show rates of return ranging from 30 to 50 per cent return on capital infused. These rates of return are feasible because these are growth companies where the capital infusion is expected to generate sales expansion, while keeping financing charges constant which is usually quite high.

(d) The divestment provision gives the entrepreneur the necessary assurance that the SEED Fund investment is interested only in generating returns and not ownership or control of his enterprise. At the same time, this gives the entrepreneur an added incentive to work hard to enable the company to generate enough income so he can gain back his original "freedom" and remove the threat of take-over.

(e) The non-voting feature of the shares is tied to the philosophy of the SEED Fund that the entrepreneur-owner should be given full autonomy, full support and full accountability for his decisions. This philosophy is particularly critical since there is a take-over provision in the investment agreement. Representation in the Board is only an instrument for monitoring since the Fund representative is there to help not to intervene.

(f) The preferred shares are convertible to common, in the event the enterprise is unable to pay at least the annual fixed dividend rates. This is the primary instrument of control of the Fund/investor over the entrepreneur and in effect serves as the surrogate for hard collaterals. The dire consequences of losing ownership and/or control of the company that the entrepreneur has worked to build up is the best incentive to push the entrepreneur to perform and do his best to pay off the investment and eventually remove even the threat of take-over.

(g) Conversion of the preferred shares into common is the mechanism for building up the equity base of the under-capitalized enterprise. This is to ensure that the SEED Program accomplishes its objective of "equity development", and remove the constraint of under-capitalization that prevents the growth of the enterprise. In this way, when the SEED Fund investment is redeemed by the entrepreneur, the capital stays with the enterprise and leaves the capital built-up by the SEED Fund with the enterprise.

3. SEED FINANCIAL SUPPORT MECHANISMS

Aside from the main investible fund, there is a need to provide for financial components within the SEED Fund to service critical needs/concerns of investors into the Fund. As a result of the "supply considerations" of the Fund (Section I.C), two particular fund components need to be adjoined to the investible funds in order to mobilize private investors in the SEED Fund: (a) the Guaranty Reserve; and (b) the Liquidity or Exit Mechanism.

a. GUARANTY RESERVE

The function of the guaranty reserve is to provide conservative private investors an insurance scheme to partially or fully guarantee return of the principal of their investments. While this fund component is not necessary to support development funds contributed to the SEED Fund since these are ready to take the risks, this Fund component is added in order to overcome the traditional conservatism of Philippine investors and thereby mobilize private investible funds to support the SME sector.

It is evident that the capital requirements of the SME sector can not be all provided by governmental or ODA funds, and so one of the principal objectives of the SEED Program is to get the private sector to contribute their savings and channel this to the needs of growth enterprises in the SME sector. Since there is an inertia of conservatism to be overcome, there is a need to get private investors to try out the SEED Fund investment offerings and gain a track record or experience factor, which may require a guaranty provision for them to venture out.

Since actuarially, investment failure in growth companies is a low probability, the provision of a guaranty mechanism, serves as leverage to bring in additional investible funds in multiples of the inverse of the default factor. This is a particularly good way of extending the benefits of grant or concessional loan funds contributed to the SEED Fund.

It is to be noted that use of the guaranty fund to support investments must generate a guarantee fee, in order to maintain the fund and generate additional reserve funds. Investors asking for a guarantee of return on their principals will be levied a guarantee fee.

b. LIQUIDITY FUND OR EXIT MECHANISM

One of the characteristics of private investible funds is that it is reluctant to be locked into an investment unable to liquified, particularly when alternative needs or opportunities occur. There is therefore a need to provide an exit mechanism which enables investors to find a ready market or buyer for their investments in the SEED Fund. This is the principal function of the Liquidity Fund, which will provide a take-out scheme for investors wanting out in consideration of a sacrifice fee. In the absence of a stock market for the SME sector, in particular for the SEED preferred stock holdings in growth SME's, this liquidity mechanism will serve as a substitute market.

As the SEED Fund grows and gains more experience and diversifies its holdings, the Liquidity Mechanism can become more complex and begin to function as a regular market for SEED Fund holdings. The experience gained here can lead to the evolution of the SEED Fund into a mutual fund for growth SME's.

C. SEED PROGRAM COSTS AND RETURNS

1. PROGRAM COSTS

The principal costs of SEED are the two financial mechanisms as described above, and the program support system consisting of the Program overhead and the Consultancy Fund for the Enterprise Building Services. While these are costs, except for the Program management overhead, the elements of the Program/Fund are revenue generating as well. Hence while funds are applied or made allocated for the guaranty reserve and the liquidity mechanism, these amounts are not expended until there is an actual default on principal or exit of investment respectively. In the meantime it generates additional revenues through its fees and fund leveraging function which mobilizes additional fund investments into the SEED Fund.

In the same way, funds are to be allocated for the enterprise building component of the Fund. These amounts are allocated to support mainly the technical services of consultants who will improve the operations of the enterprise and guide its transformation into a growth company. These are services which the enterprise recipient would have paid for on its own account, even in the absence of the SEED Program support system. As such fund expenditures for these services should be partially recovered thru fees charged to the enterprise for these services. Economies can be achieved by conducting workshops or seminars for the entrepreneurs and officers of the SEED assisted companies on various aspects of enterprise building.

Hence of the total funding of the SEED Program, operating costs would range from five (5) to ten (10) per cent consisting mainly of the costs of managing and administering the Program. This would include expenditures for office rentals, furniture, equipment, and the like. This percentage decrease as the SEED Fund grows bigger. The balance of the Fund would all be for revenue generating uses.

Considering the size of the SME sector -- accounting for 85 per cent of industrial establishments; considering further the amount of P 3 billion renegotiated loans in 1986 which serves as an indicator of the amount of capital requirements of the growth SME's, the SEED Progam is targetting a P100 Million total project cost or $5 Million to initiate the SEED Fund during the pilot launch stage, and about $25 Million to do the commercial launch of the Fund. Accordingly the SEED Fund costs will follow the structure discussed above. Hence for a $5 Million (pilot stage), and a $25 Million (operating stage) Fund, the Program costs are estimated as follows:

SEED PROGRAM COSTS
(US$ Million)

		PILOT STAGE		OPERATING STAGE
1. INVESTIBLE FUNDS		$ 3.75		$ 18.75
Equity Investments	3.0		15.0	
Transactional Financing	.75		3.75	
2. FINANCIAL SUPPORT MECHANISM		.5		2.5
Guaranty Reserve	.25		1.25	
Liquidity Mechanism	.25		1.25	
3. PROGRAM SUPPORT SYSTEM		.75		3.75
Program Management	.25		1.25	
Enterprise Building Services	.50		2.0	
TOTAL PROGRAM COSTS		$5.0 M		$25.0 M

2. SEED FUND RETURN

The financial objective of the SEED Fund is to maintain the initial capital endowment and make the Fund grow in two ways:

(a) Fund Returns from its Investible Funds and Financial Support Mechanisms. Following projects the annualized rates of returns from these Fund components:

Equity Investments	35 to 45 per cent
Transactional Financing	30 to 36 per cent
Guaranty Reserve	3 to 5 per cent
Liquidity Mechanism	5 to 10 per cent

(b) Additional Fund Contributions from investors who may be attracted to participate in the Fund because of the returns on investments offered by the SEED Fund as a whole (ie., based on its total portfolio) and the guarantee and liquidity features of the investment offering.

All the returns generated by the SEED Fund will be plowed back in order to extend the benefits of the initial endowment to more enterprises in the SME sector.

The rates of return quoted here are based on what is believed to be reasonable fee rates based on prevailing market prices for similar financial services,making adjustments on the risk factor since these are unsecured investments. This guideline applies to the transactional financing, guarantee, and liquidity or exit fee. The return on equity investments is premised on the typical financial structure and parameters for and SME enterprise, and run-outs on the impact of a sales growth on returns to the entrepreneur and the Fund.

D. PROJECT INVESTMENT RETURNS

To estimate project investment returns, a series of financial simulations were undertaken, utilizing alternative financial structures of a growth SME enterprise. The financial runs and charts of the results are reported in Annex A. Following are the financial parameters utilized:

The analysis is based on a financial profile of a typical growth SME with parameters as follows:

Assets -- 3.0 M; Equity -- .5M; Loans -- 1.5 M;

Sales -- 4.0 M; Net Income Margin -- varying 15% and 20%

Amount of investments of SEED infused into enterprise- 1.0 M;

Preferred dividend rate - guaranteed fixed rate of 15 % plus varying income participation rate with common stocks varying from 10,20,30,and 50%.;

Sales as a result of infusion -- made to vary from 4.0 to 6.5 M in increments of .5.M, or 12.5% to 62.5 % growth.

The two sets of simulation seeks to establish the level of growth in sales that must be attained before the returns on the SEED Fund investments achieve the targetted rate of return of at least 36 per cent.

Parameter 1 is based on a net income margin to sales ration of 15 per cent. The dividends on preferred shares is made to vary thru its income participation rate at 10, 20, 30, and 50 per cent for runs 1.1 to 1.4 respectively.

Parameter 1 run 1.3 (see Chart) show that sales must grow by almost 50 pere cent from 4.0 to 6.0M, before the SEED fund yields an investment return of 39 per cent for the Fund. At the same time, it is only at that level that the entrepreneur is able to attain a rate of return of equal in absolute terms to his income prior to the fund entry, ie about 564.000 or about 113 percent on his original equity base.

In short, while capital infusion results in bigger sales and net income, absolute returns to the entrepreneur suffers until he is able to gain an incremental sales equivalent to two times the investment infusion. Of course while his income rate suffers, he gains in terms of being owner of a larger scale operation which will ultimately return to him.

Given a higher net income margin of 20 per cent (parameter 2), a rate of return of 37 per cent is achieved with a sales growth of only 10 per cent, assuming a similar preferred dividend rate of 15 per cent fixed and 30 per cent income sharing after prior claims. Simulation rund 2.3.

This serves as a guide in enterprise selection: that the program should target firms with at least 20 per cent net income margin and that it should target a 15 percent fixed dividend rate plus a profit share of about 30 per cent in order to generate at least a 37 % return on SEED 's capital infusion.

This also serves as an indication of the feasibility and the mutual profitability of the SEED investment for both the entrrepreneur and the SEED Fund/investor. Simulations 2.1-2.4 are interesting in that it shows an increasing returns to the entrepreneur given any increase in sales. Hence at a 20 net margin, capital infusion will lead to a win-win situation for both the entrepreneur and the SEED Fund investor. All the Charts indicate increasing returns for both the entrepreneur and the Fund investment as a result of the sales increase made possible by the fund infusion. This means that given the right financial criteria and that provided the investment results in an increase in sales, the SEED Fund investment into the enterprise will mutually improve the returns to the Fund and the enterprise.

This proves that the SEED Fund investment is a viable investment proposition in that given the right selection parameters, the ' investment results in a favorable financial return for both.

A second set of simulation undertaken is the break-even analysis. A rate of return of 35% is targetted for the Fund. Given the enterprise's earning performance of 15% and 20% net income margin alternatively, the simulation run examines at what level of sales is the targetted rate rate of retun achieved for the SEED Fund and what happens to the sharing of income, between the entrepreneur..

The analysis shows that given a 15% net inocme margin, the the Fund's targetted return of 35% is achieved at a sales growth of 13 per cent. At this point the Fund will require a 52- 48% income sharing in its favor to secure its targetted return, and the entrepreneur suffers a drop in his absolute income share from a 1.16 return on equity to .65 return on equity. As sales grow by 50% from P4m to P6m, the entrepreneur's return on equity goes to 1.21 and the income sharing to generate the 35% Fund return is 37-63% between the Fund and entrepreneur respectively.

Given a 20% net income margin, the targetted return is also achieved at a sales growth of 13 %but the income sharing for the entrepreneur is improved to 40-60 for the Fund and entrepreneur respectively, with the entrepreneur earning a 1.06 % return on equity compared to his origianl 1.16. Given a 25 % sales growth, the entrepreneur's income reaches a 1.29 % return on equity and the Fund will share 35% of income while tne entrepreneur's share is 65% , to generate the Fund's targetted rate of return of 35%.

This indicates the viability and profitability of the Fund, provided that the investment is infused in growth companies.ie that the investment does result in an increase in income.

IV. IMPLEMENTATION PLAN

The following implementation scenario is based on a series of discussions with key institutions who will play a signficant role in the realization of the Program, either as sponsors, team players or approving authorities in programming of development funding.

The Implementation Plan covers two basic aspects: the funding and the management of the program. Necessarily the institutional set-up to undertake these two aspects are inter-linked, and have to be designed accordingly. The following considerations have to be considered in formulating the strategy for the Fund Sourcing Plan and the Program Management.

A. STRATEGIC CONSIDERATIONS

1.SEED PROGRAM SPONSORS--

The strategy of implementation takes off from the status of the program insofar as the institutional support that the SEED Program has obtained at this point, as well as the concerns expressed.

It will be noted that the SEED Program has undergone some evaluation process in the past and has been favorably endorsed by the key governmental agencies involved in the programming of ODA funds ie., the National Economic Development Authority (NEDA) and the Department of Trade and Industry (DTI). As a result NEDA had endorsed the Program first to the Canadian International Development Agency (CIDA) and the United Nations Industrial Development Organization (UNIDO). The bid for CIDA funding was not favorably received because of the agency's policy not to get involved in equity investments. This preliminary response indicated that while there was a general recognition for the innovative contributions of the Program and a crticial need for the Program in the SME sector, there was a need to clarify the program design and the nature of the Fund. It was also felt that there was a need for an international development agency to participate in the appraisal of the Program and subsequently in soliciting funding support from ODA sources.

It was at this point that the UNIDO took interest in the SEED Program and has provided the technical assistance to appraise the Program in preparation for marketing the SEED Fund to local and international funding and sponsoring entities.

It is for this purpose that this study has been prepared, in the course of which the institutional arrangements for the implementation of the SEED Program has been defined and the support of lead institutions secured. The Development Bank of the Philippines, the premier government development banking institution of the Philippines has agreed to undertake the lead in promoting the financing of the SEED Program with the assistance of UNIDO. The Economic Development Foundation, one of the oldest private development institution has likewise agreed to take the lead in developing the private institution that will manage the SEED Fund and provide the program support system.

