# SUBCONTRACTING AND MARKETING FOR MICRO AND SMALL ENTERPRISES

**(SP/TC-00-10-03-7-PE)**

## EXECUTIVE SUMMARY

**Executing agency:** Centro de Promoción Integral [Center for Comprehensive Business Development] (CEPI)

**Amount and source:**

| | US$ | Euros* |
|---|---|---|
| European Commission financing: | 450,000 | 453,848 |
| European Commission nonreimbursable technical-cooperation funding: | 160,000 | 161,368 |
| Local contribution: | 240,000 | 242,052 |
| Total: | 850,000 | 857,268 |

The funding will be provided by the Special Fund for the Financing of Microenterprises of the European Economic Community. Bank commitments against these resources will be calculated in euros.

*Exchange rate: US$1.00 = 1.00855 euros (as of 28 June 2002)

**Terms and conditions:**

**Financing**:

| | |
|---|---|
| Amortization period: | 10 years |
| Grace period: | 4 years |
| Disbursement period: | 48 months |
| Interest rate: | 4% in US$ |

**Technical cooperation**:

| | |
|---|---|
| Execution period: | 36 months |
| Disbursement period | 48 months |

The grace period will only apply to amortization of the principal, not to interest payments. The financing will be denominated in euros and disbursed in United States dollars. Repayments of the financing will be made in new soles with maintenance of the value in United States dollars.

**Problem to be addressed:**

In general, micro and small enterprises (MSE) in the apparel and textile industry yield low revenue and face various constraints that prevent them from developing enough to become competitive and profitable. It is difficult for them to find and penetrate broader, more diversified markets to sell more, strengthen their businesses, and increase their installed capacity. This leads to a vicious circle of low sales, low income, and little investment in their productive capacity.

The main constraints faced by the MSEs in the apparel and textile industry include: (i) **poor production processes and organization**, which reduce productivity; (ii) **products without much differentiation** sold to the mass market, which does not demand high quality; (iii) **lack of economies of scale** to help businesses sell larger volumes and lower unit costs; (iv) **difficulty accessing market information** and therefore new marketing channels for their products; and (v) **difficulty accessing working capital** in line with their needs on a timely basis.

**Objectives:**

The **general objective** of the project is to help increase income and strengthen employment for micro and small apparel producers in urban areas by improving their competitiveness. The **specific objectives** are to: (i) increase the coordination between MSE apparel production and both local and international markets through business development and subcontracting by the Center for Comprehensive Business Development (CEPI); (ii) improve MSEs' access to appropriate and timely sources of working capital to ensure fulfillment of the contracts obtained; (iii) improve MSE production and management to ensure survival over time and market competitiveness; and (iv) strengthen the CEPI's institutional capacity and ensure its self-sustainability.

**Description:**

The CEPI acts as a business and production intermediary in two ways: (i) by *marketing* MSE products to target markets; and (ii) by acting as the *link in production* that organizes and subcontracts production and provides advisory services to MSE groups in the most efficient manner to fulfill the contracts obtained. The CEPI also works to expand and improve the quality of its MSE production force through training and technical assistance. In addition, an integral part of the service the CEPI provides its clients is a system of advances for raw materials and working capital to help finance the orders assigned to each MSE.

The program has two components: (i) a reimbursable financing component; and (ii) a nonreimbursable technical-cooperation funding component. The financing will be used to increase the working capital necessary to significantly increase the volume of sales by the participating MSEs, and the number of MSEs involved in subcontracting. The technical-cooperation funding component will be used to increase MSE technical and productive capacities and to help strengthen the operation of the executing agency.

The **reimbursable financing** (European Commission: Euros 453,848; CEPI: US$100,000) will be used to create a marketing fund to help the CEPI boost the average annual sales of subcontracted MSEs from US$550,000 to US$1.25 million by year four of project execution.

This marketing fund will be used essentially as working capital for the production and marketing of apparel manufactured by participating MSEs. Specifically, the following will be financed: (i) the purchase of raw materials and/or other materials used by the MSEs to fill orders placed; and (ii) advances so MSEs can finance production costs to manufacture the apparel specified in the contracts. These additional resources will help the CEPI to increase the number of MSEs that can benefit from its services, and to increase sales for such MSEs.

The CEPI will handle the fund in accordance with the Credit Regulations established for the program. The main terms and conditions for management of the resources are the following: (i) **Eligible clients:** to qualify, a MSE must have been in operation continuously for at least six months, be legally established, located where the CEPI is executing the program, have the space, infrastructure, equipment, personnel, and tools necessary to fulfill work requirements, have received assistance and training, and not use processes harmful to the environment or child labor; (ii) **Use of funds:** the resources may be used to: (a) purchase and deliver to the MSEs raw materials used for the production of specific orders, as an advance; (b) provide working capital in advance for labor directly related to the subcontracting order; and (c) in special cases (up to 15% of the total fund), purchase machinery and/or improve the facilities directly used for production work, only for the best clients, who because of their credit history and financing needs, warrant special consideration; (iii) **Terms:** the terms for the advances for working capital are one to three months, depending on the

circumstances of each order, and for machinery and equipment, one year; and (iv) **Interest rate:** 18% annual rate, in United States dollars, on outstanding balances for working capital advances, and from 1.5% to 2.5% monthly, in United States dollars, on outstanding balances for special loans for machinery or equipment.

The **technical-cooperation funding** (