2. MARKET BY DOING

The pioneering nature of the SEED equity financing approach requires an equally aggressive development leadership and commitment to champion this innovation in development financing for the SME sector. There is a need for a credible leader of the financial sector to take a lead in sponsoring SEED in order to demonstrate the effectiveness of the SEED approach and overcome the traditional conservatism of the Philippine financial sector.

It is realized that a new program concept can be discussed and analyzed a priori endlessly without proving anything. What is finally needed is sufficient conviction to invest some funds to try out the program. The DBP leadership has arrived at this conclusion and at the time of preparation of this study, is preparing to present to its Board, a plan to allocate a target amount of P50 Million or about $2.5 Million in order to launch the SEED Program on a pilot basis. DBP has adopted the strategy of marketing participation in the SEED Fund to prospective ODA donors and private institutional investors, by demonstrating its conviction and the workability of the SEED financing approach thru an actual investment of funds and gaining a portfolio experience.

3. NEED FOR GRANT FUNDS

The nature of the funds to be sourced for the SEED Program is a critical issue because it affects the viability of the SEED Fund. The Program Support System and the Financial Mechanisms need to be supported by Grant fund sources, while the Investible Funds can be obtained in the form of long term concessional loans.

The SEED bid for grant funds is sometimes misunderstood because it is argued that the SEED Fund seems to be highly profitable and that grant funds are generally not programmed for revenue generating programs.

Three points must be considered: One, the initial endowment to the SEED Fund is a kind of infra-structure which establishes the vehicle, the foundation for investible funds to develop a capital market mechanism for the SME sector.

Two, the earnings of all ODA sourced funds utilized for the SEED Program will all be plowed back to the Fund in order to extend the benefits of the initial endowment to the SME sector.

Three. it must be realized that the SEED Fund requires substantial infra-structural costs in terms of the program support system and the financial mechanisms that have to be in place before returns are generated. If these cost are to be borne by the investible funds as well, this means reducing the returns generating portion of the Fund by 25 % which will bring down average Fund returns. This will bring up the hurdle rate for the average return of the Fund portfolio to such a high level that it may no longer be feasible to achieve.

Failing this, the SEED Fund will not be able to achieve returns that will motivate investors to participate in the SEED Fund. The moment the SEED Fund loses its market viability or profitability, the sustainability of an equity financing facility is lost and will fail in its objective to create a capital market for the SME sector. Hence it is essential that the infra structure requirements of the SEED Fund receive grant funding support from ODA sources.

4. SEED FUND SOURCE

The SEED Fund strategy for sourcing must be reconciled with the characteristics of each fund source. in order to tap them effectively. The SEED Fund will seek the following sources:

a) Program Sponsoring Institutions-- Given the pioneering nature of the SEED funding approach, the most effective way to launch the Program is for a credible financial institution to champion it by investing an initial fund to demonstrate its viability to fund contributors. The DBP has initiated the process of undertaking the sponosorship of the SEED Program by considering the investment of an initial fund. The fund could then be leveraged with other smaller funds to gather enough institutional base support. The initial fund willbe limited but should be of sufficient size to be a viable pilot.

b) Funds for Non-government Organizations -- The Philippine development scene is now visited by the presence of international funding to support the initiatives taken by private institutions in the field of development particularly in the rural areas and small scale industry development. It has been recognized that private institutions (NGO's or PVO's) single-mindedly committed to a development mission have demonstrated their effectiveness in development work if properly organized and supported. Their private character has endowed them with superior operational flexbility over similarly chartered government organizations flexbility over similarly chartered government organizations which must abide with governmental administrative and financial regulations that have seriously hampered their responsiveness to the development needs at the field level.

In view of this effectivity, the Philippine government has officially recognized the role of NGO's in development work and has commissioned and financed them as delivery mechanisms for development assistance to small scale industries and rural development in particular. Accordingly national government funds and international funding support both from foreign counterpart NGO's and/or Official Development Assistance (ODA) sources have coursed some limited funds to be channelled to NGO's.

While these amounts may be limited, the initial SEED Fund could tap these funds to finance the grant elements needed to launch the SEED fund. In this connection, the Economic Development Foundation which is eminently qualified as far as its track record and sponsor of the institution building requirements of the SEED Program, has initiated the process of tapping the Dutch Rural Development Assistance Program (DRDAP) to finance the initial program support and institution building requirements of the SEED Program.

c) Official Development Assistance (ODA Funds) -- The principal source of development funding that can provide the funding needed by SEED in the scale required, will still be the ODA or government to government assistance sources. However it must be noted that in general ODA funds will require that the recipient institution or owner of the fund will be a governmental entity. In this connection DBP will take the lead in sourcing the funds from Official sources in behalf of the SEED Program. As ODA funds, the national government will be the recipient or borrower of the funds which are then on-lent to the DBP for re-investment in SME's under the SEED Program. While the national government is the borrower or grantee as the case may be, the credit risk remains with DBP which means that in the event of default, the Bank must repay the national government which in turn is responsible to repay the donor source. This financial arrangement has many precedents in DBP's operations and is in fact the arrangement currently in force with DBP's bilateral credits that it is now administering. On the other hand the DBP has the option to handle the funds as a trust fund or use one of its subsidiaries as its fund administrator, in tandem with the SEED Program manager.

It is important to note that administration of the funds by DBP does not preclude the bank from working with a private development institution such as the SEED Foundation as the Program Manager or as a sub-borrower of the funds. While the funds are conduited thru DBP, the SEED Foundation will maintain its role as the institutional manager of the SEED Program which it will coordinate and undertake co-financing activities with its own funds with DBP.

d) Private Sector Investible Funds -- The ultimate objective of the SEED Fund is to tap the private sector sources both foreign and local, to respond to the capital needs of growth enterprises in the SME sector. In short this means developing the SEED Fund as an access mechanism to the capital market. The market is the final resource base which can respond to the volume of capital resources required by the SME sector.

However, tapping this resource base means developing a fund mechanism and presenting an investment offering that will pass the test of the market. The SEED Fund hopes to develop this by first laying down the infra-structure of this market mechanism, in terms of a program support system, financial mechanisms, and institution building. After gaining at least a year of portfolio experience using institutional and ODA sourced funds, the SEED Fund could unitize its investments and make an investment offering to private investors.

5. NEED FOR A PRIVATE DEVELOPMENT INSTITUTION

The choice between selecting a private or governmental character of the SEED Foundation, the Program manager poses an issue. A governmental institution has an advantage in tapping larger amounts of funding from ODA donor sources, because of their preference for a governmental entity to be the recipient of the funds. Utimately this is rooted in the ability of the entity to elicit Philippine government guarantee for the debt, in case it is a concessional loan.

Because of these factors, a private institution is limited in its ability to access international development assistance except for those coming from NGO fund sources or are coursed thru some governmental administering body such as the DRDAP Program cited. To limit the SEED's access to ODA funds because of its institutional character would reduce the capability of the SEED Program to be a serious response to the savings constraint of the SME sector. The Program may be launched, but will not mobilize savings/capital in the scale needed, nor establish the financial infrastructure so critically needed by the SME sector.

On the other hand, the private sector character of SEED Foundation is necessary to the effectiveness and operational flexibility required by the SEED program. Government financial and administrative controls would make it very difficult to respond in a timely and cost effective manner to, the business exigencies faced by the SME enterprise. In contrast private entities such as the NGO's, have full administrative and financial flexibility to respond to day to day market conditions.

This is a well-known fact of government administrative experience, which accounts for the official policy to make use of NGO's as the delivery mechanism for providing development assistance. Hence from an institutional and program operations standpoint, the private character of SEED is a must to achieve its mission.

B. THE FUND SOURCING PLAN / INSTITUTIONAL SET-UP

Given the strategic considerations regarding the funding and the management of the SEED Program, the following fund sourcing plan is proposed, together with the institutional arrangements for the fund management and disposition. The Fund establishment goes thru a process of evolution, going thru three stages:

1. PHASE I--THE PILOT STAGE

SEED will be launched on a pilot basis with the initial funding coming from the sponsoring institutions, namely DBP and EDF.

Initially the DBP as the lead financial institution proposes to contribute funds to be drawn from the Bank's Window III, which is a special funding facility, that provides loans under concessional terms to support innovative development interventions in the SME sector and/or the rural sector. The Fund will then be set aside for the sole purpose of implementing the SEED Program. The targetted amoount is P50 Million.

In a parallel effort, the EDF as the lead institution for the SEED program support system will likewise seek funding support from the DRDAP for the purpose of funding the cost elements in the SEED Program that require a grant or concessional loan source. This ODA fund source will support the Program support system and the financial support mechanisms, which are the infra-structure components of the program. The targetted amount is P25 Million.

The two fund contributions will be put together as a SEED Program fund to be managed jointly by DBP and EDF under a SEED Program Office. The application or investment of funds sourced from DBP may require confirmation by the DBP Board, because of DBP charter requirements, while those sourced externally specifically for the SEED Program will be governed by the SEED Program Board. The SEED Program Board will be composed of DBP, EDF, SEED Program Director, Department of Trade and Industry, and Private SME Sector Representative(s). See Chart IV-B-1.

In the meantime fund sourcing will be a joint effort, thru the SEED Program Office.Each organization will contribute to the technical capabilities required with the DBP concentrating on the credit evaluation and supervision aspects and EDF on the project generation and enterprise building aspects.

This is an interim arrangement institutional set-up which will be adjusted when the principal funding for SEED is obtained. In the meantime, UNIDO will assist in the marketing of the Fund in order to secure the principal funding for the SEED Program from ODA sources. Once the principal ODA fund sourcing has been secured, the SEED Foundation will be established to signal the full operationalization of the SEED Fund/Program, with DBP and EDF as founding members.

2.PHASE II -- ODA FUND MOBILIZATION /ESTABLISHMENT OF THE SEED FOUNDATION

Parallel to the pilot launch, efforts will be undertaken to source the principal funding of the SEED Program from ODA sources with the assistance of UNIDO offices in different donor country sources. Once the funds are received, the institutional plan for the program will go into full swing with the formal establish of the SEED Foundation as the development institution chartered to implement the SEED Program.

The institutional arrangement proposed here provides for a combination of the advantages of both a governmental and a private development institution. This is summarized in Chart IV-B-2, which shows the establishment of the SEED Foundation as an NGO, chartered to lead the implementation and management of the SEED Program. The Foundation will source its own development funds, from donor sources who do not require a governmental entity to be the fund administrator, and contribute it into the SEED Fund. For this tranche of the SEED Fund, the SEED Foundation Board is the approving authority of the investments or disposition of the funds.

At the same time the DBP as co-sponsor of the program, together with the SEED Foundation, will likewise seek ODA funds from donors who do require governmental ownership or control of the funds and likewise pool these into another tranche within the overall SEED Fund. Investments of this fund will be approved by the DBP Board or its subsidiary.

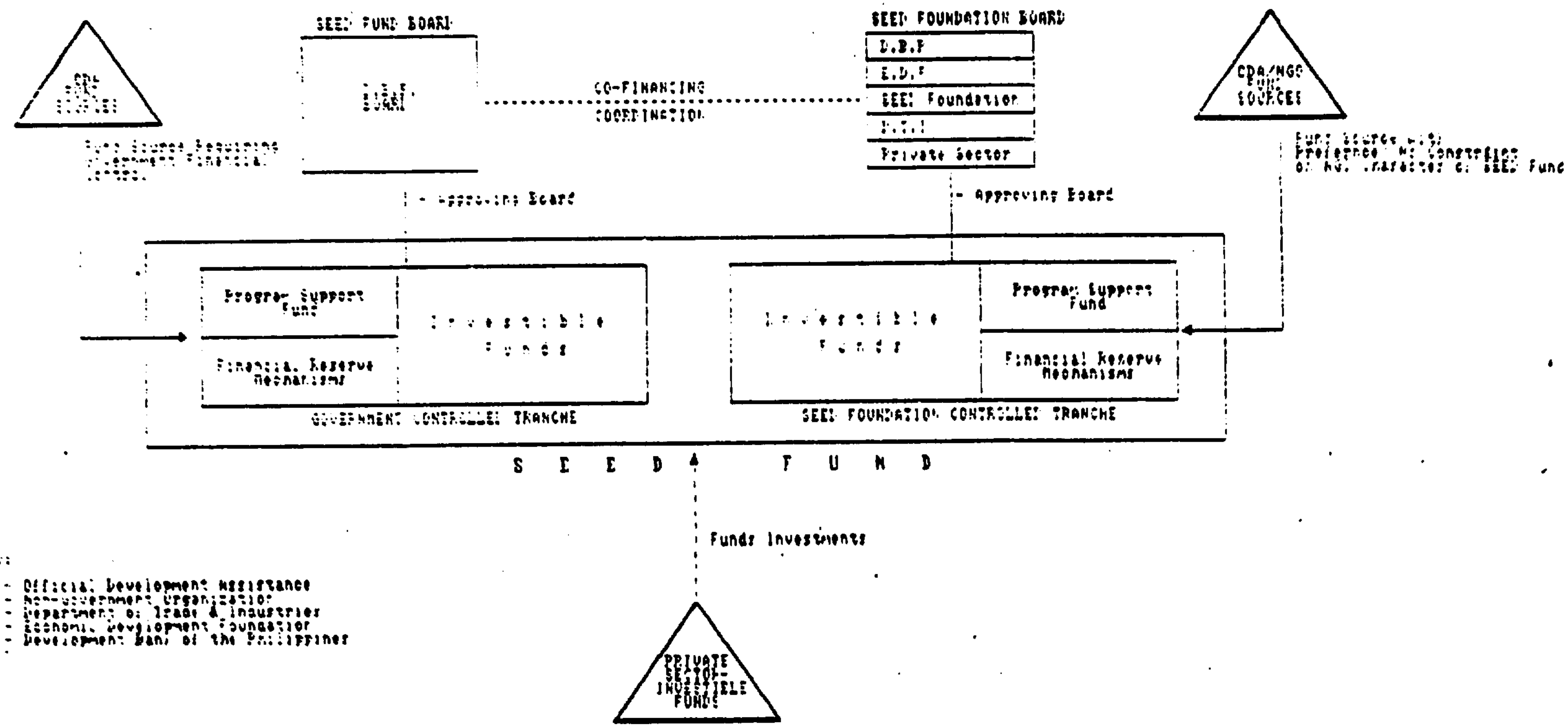
The utilization of the two tranches of the SEED Fund will be coordinated through the presence of DBP, EDF, and SEED in the policy, investment approving board of the two fund tranches, as seen in the chart. The use of the two tranches will be coordinated, with the SEED Foundation funds concentrating on the program support elements and the DBP sourced funds on the investible and financial elements of the fund. However, the SEED Foundation will maintain its role of program manager and support system for SEED, wherever the funds are lodged.

The team-up between DBP, EDF, and SEED Foundation is now an often repeated combination in the Philippines for the development work required on the SME sector. Particularly in the field of livelihood generation or rural development, government agencies

CHART IV-B-2

SEED FUND/INSTITUTIONAL SET-UP

PHASE II AND III



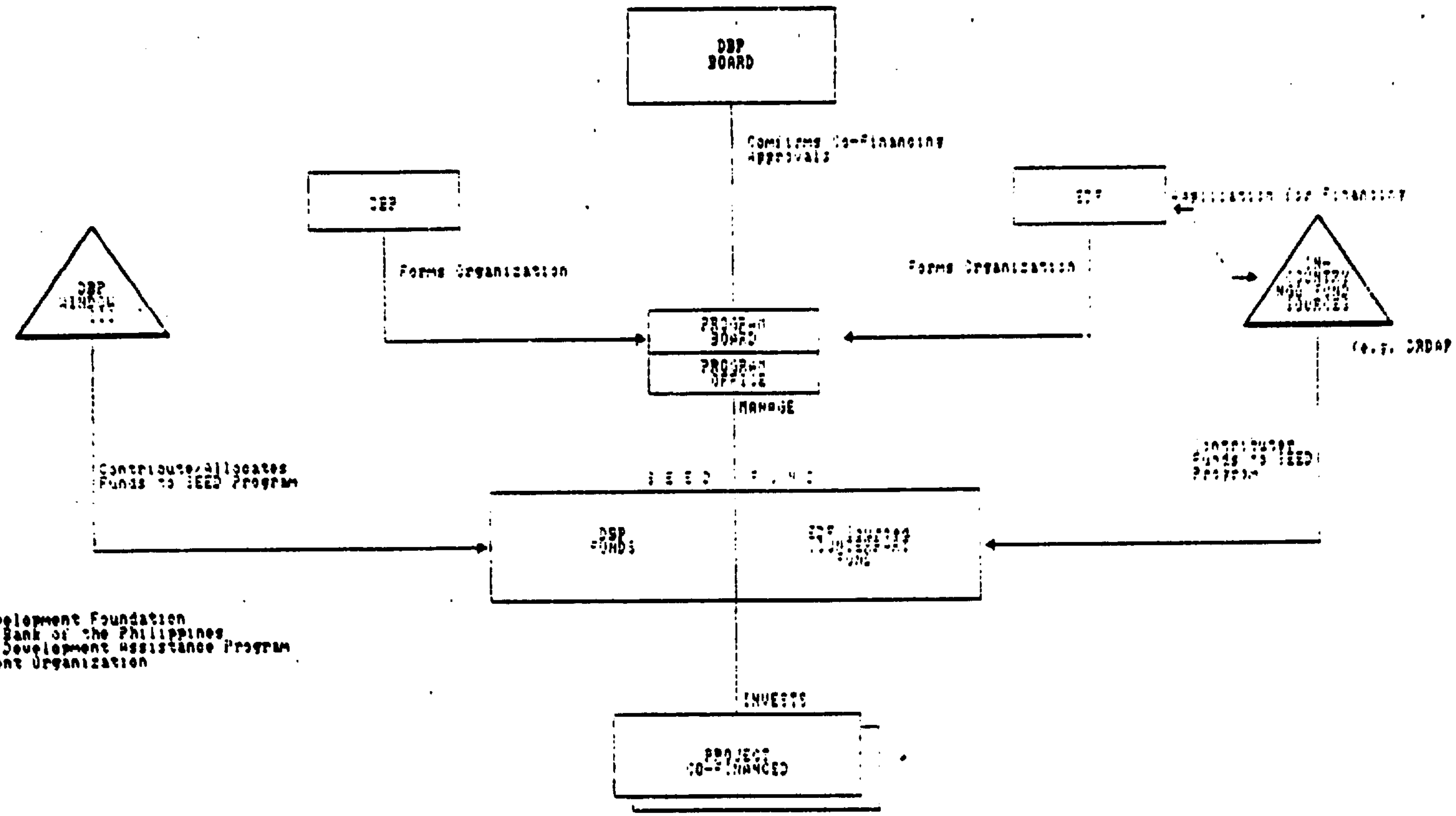
LEGEND:

ODA - Official Development Assistance
NGO - Non-Government Organization
DTI - Department of Trade & Industries
EDF - Economic Development Foundation
DBP - Development Bank of the Philippines

CHART IV-B-1

SEED FUND/INSTITUTIONAL SET-UP

PILOT STAGE



LEGEND:

EDF - Economic Development Foundation
DBP - Development Bank of the Philippines
DRDAP - Dutch Rural Development Assistance Program
NGO - Non-Government Organization

have noted their limitations in operations and have relied on NGO's as their delivery mechanism for financial and technical assistance. Thus the involvement of SEED as a private sector development oriented institution is in keeping with the official government policy as stated in its National Development Program, to utilize NGO's (non-government organizations) or PVO's (private voluntary organizations) as its delivery mechanism for development assistance to small scale enterprises particularly in the rural areas. It is noted that as a result NGO's have now been authorized to receive ODA funds (thru governmental fund administrators) for its development activities/programs, a policy liberalization that allows the SEED Foundation to source ODA funds for the Program, the Fund and the institution.

3. PHASE III --MOBILIZATION OF PRIVATE SECTOR INVESTMENTS INTO THE SEED FUND / MUTUALIZATION OF THE SEED FUND

A principal objective of the SEED Program is to mobilize private investible funds for the SME sector thru the SEED Fund since the investment gap in the sector is beyond the resources of any institution or program. As SEED gains a portfolio track record and the program gains public confidence with the participation of international development institutions, the Fund can be opened to the public by unitizing the investments in the Portfolio and offering its own financial instruments to investors, and using its liquidity fund mechanism as a market exchange mechanism.

This stage of development will be reached only when the SEED Fund has passed the test of the market in terms of being able to make an investment offering that will yield at least 35 per cent given the present levels of interest rates on secured and unsecured loans. The SEED Fund reserve for the exit mechanism must at this time be large enough to handle the volume of entries and exits from SEED Fund.

Chart IV.B-2 likewise shows the integration of the this third source of fund contribution into the SEED Fund. As a private contribution these funds may be lodged with the tranche under the administration of the SEED Foundation.

C. PROGRAM SUPPORT SYSTEM / INSTITUTIONAL STRUCTURE

1. THE SEED FOUNDATION

The need to set up a specialized institution to implement the SEED Program and manage the Fund is evident from the following:

The SEED Program is a unique combination of a development program utilizing a market oriented mechanism which harnesses the profit objective of entrepreneurs and investors to achieve the development goals for the SME sector. The program calls for a fine balancing of commercial and developmental objectives and means to these goals.

It is evident from the 1980 experience with venture capital corporations which were lodged with private commercial banks, that banking institutions can not provide the kind of organizational orientation, temperament, and capability that would be required to manage an equity financing program. There is a need for a fine blend of entrepreneurial and developmental perspective in the organization tasked to manage SEED. Being the first equity financing program of this nature, the SEED institutional plan calls for the establishment of a SEED Foundation, grafted to the capabilities of existing institutions with the capabilities needed for the SEED Program, ie.DBP and EDF.

The SEED Foundation is the private development institution that will be formed to undertake the development of the SEED Fund, manage the program and the funds of the SEED Program. The Foundation is a private non-stock, non-profit corporation chartered to fulfill the mission of the SEED Program.

The founding members of the Foundation will come from the sponsors of the SEED Program to include the DBP as the lead institution for the funding of the program, and the Economic Development Foundation as the lead for the program management and institution building.

Role of the Development Bank of the Philippines -- The DBP is taking up the challenge of launching the SEED financing approach to the SME sector in accordance with its mission and commitment to entrepreneurial development and the implementation of new approaches to development financing particularly in the rural areas. DBP has been espousing the cause of Philippine entrepreneurship as evidenced by its sponsorship of a DBP entrepreneur's forum under the DBP Venture Club. The Bank has projected itself publicly as championing the cause of Filipino entrepreneurs, by featuring stories of Filipino entrepeneurs, their values, their heroism not only for the cause of their families but also for their community and the country. SEED presents itself as a pro-active approach to entrepreneurial development by providing a nursery for promising entrepreneurs which will provide the critical financial and technical support during its take-off stage in order to shorten the gestation period for growth.

It is noted as well that the DBP has recently opened up two new financing windows (Window III and IV) which the Bank has used to implement its innovations and new initiatives in development financing particularly in the rural areas. It is from these funds that the DBP plans to draw the initial fund base for the SEED Fund, for the pilot launch of the program. This contribution is critical to the mobilization of further contributions to the SEED Fund. Considering the pioneering nature of the SEED funding approach, and the traditional conservatism of the Philippine financial sector, there is a critical need for an established financial institution such as DBP to lead this initiative and demonstrate its effectiveness as a development mechanism for the SME sector and its profitability to prospective investors.

In sum the role of DBP is to provide the seed capital for the SEED Fund in order to demonstrate the effectiveness of the SEED funding approach and thereby market the SEED Fund to other prospective contributors/investors.

Role of the Economic Development Foundation --- The Economic Development Foundation, an established non-government organization involved in development consultancy, in association with Development Initiatives as the consultant who authored the SEED Fund mechanism, has provided the SEED Program blueprint. The plan is to continue this initiative and momentum by, tasking EDF as a founding sponsor of the SEED Foundation to provide the organizational capability to provide build up the technical and management services to support the program and its investments.

The EDF has nurtured the developement of similar NGO's, using the Foundation as a staging area for the nucleus organization until it has gained sufficient financial base and spun-off as a separate Foundation. A prominent example in this regard is the Philppine Business for Social Progress (PBSP), now the biggest private sector initiated NGO involved in various poverty alleviation programs thru livelihood generation schemes. PBSP started as a Program office within EDF with its sepearate Program Board and subsequently spun off when it had sufficient funds and organizational strenght.

A similar staging process is envisioned for SEED except that DBP and EDF will co-sponsor the interim Program Office of SEED which will be supervised by the SEED Program Board, while it is still at its Phase I Pilot stage. Once the principal funding is obtained, the SEED Foundation will be formed, with its own distinct Board, but whose membership will continue to have the originating sponsors of the Foundation.

Role of Founding Members -- The preservation of the SEED development approach and perspectives is critical to the success of the program. There is a need to insulate this development institution from the political events and leadership changes that may affect DBP which would affect the original philosophy and approach of the SEED Program. It was noted that even in the course of the formulation of the program design, there were substantial points of departure from the traditional approaches /policies of financial institutions to critical features of the SEED Program. Thus there were lengthy discussions on the policy control or voting power of the SEED Program in the assisted enterprise. The SEED philosophy is premised on fostering responsible entrepreneurship with full autonomy, accountability and support which is a contrast to the control oriented approach of a conservative financial sector.

The task of preserving the SEED philosophy will be secured thru the appointment of Founding Members in the SEED Foundation, who as originators of the SEED Program will have a secured tenure of at least five years during which they may not be replaced by other persons except for cause. These founding members will be nominated by DBP and EDF.

The Institutional Form of SEED Foundation-- The private and developmental character of the institution is necessary to insulate the SEED Program from the politics and avoid the administrative inflexbilities of a governmental organization. On the other hand its developmental nature serves as the balancing agent/factor to reconcile the developmental objectives of the program and the commercial objectives of the investors in the Fund.

The Foundation's private character is likewise necessary to be a recipient of development assistance meant to be channelled thru non--government organizations (NGO's) as delivery mechanisms for development programs. The National Development Plan prepared by the Natiional Economic Development Authority and the national livelihood generation programs of the government have given NGO's a prominent role in delivering financial and technical assistance to small scale enteprises particularly in the rural areas. Recognizing the signficant role that such institutions can play, development funds have been channelled to these institutions. It is likewise noted that NGO's have been allowed to perform a lending function by the Securities and Exchange Commission, a function for which corporate entities must obtain a special license for, as a concession to the developmental character of these NGO's.

2. PROGRAM SUPPORT SYSTEM

The Program support requirments of SEED calls for the building up of the capabilities listed below. These capabilities need not all be housed or financed by the SEED Foundation. The strategy is to utilize the capabilities of existing organizations and developing synergies with them thru a network of SEED Program co-operators.

The organization of SEED will be structured along the following capabilities:

a. Project Development and Syndication

The SEED Program's success hinges on its ability to select correctly the growth enterprises in accordance with its strategy of selective intervention. The tasks of this unit are as follows

(1) to formulate the necessary criteria for selection of SEED equity recipients;

(2) to select the recipient enterprise with the assistance of appropriate endorsing entities who vouch for the integrity track record, and growth potential of the enterprise.

(3) to serve as the program's promoter, briefing prospective participants on the terms, relationships, mechanisms, and implications of SEED equity involvement on the entrepreneur and enterprise operations.

(4) to negotiate with the entrepreneur, the terms of SEED's investment in his enterprise and formulate a mutually acceptable and profitable financial package.

Selection of these growth enterprises can be facilitated with the assistance of:

(1) Industry associations and chambers -- It is noted that these bodies have undertaken a function of officially endorsing and at times providing guarantees for fellow member enterprises which they endorse for financial assistance to various lending programs. This is a service which the SEED can utilize in selecting its clientele. It will be noted that in the course of formulating this program study, the Philippine Chamber of Commerce and Industry has expressed its readiness to participate in the SEED program as project endorser and guarantor in some cases.

The associations/chambers will be an important group to work with in identifying enterprises which can have a large mulitiplier effect in rural industries. These entities have regional and provincial chapters who have a roster of countryside enterprises who function as sub-contractors to urban based export manufacturers. SEED funded enterprises can then be linked to these sub-contractors who will then likewise benefit from the assistance given to the growth companies in terms of expanded markets and sub-contractor financing.

(2) Banks -- The performing enterprises who are in need equity build-up are well-known to the banks as those who though not in default pereniallly roll-over their debts. As discussed earlier these are the "evergreen loans" portion of the commercial banks' portfolio, which they would be more than willing to endorse to SEED because SEED's entry would release their frozen funds, and enable them to shift their operations to transaction related services where their revenue rates are larger with no liquidity drain.

(3) International Buyers/ Bonded Trading Importers -- This is another sector who work closely with export manufacturer sales and production. International buyers have a roster of reliable suppliers who are capable of servcing their export market principals. Frequently they work with them in terms of design and product development and financing them in some cases.

Bonded trading importers are suppliers of imported raw materials which are used by export manufacturers as inputs for their export products. These traders also work closely with the exporters and have a first hand knowledge of who are the performing and growing export manufacturers by the volume and frequency of their import requirements.

Both these groups can be a reliable source of information as to which enterprises are really on a fast track and can be effective users of SEED equity funds.

(4) NGO's and Rural Livelihood Programs -- There is currently a network of NGO's working on livelihood programs in the countryside developing small enterprises to generate livelihood opportunities. Their principal limitation is the reach of their financial and market assistance to these enterprises. As a result many of these enterprises reach the dead-end size or scale of operation resulting in stagnation. The need is for them to have access to capital and/or markets which will enable them to break out of their vicious cycle of smallness. In particular, the Philippine Business for Social Progress (PBSP) which has a network of such rural livelihood programs has express its interest to work together with SEED which can then selectively pick up the growth enterprises in these localities who can act as catalyzers or multipliers of growth in the rural areas. The SEED Program fills in a critical gap in the current livelihood programs in the rural areas, picking up the mature and potential growth multipliers which can not be assisted by these livelihood programs because of their design and resource limitations.

b. Project Evaluation and Financial Engineering

This unit will undertake:

(1) the credit and business evaluation of the SEED Client enterprise. The evaluation should take into consideration the willingness and temperament of the entrepreneur to work with the terms of relationship with the SEED Fund.

(2) Finalize the financial package that will be structured to reconcile the interests of the entrepreneur, the requirements of the Fund design, and the financial and business realities faced by the enterprise.

Project evaluation can be undertaken with the assistance of the industry associations which will be working with the SEED Program. Evaluation should be based on the business track record and growth potential of the enterprise, backed up by contracted forward sales if possible.

The terms of the financial package arranged between the enterprise and SEED should result in a win-win situation for both to ensure the cooperation of the entrepreneur with the SEED involvement. The financial package will determine the mix of financial assistance in terms of loans and equity infusion, and the terms of income sharing between the entrepreneur and SEED and the divestment period allowed.

c.Project Supervision and Enterprise Building Services

This department will take care of the following functions:

(1) Monitor and protect the SEED Fund investment in the enterprise.

(2) Install the necessary operating,planning, and financial control systems that will enable the enterprise to cope effectively with the expanded operations and effectively utilize the capital infused by the SEED Fund.

(3) Provide the entrepreneur the necessary support services in order to assist him to cope with the demands of transformation on all aspects of the organization.

(4) Conduct technical training, consultancy services, and enterprise building services to help the entrepreneur actualize the transformation into a larger scale corporate entity.

(5) Maintain a pool of professional and entrepreneurs who can assist enterprises solve technical and management problems.

The department while tasked to protect the SEED investments, should be service oriented that is to provide the entrepreneur with the maximum in technical, management, and marketing services, in accordance with the SEED approach. Since the entrepreneur is given full autonomy, SEED supervision is concerned with preventive maintenance thru monitoring, systems installations, enterprise building services.

d. Fund Management and Sourcing

A fourth unit in the SEED organizational structure will take care of the SEED Fund related functions, as follows:

(1) Manage the utilization of the funds, ensuring optimal investment placements, diversifying the risks of the portfolio.
(2) Monitor investment returns, availments of guarantee and exit reserves, to ensure the viability of the Fund.
(3) Undertake a continuing marketing campaign to invite more investors and institutional fund participants/ donors to the SEED Fund.
(4) Develop and package fund cooperation schemes with other fund sources to leverage SEED fund resources and gain more participants to the Fund.
(5) Evolve the SEED Fund into a mutualized fund which can issue its own notes and develop a capital market for SME capital requirements.

This is a small top-level staff that will aggressively market Fund participation to institutional investors both locally and internationally. As the unit in contact with the capital markets and ODA Fund sources, the staff must be entrepreneurial in its approach, designing and modifying fund schemes to be responsive to the capital market requirements. Its ultimate objective is to evolve SEED into a capital market for the growth enterprises of the SME sector.

PARAMETER 1

Cost of Sales to Sales Ratio - 46%
Operating Expense to Sales Ratio - 25%
Interest Rate on Loan - 24% per annum
Loan for 9 months

Sales	4,000,000	4,500,000	5,000,000	5,500,000	6,000,000	6,500,000
Less: Cost of Sales	1,840,000	2,070,000	2,300,000	2,530,000	2,760,000	2,990,000
Gross Profit	2,160,000	2,430,000	2,700,000	2,970,000	3,240,000	3,510,000
Operating Expenses	1,000,000	1,125,000	1,250,000	1,375,000	1,500,000	1,625,000
Income From Operation	1,160,000	1,305,000	1,450,000	1,595,000	1,740,000	1,885,000
Other Charges						
Interest	270,000	270,000	270,000	270,000	270,000	270,000
Net Income Before Tax	890,000	1,035,000	1,180,000	1,325,000	1,470,000	1,615,000
Less: Income Tax	311,500	362,250	413,000	463,750	514,500	565,250
NET INCOME	578,500	672,750	767,000	861,250	955,500	1,049,750
Sales Growth (%)		0.13	0.25	0.38	0.50	0.63
Net Income Margin (%)	0.14	0.15	0.15	0.16	0.16	0.16

PARAMETER 1

Assets - $3.2mm
Sales to Asset Ratio - 10%
Enterpreneur Equity - $500,000
Loan - 1.5mm
Net Income Margin - 15%
Amount of Investment - $1.0mm
Preferred Dividend - 15%

Independent Variable - Total Sales
Dependent Variable (A) - Return to Fund
Dependent Variable (B) - Return to Entrp

SIMULATION NO.1.1

Total Sales	GROWTH SALES	INC SALES/ INVESTMENT	NET INCOME	RETURN TO FUND PREF DIV 15%	RETURN TO FUND PARTG DIV 10%	RETURN TO FUND TOT DIV	% TO INVEST	RETURN TO ENTRP	% TO EQUITY
4,000,000	0	0.00	578,500	0	0	0	0.00	578,500	1.16
4,500,000	500,000	0.50	672,750	150,000	52,275	202,275	0.20	470,475	0.94
5,000,000	1,000,000	1.00	767,000	150,000	61,700	211,700	0.21	[illegible]	1.11
5,500,000	1,500,000	1.50	861,250	150,000	71,125	221,125	0.22	[illegible]	[illegible]
6,000,000	2,000,000	2.00	955,500	150,000	80,550	230,550	0.23	[illegible]	[illegible]
6,500,000	2,500,000	2.50	1,049,750	150,000	89,975	239,975	0.24	[illegible]	[illegible]

SIMULATION NO.1.2

Total Sales	GROWTH SALES	INC SALES/ INVESTMENT	NET INCOME	RETURN TO FUND PREF DIV 15%	RETURN TO FUND PARTG DIV 20%	RETURN TO FUND TOT DIV	% TO INVEST	RETURN TO ENTRP	% TO EQUITY
4,000,000	0	0.00	578,500	0	0	0	0.00	578,500	1.16
4,500,000	500,000	0.50	672,750	150,000	104,550	254,550	0.25	418,200	0.84
5,000,000	1,000,000	1.00	767,000	150,000	123,400	273,400	0.27	493,600	0.99
5,500,000	1,500,000	1.50	861,250	150,000	142,250	292,250	0.29	569,000	1.14
6,000,000	2,000,000	2.00	955,500	150,000	161,100	311,100	0.31	644,400	1.29
6,500,000	2,500,000	2.50	1,049,750	150,000	179,950	329,950	0.33	719,800	1.44

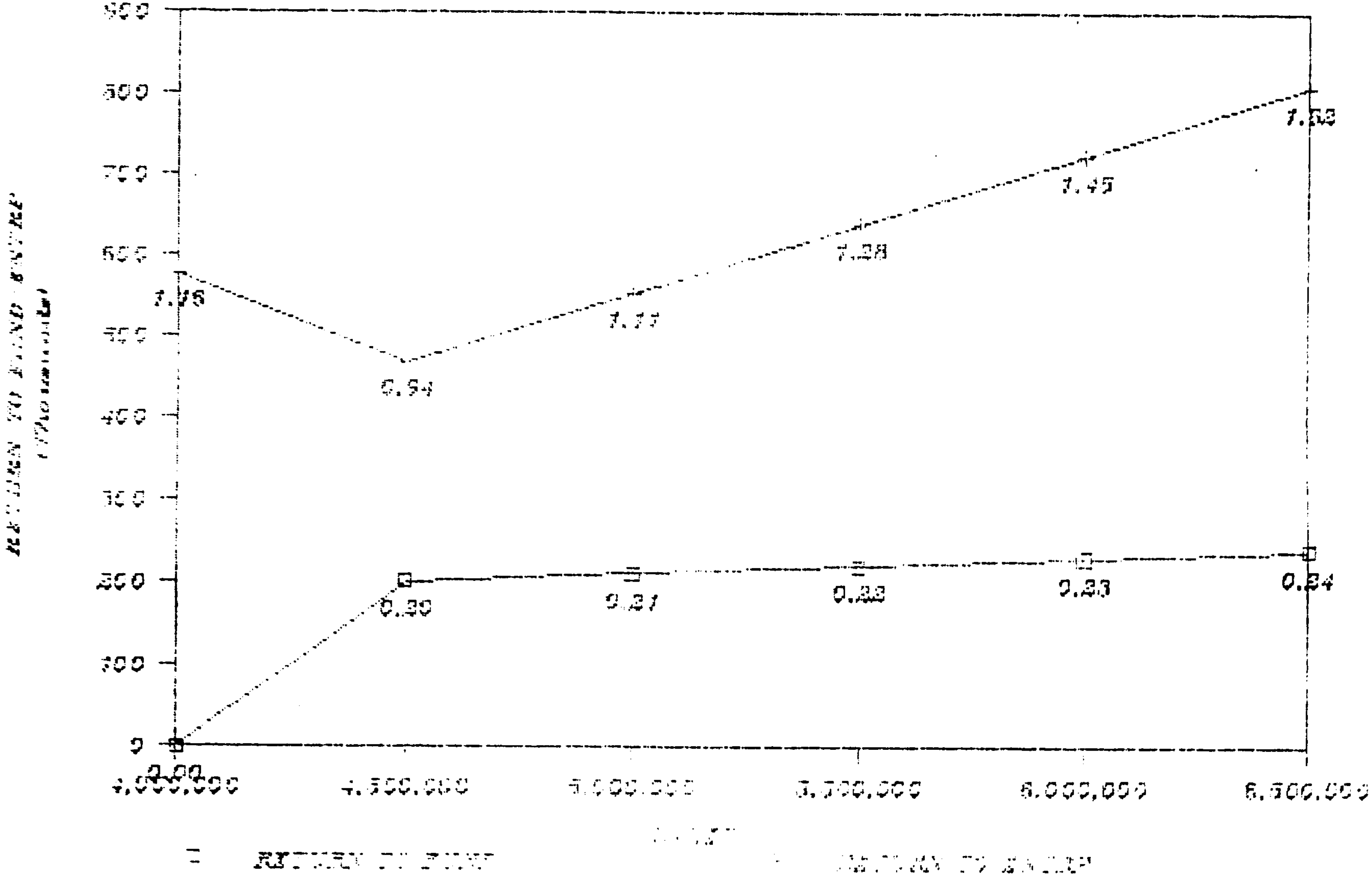
PARAMETER 2

Cost of Sales to Sales Ratio - 41%
Operating Expense to Sales Ratio - 23%
Interest Rate on Loan - 24% per annum
Loan for 9 months

Sales	4,000,000	4,500,000	5,000,000	5,500,000	6,000,000	6,500,000
less: Cost of Sales	1,840,000	1,945,000	2,050,000	2,255,000	2,460,000	2,665,000
Gross Profit	2,160,000	2,655,000	2,950,000	3,245,000	3,540,000	3,835,000
Operating Expenses	1,000,000	1,035,000	1,150,000	1,265,000	1,380,000	1,495,000
Income From Operation	1,160,000	1,620,000	1,800,000	1,980,000	2,160,000	2,340,000
Other Charges						
Interest	270,000	270,000	270,000	270,000	270,000	270,000
Net Income Before Tax	890,000	1,350,000	1,530,000	1,710,000	1,890,000	2,070,000
less: Income Tax	311,500	472,500	535,500	598,500	661,500	724,500
NET INCOME	578,500	877,500	994,500	1,111,500	1,228,500	1,345,500
Sales Growth (%)		0.13	0.25	0.38	0.50	0.63
Net Income Margin (%)	0.14	0.20	0.20	0.20	0.20	0.21

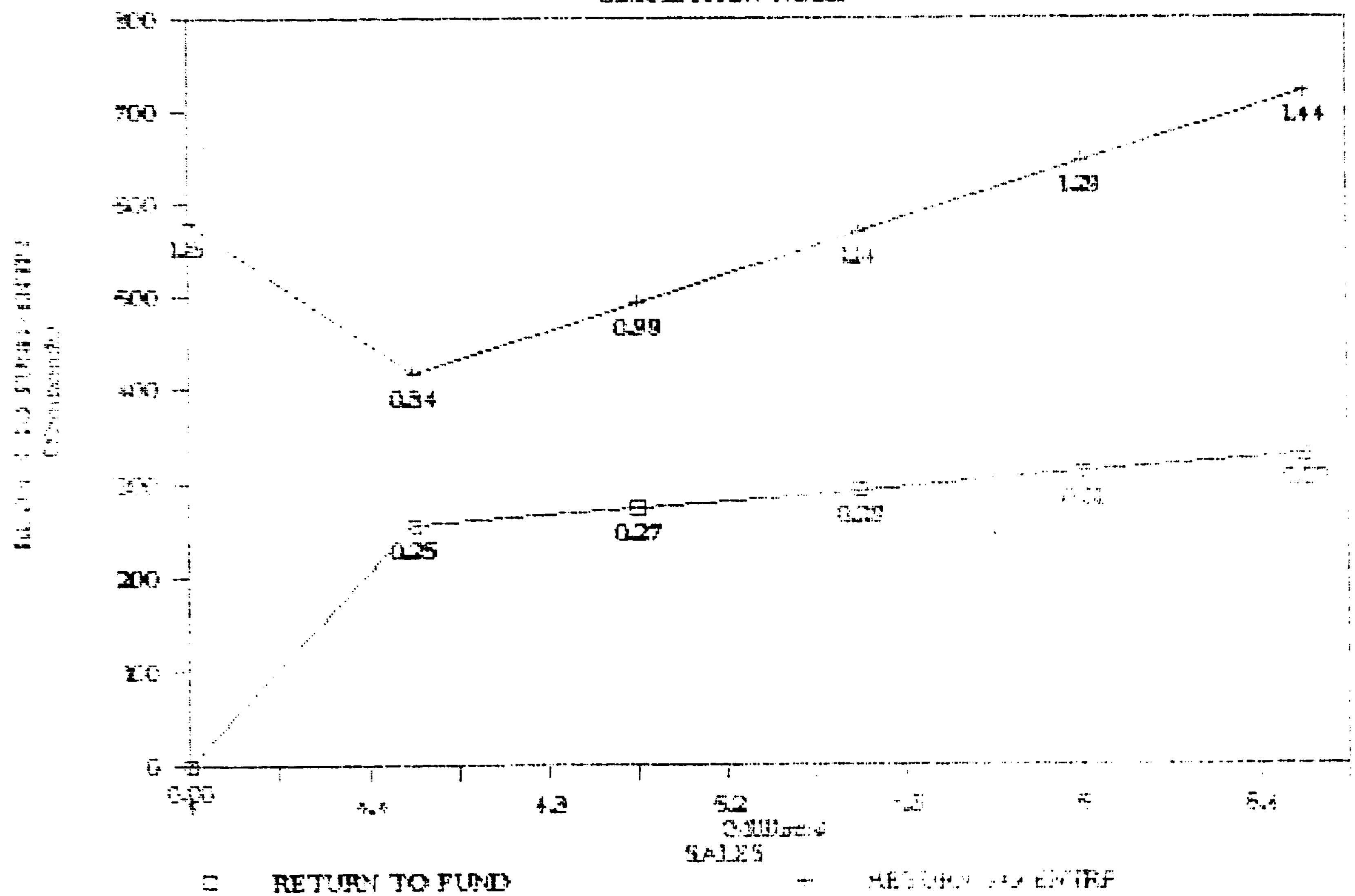
PARAMETER NO.1

SIMULATION NO.1.1



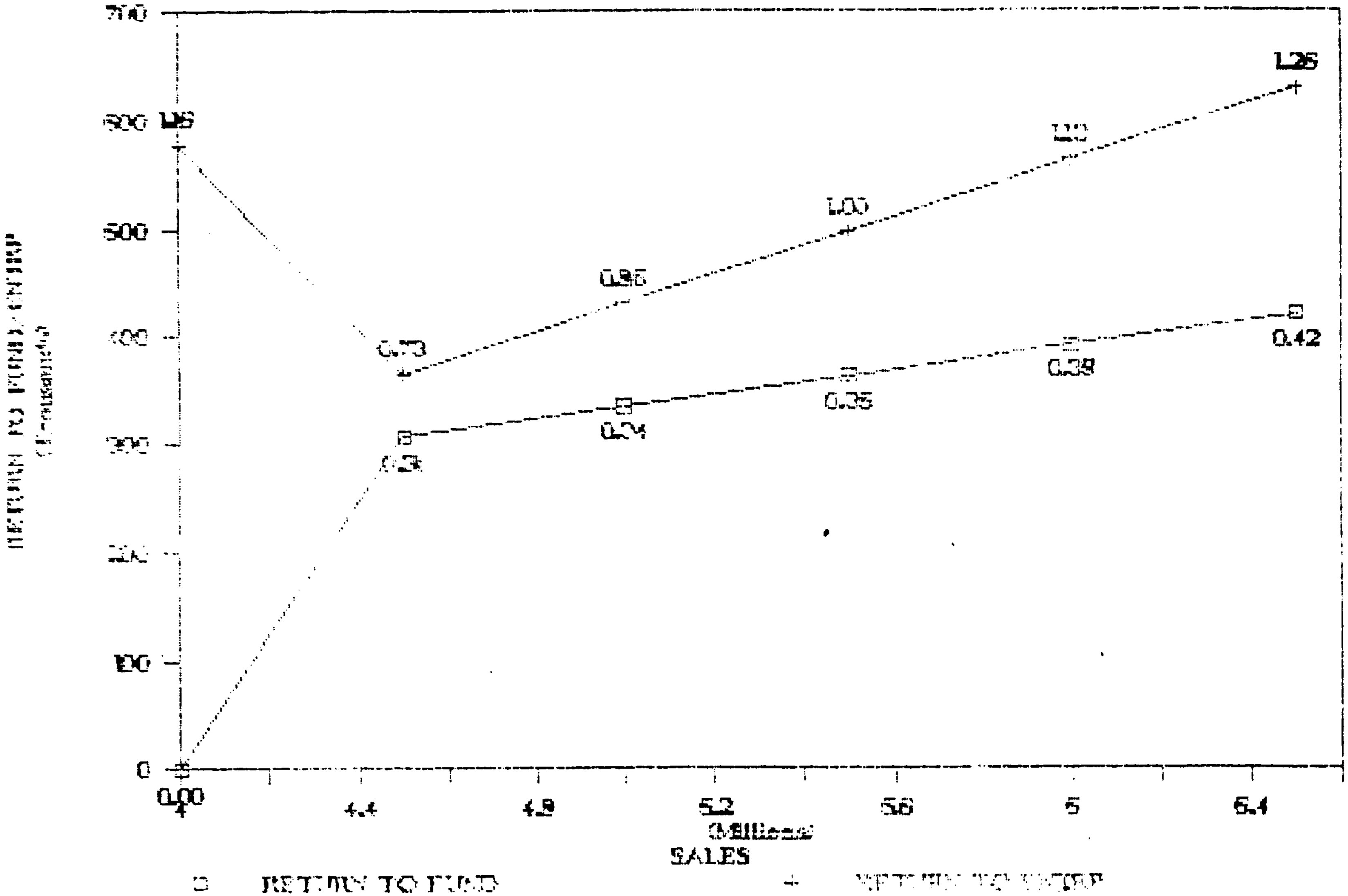
PARAMETER NO.1

SIMULATION NO.12



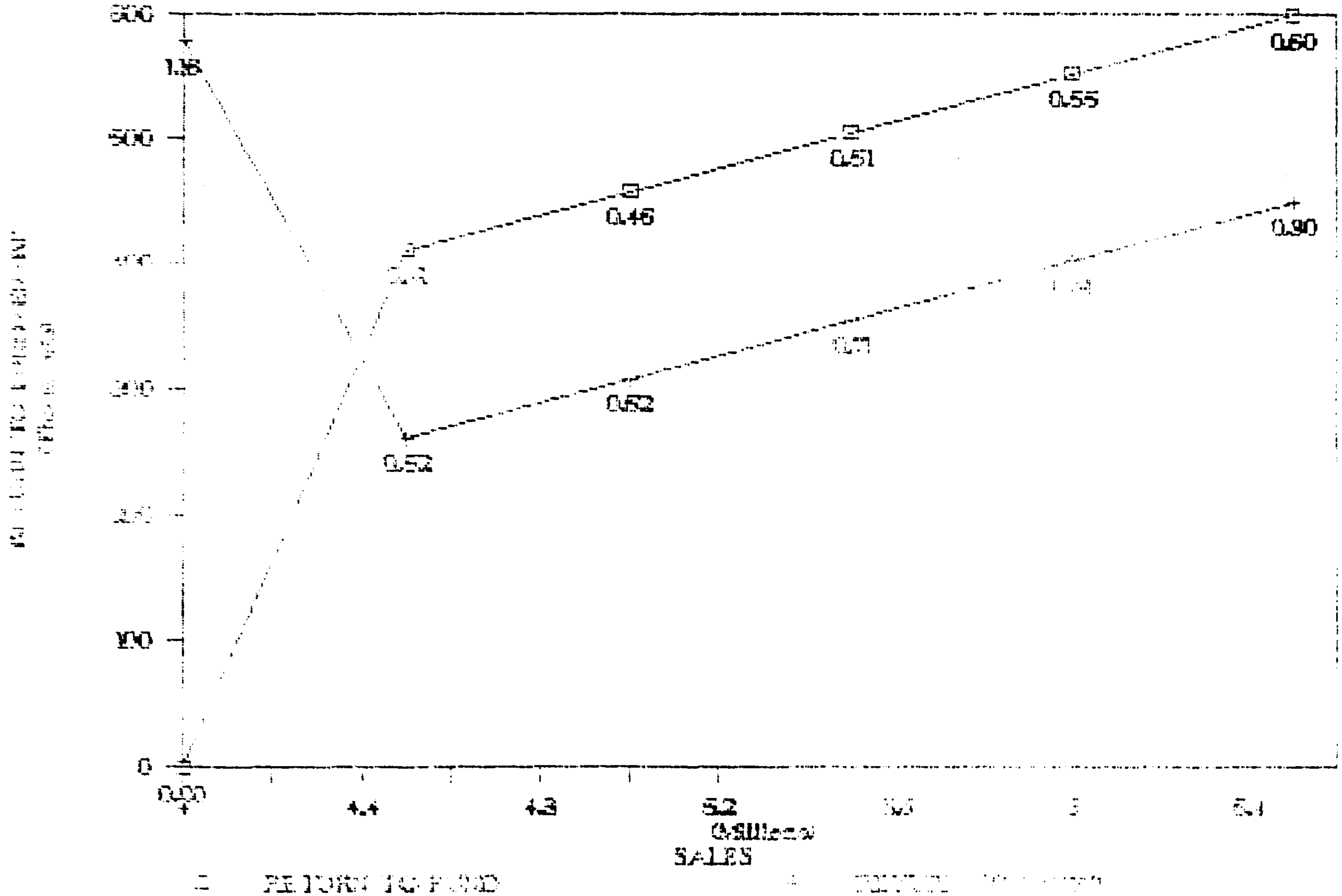
PARAMETER NO.1

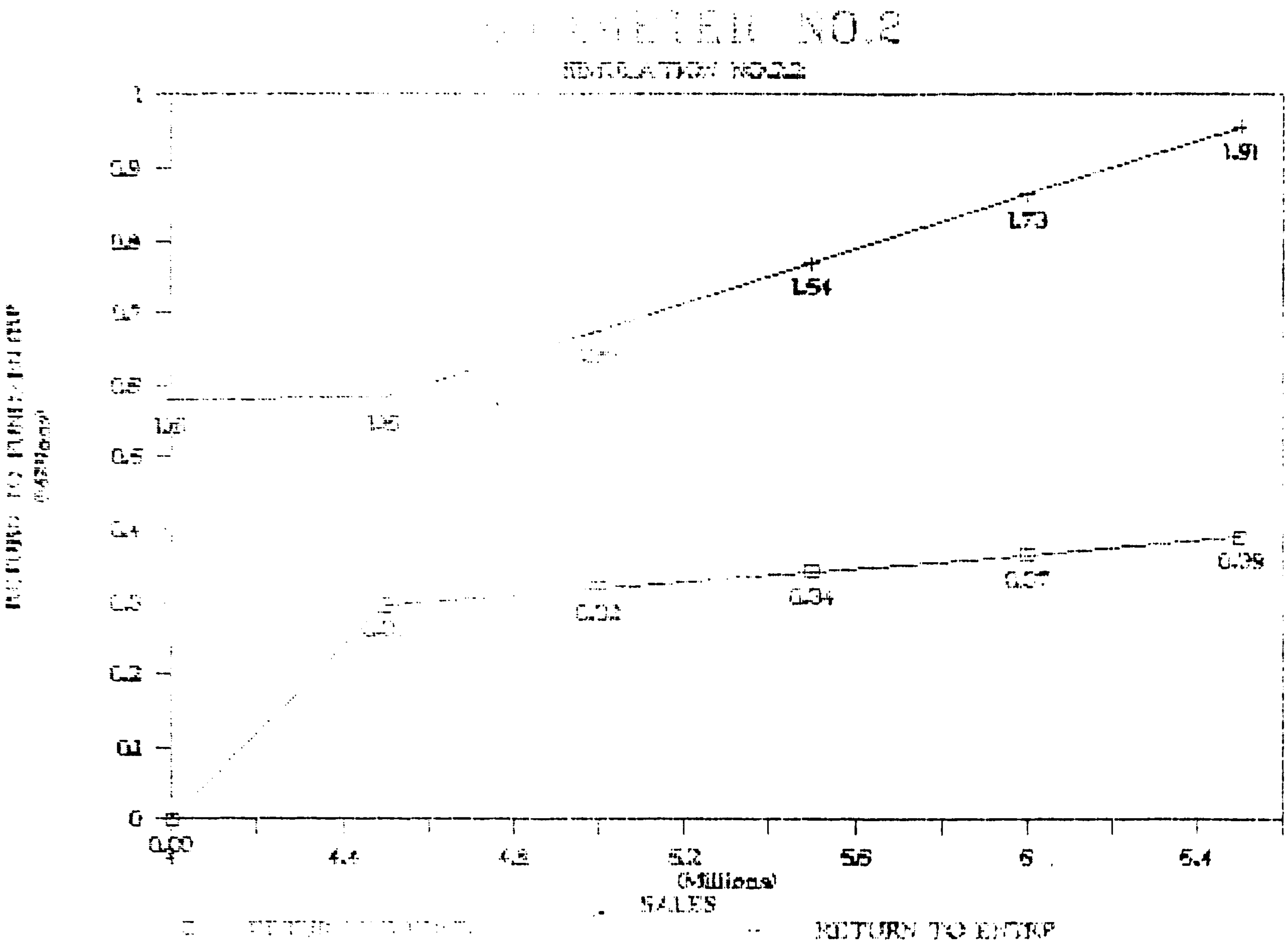
SIMULATION HOLD



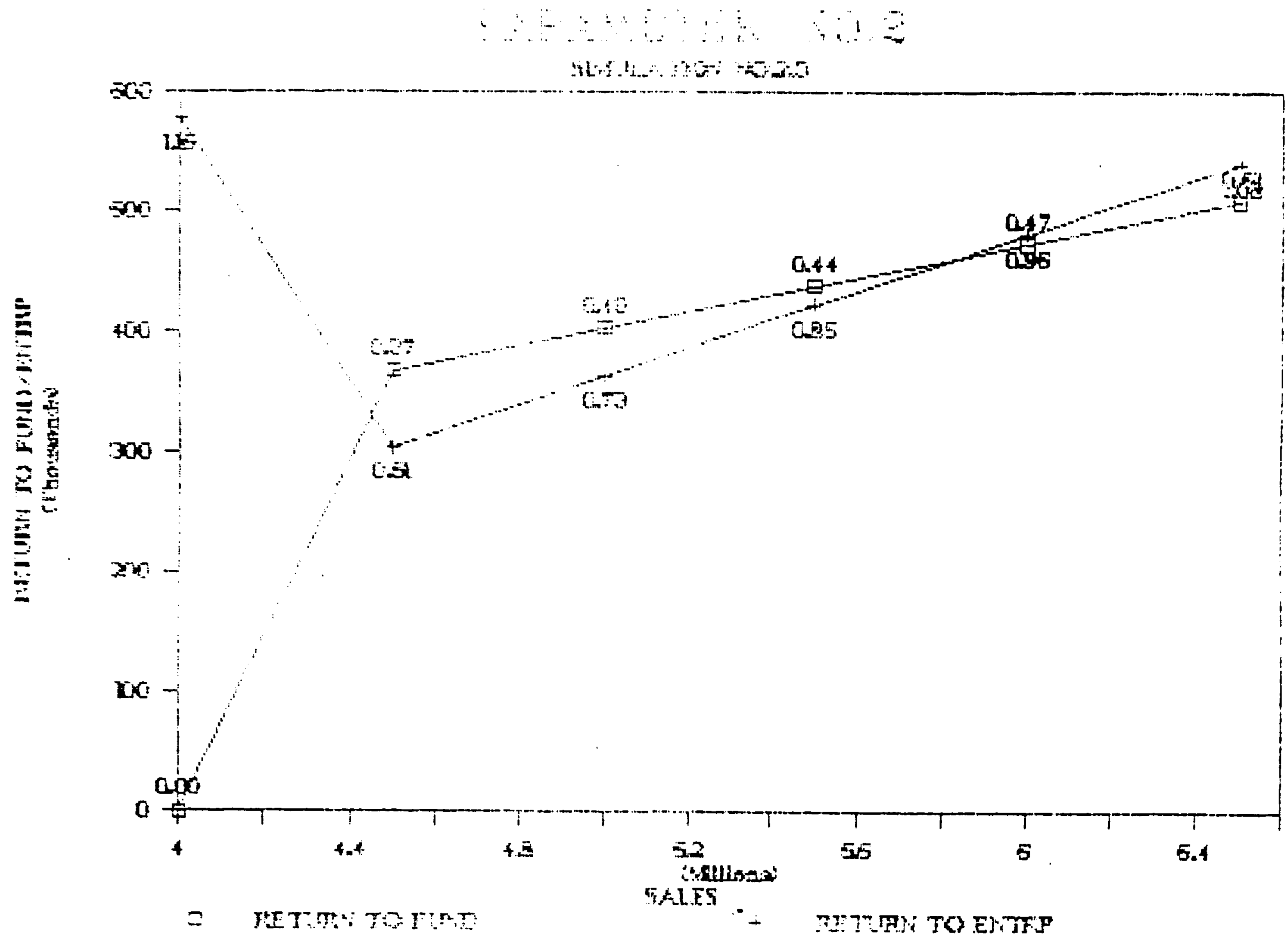
PARAMETER NO.1

SIMULATION NO.14

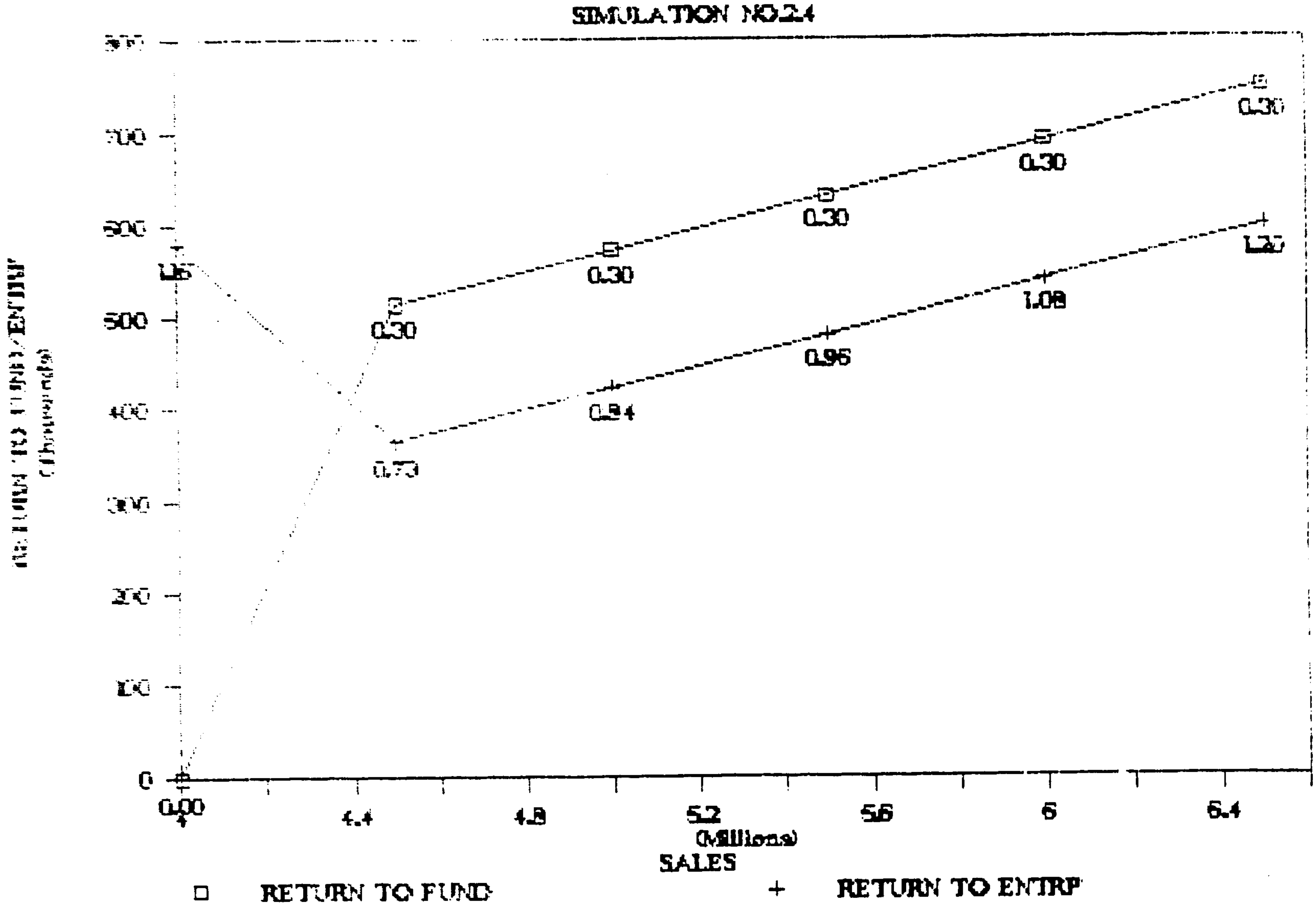




NO.2
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
1.91
1.73
1.54
0.34
0.00
4.4
4.8
5.2
5.6
6
5.4
(Millions)
SALES
RETURN TO ENTRP



1.15
0.27
0.40
0.44
0.47
0.00
0.51
0.73
0.85
0.96
0
100
200
300
400
500
600
4
4.4
4.8
5.2
5.6
6
6.4
(Millions)
SALES
RETURN TO FUND
RETURN TO ENTRP



SIMULATION NO.2.4
RETURN TO FUND/ENTRP
(Thousands)
0
100
200
300
400
500
600
700
0.00
4.4
4.8
5.2
5.6
6
6.4
(Millions)
SALES
0.30
0.30
0.30
0.30
0.30
0.73
0.84
0.96
1.08
RETURN TO FUND
RETURN TO ENTRP

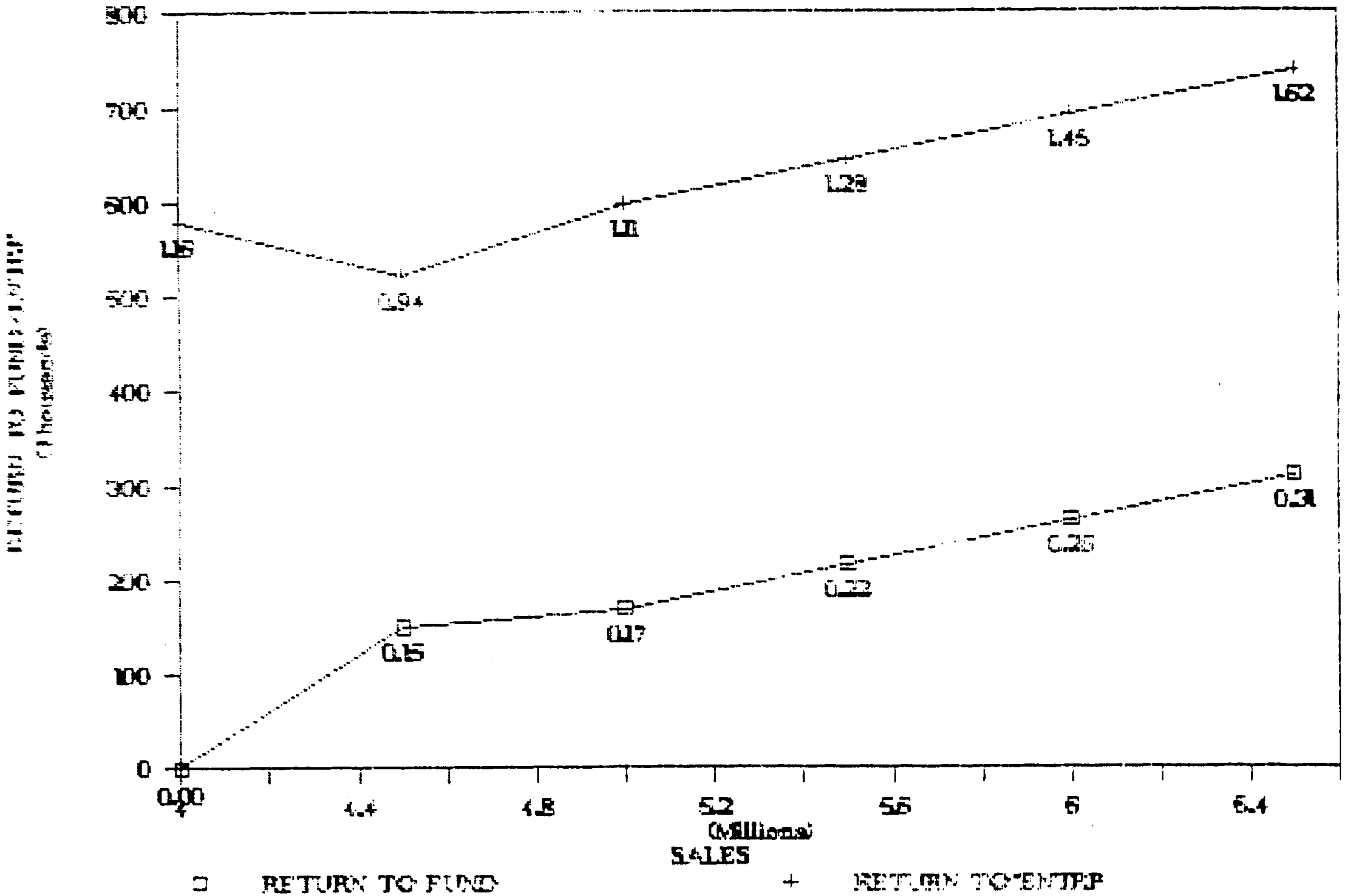
PARAMETER 3

Assets - 3.2mm
Sales to Asset Ratio - 10%
Amount of Investment - $1.0mm
Preferred Dividend - 15%
Enterpreneur Equity - $500,000
Loan - 1.5mm
Net Income Margin - 15%
Participating Dividend - 50% of the amount exceeding $578,500

Independent Variable - Total Sales
Dependent Variable (A) - Return to Fund
Dependent Variable (B) - Return to Entrp

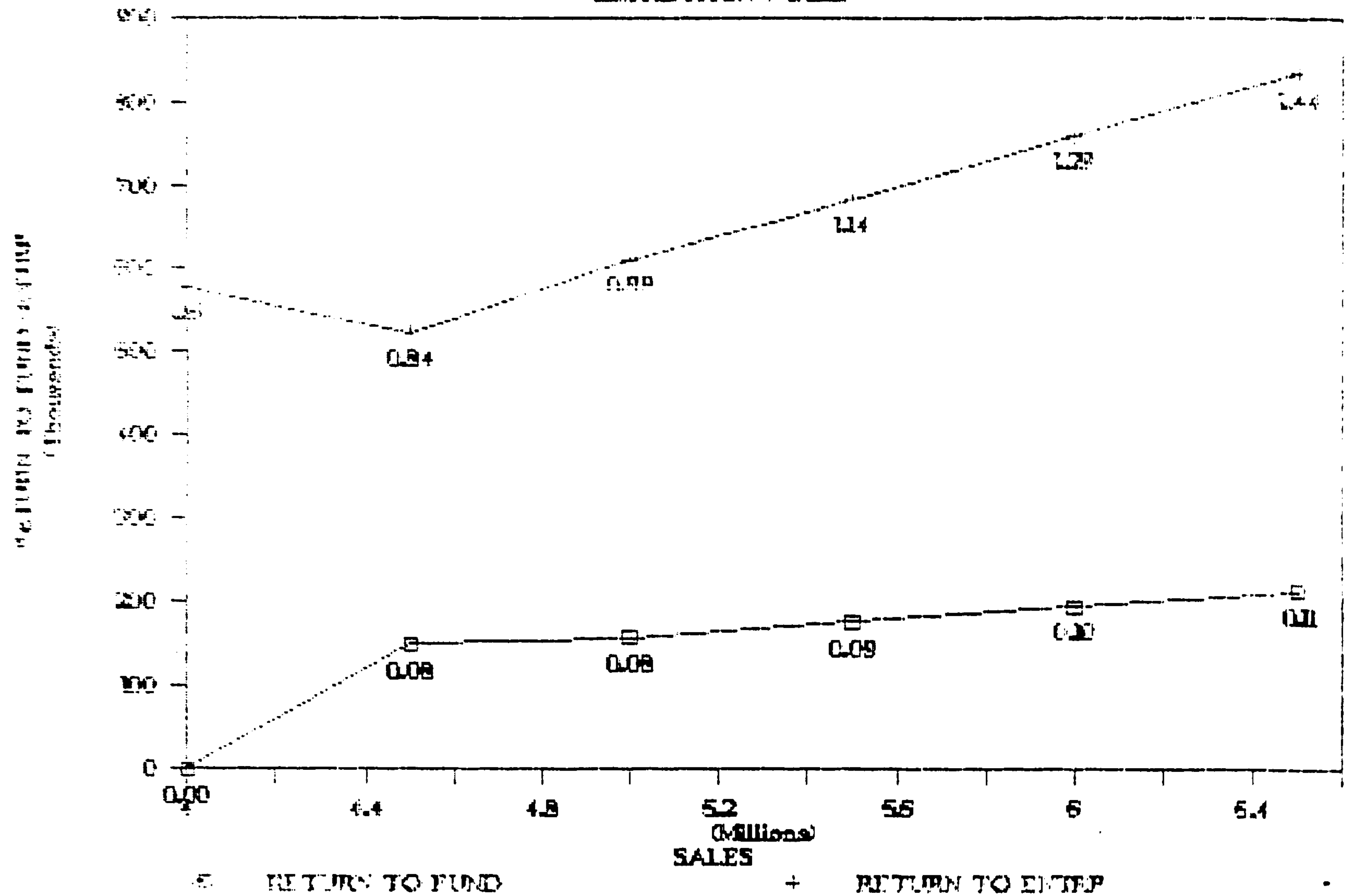
SIMULATION NO.3.1

Total Sales	GROWTH SALES	INC SALES/ INVESTMENT	NET INCOME	RETURN TO FUND PREF DIV 15%	PARTG DIV 50%	TOT DIV	% TO INVEST	% TO TO ENTRP	EQUITY
4,000,000	0	0.00	578,500	0	0	0	0.00	578,500	1.16
4,500,000	500,000	0.25	672,750	150,000	0	150,000	0.15	522,750	0.94
5,000,000	1,000,000	0.50	767,000	150,000	19,250	169,250	0.17	597,750	1.11
5,500,000	1,500,000	0.75	861,250	150,000	66,375	216,375	0.22	644,875	1.28
6,000,000	2,000,000	1.00	955,500	150,000	113,500	263,500	0.26	692,000	1.45
6,500,000	2,500,000	1.25	1,049,750	150,000	160,625	310,625	0.31	73' 175	1.62


800
700
600
500
400
300
200
100
0
0.00
4.4
4.8
5.2
5.6
6
6.4
(Millions)
SALES
RETURN TO FUND
1.45
1.62
0.94
0.15
0.17
0.22
0.31

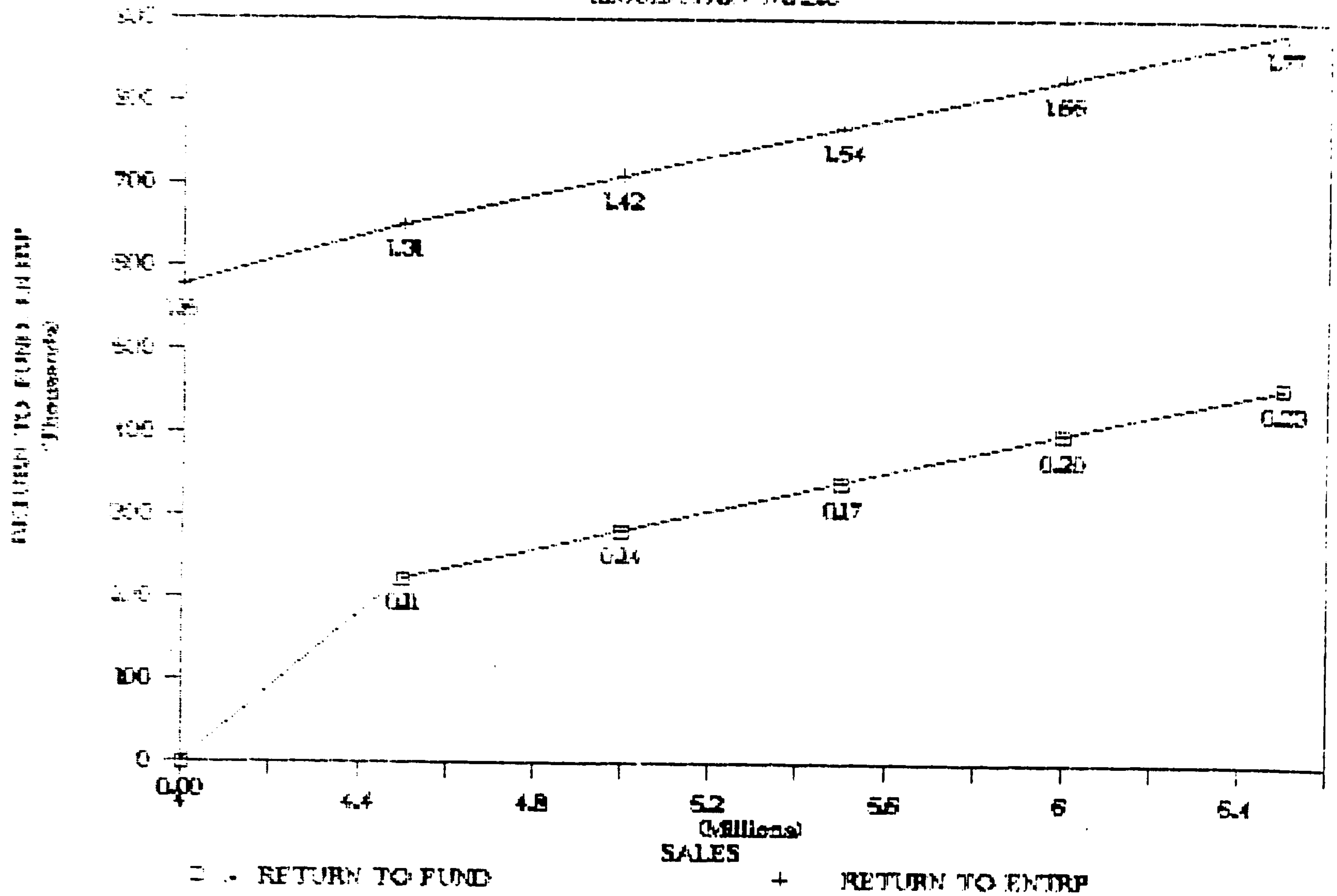
PARAMETER NO 3

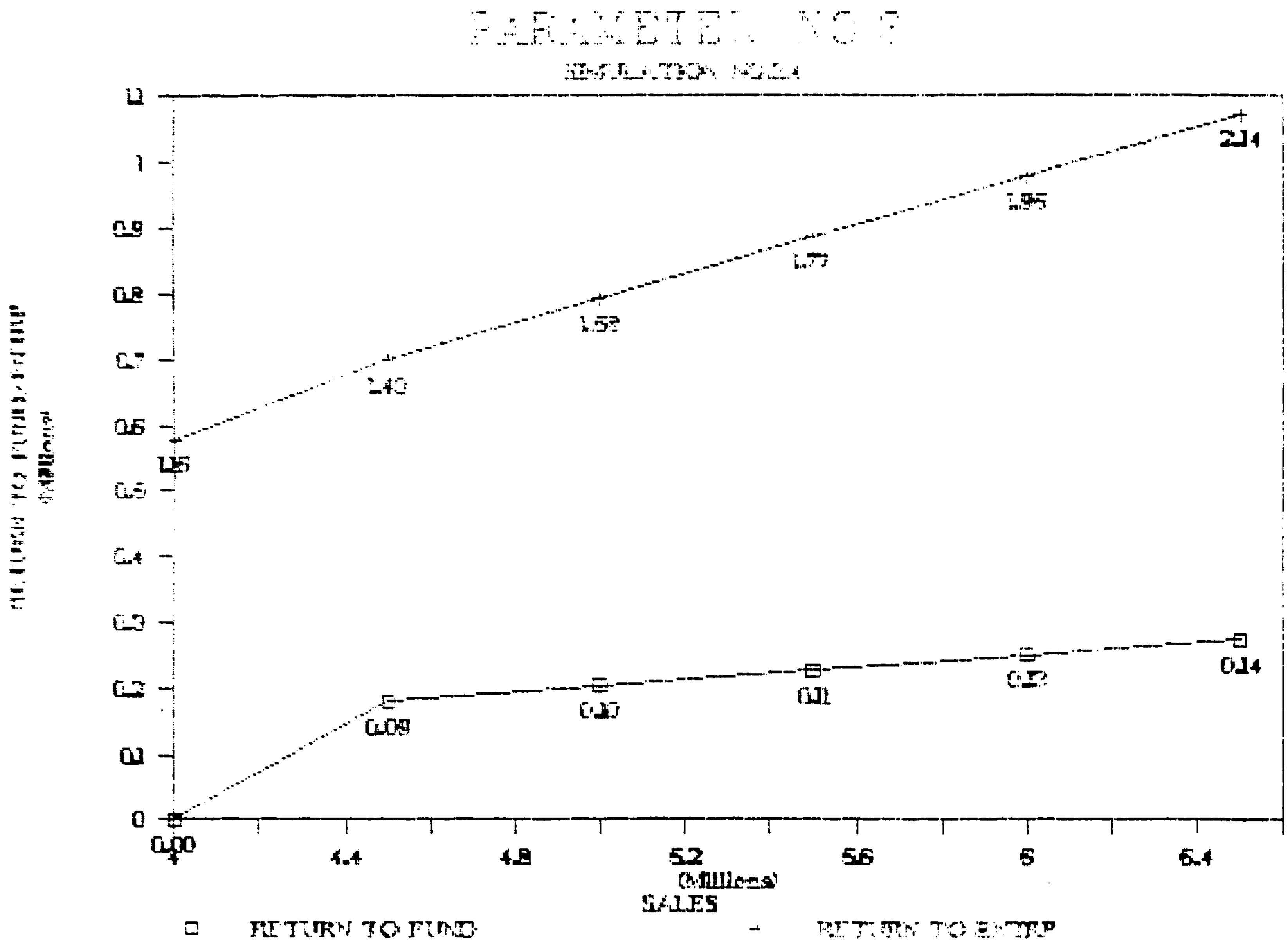
SIMULATION NO 2.2



PARAMETER NO 3

SIMULATION NO 23





PARAMETER NO 7
1.1
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
4
4.4
4.8
5.2
5.6
6
6.4
(Millions)
SALES
RETURN TO FUND
RETURN TO ENTRP
0.00
0.09
0.14
2.14
1.95
1.77
1.59
1.40

BREAK - EVEN PARTG DIVIDEND RATE

SIMULATION NO.18E
Amount of Investment - $1.0mm
Preferred Dividend - 15%
Enterprenuer Equity - $500,000
Loan - 1.5mm
Net income margin - 15%
Return to Fund - 35%

Independent Variable - Sales Growth (%)
Dependent Variable (A) - Income Share (Fund)
Dependent Variable (B) - Income Share (Entrp)

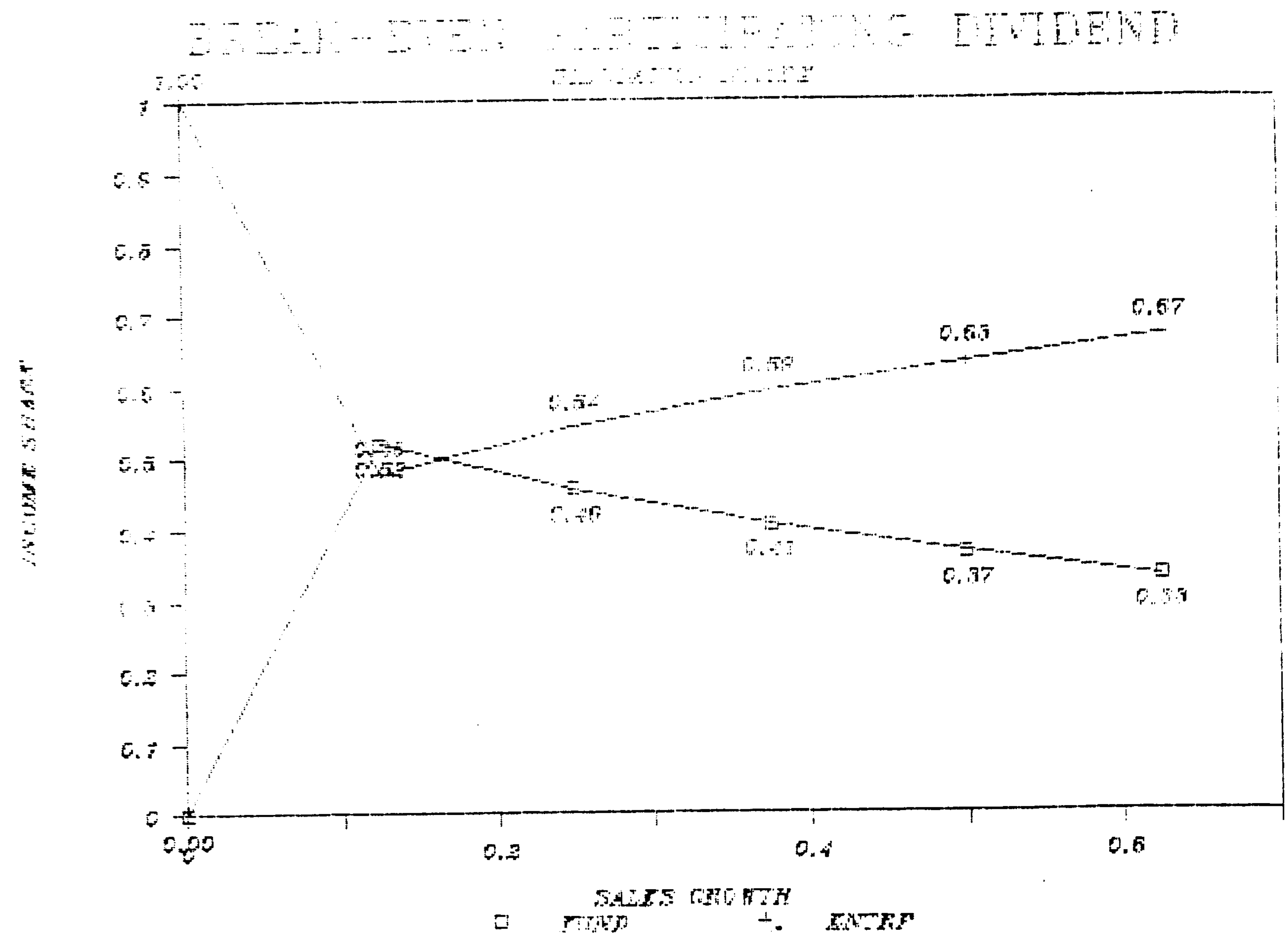
Total Sales	SALES GROWTH AMOUNT	%	INC SALES/ INVESTMENT	NET INCOME	NI MARGIN	RETURN TO FUND AT 35%	PREF DIV 15%	BREAK-EVEN PARTG DIV AMOUNT	RATE	RETURN TO ENTRP	% TO EQUITY	SHARE IN NET INC FUND	ENTR
4,000,000	0	0.00	0.00	578,500	0.14	0	0	0	0.00	578,500	1.16	0.00	1
4,500,000	500,000	0.13	0.50	672,750	0.15	350,000	150,000	200,000	0.38	322,750	0.65	0.52	0
5,000,000	1,000,000	[illegible]	1.00	[illegible]	[illegible]	350,000	150,000	200,000	0.32	417,000	[illegible]	[illegible]	[illegible]
5,500,000	1,500,000	0.38	1.50	861,250	0.16	350,000	150,000	200,000	0.28	511,250	1.02	0.41	0
6,000,000	2,000,000	0.50	2.00	955,500	0.16	350,000	150,000	200,000	0.25	605,500	1.21	0.37	0
6,500,000	2,500,000	0.63	2.50	1,049,750	0.16	350,000	150,000	200,000	0.22	699,750	1.40	0.33	0

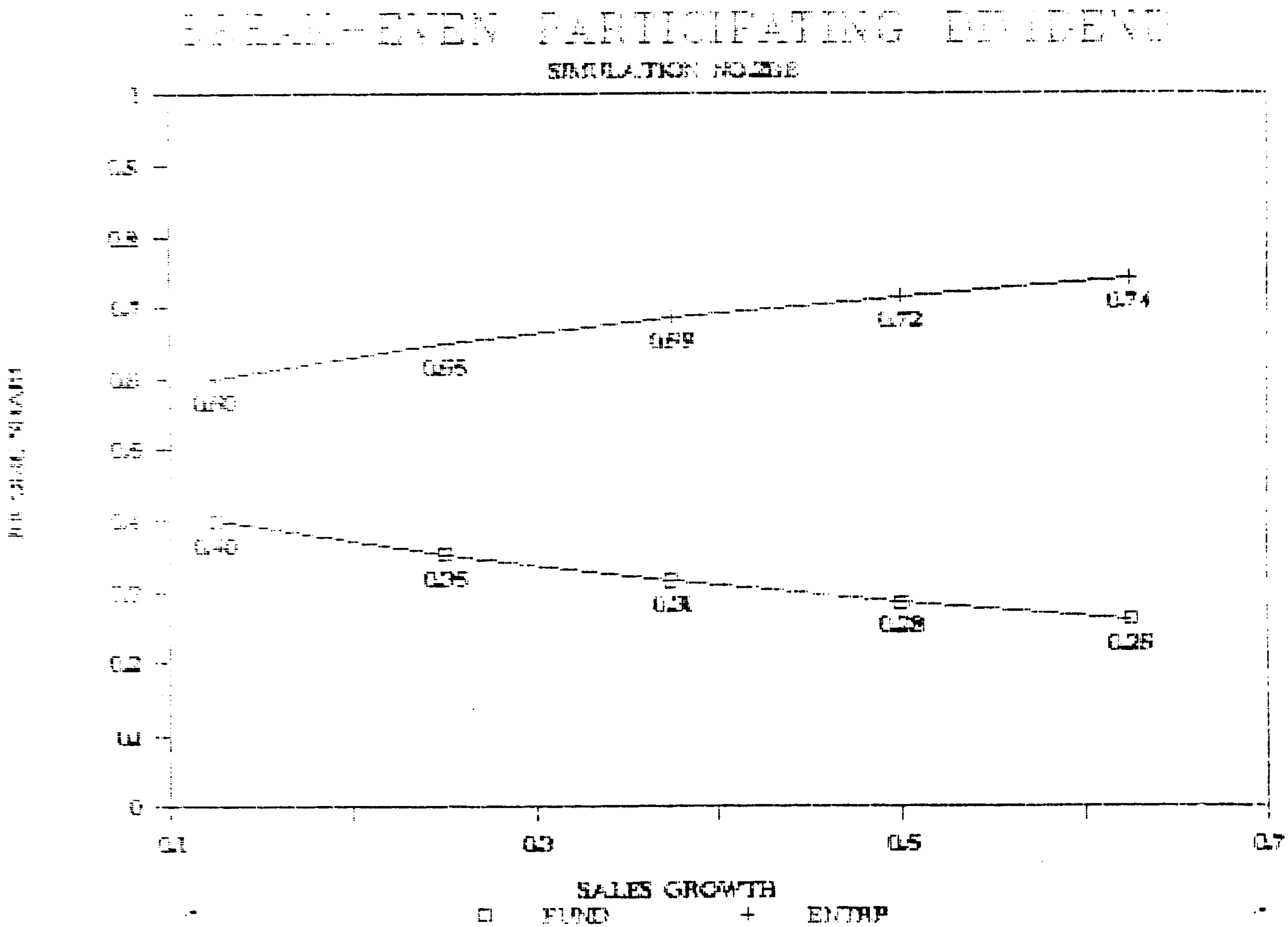
SIMULATION NO.[illegible]

Amount of Investment - $1.0m
Preferred Dividend - 15%
Enterprenuer Equity - $500,000
Loan - 1.5mm
Net Income Margin - 20%
Return to Fund - 35%

Independent Variable - Sales Growth (%)
Dependent Variable (A) - Income Share (Fund)
Dependent Variable (B) - Income Share (Entrp)

Total Sales	SALES GROWTH AMOUNT	SALES GROWTH %	INC SALES/ INVESTMENT	NET INCOME	NI MARGIN	RETURN TO FUND AT 35%	RETURN TO FUND PREF DIV 15%	RETURN TO FUND BREAK-EVEN AMOUNT	RETURN TO FUND PARTIC DIV RATE	RETURN TO ENTRP	% TO EQUITY	SHARE IN NET INCOME FUND	SHARE IN NET INCOME ENTRP
4,000,000	0		0.00	578,500	0.14	0	0	0	0.00	578,500	1.16	0.00	1.
4,500,000	500,000	0.13	0.50	877,500	0.20	350,000	150,000	200,000	[illegible]	[illegible]	[illegible]	0.40	0.
5,000,000	1,000,000	0.25	1.00	994,500	0.20	350,000	150,000	200,000	0.24	644,500	1.29	0.35	0
5,500,000	1,500,000	0.38	1.50	1,111,500	0.20	350,000	150,000	200,000	0.21	761,500	1.52	0.31	0
6,000,000	2,000,000	0.50	2.00	1,228,500	0.20	350,000	150,000	200,000	0.19	878,500	1.76	0.28	0
6,500,000	2,500,000	0.63	2.50	1,345,500	0.21	350,000	150,000	200,000	0.17	995,500	1.99	0.26	0


DIVIDEND
1.00
1
0.9
0.8
0.7
0.6
0.5
0.4
0.2
0.1
0
0.67
0.63
0.59
0.54
0.46
0.37
0.00
0.2
0.4
0.6
SALES GROWTH
ENTRP

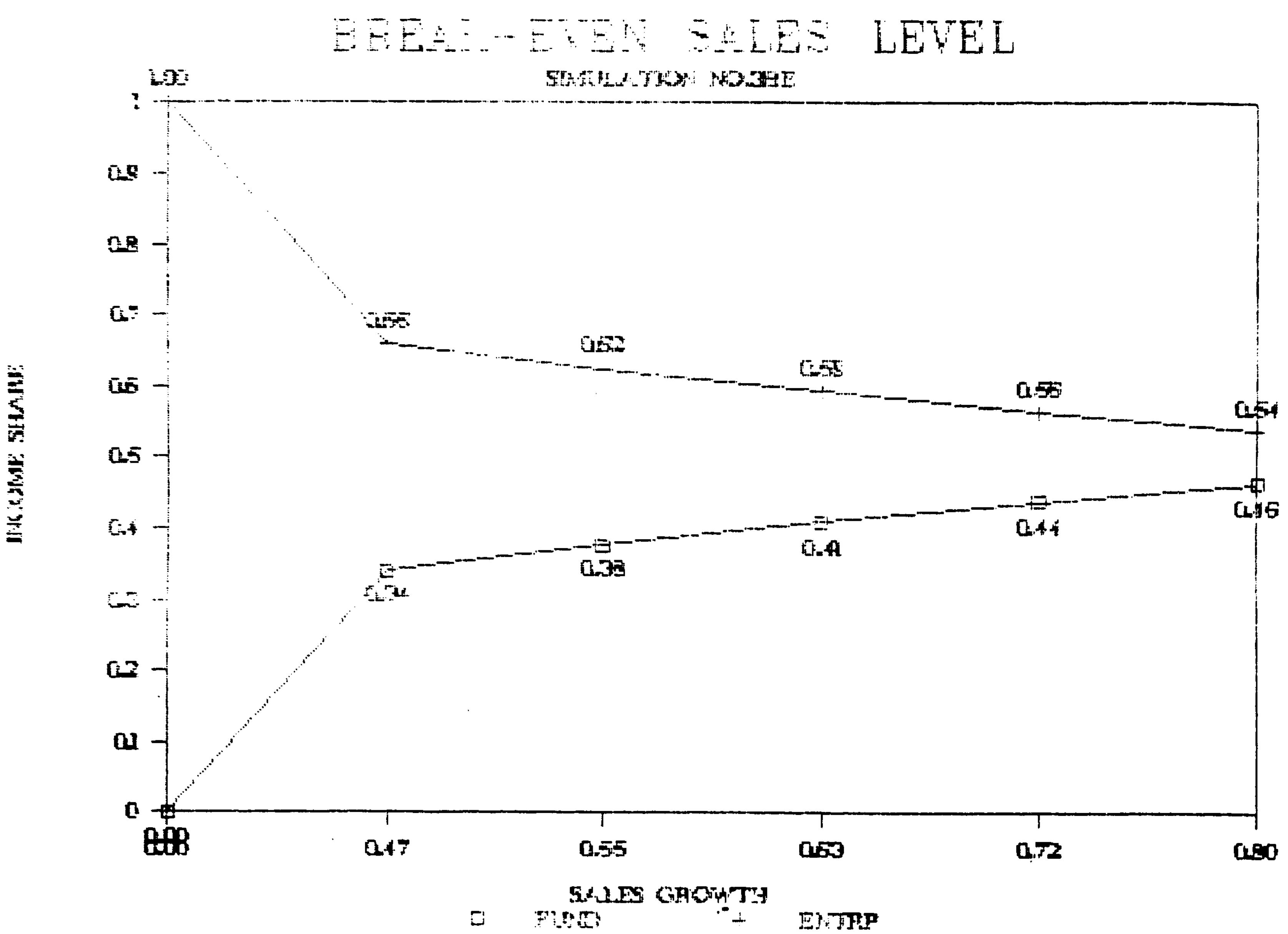

PARTICIPATING
SALES GROWTH
FUND
ENTRP
0.60
0.65
0.69
0.72
0.74
0.40
0.35
0.31
0.28
0.26
0.1
0.3
0.5
0.7

BREAK-EVEN SALES LEVEL

SIMULATION NO.4BE
Amount of Investment - $1.0mm
Preferred Dividend - 15%
Enterprenuer Equity - $500,000
Loan - 1.5mm
Net Income Margin - 20%

Independent Variable - Sales Growth (%)
Dependent Variable (A) - Income Share (Fund)
Dependent Variable (B) - Income Share (Entrp)

RETURN TO FUND		RETURN TO ENTRP		NET INCOME	NET INCOME SHARE		BREAK EVEN	SALES
AMOUNT	%	AMOUNT	%	AT 20%	FUND	ENTRP	SALES	GROWTH
0	0.00	578,500	1.16	578,500	0.00	1.00	N.A.	0.00
300,000	0.30	580,000	1.16	880,000	0.34	0.66	4,400,000	0.10
350,000	0.35	580,000	1.16	930,000	0.38	0.62	4,650,000	0.16
400,000	0.40	580,000	1.16	980,000	0.41	0.59	4,900,000	0.23
450,000	0.45	580,000	1.16	1,030,000	0.44	0.56	5,150,000	0.29
500,000	0.50	580,000	1.16	1,080,000	0.46	0.54	5,400,000	0.35


BREAK-EVEN SALES LEVEL
SIMULATION NO.3HE
INCOME SHARE
SALES GROWTH
FUND
ENTRP
0.47
0.55
0.63
0.72
0.80
0.66
0.62
0.59
0.56
0.54
0.34
0.38
0.41
0.44
0.46

BREAK-EVEN SALE LEVEL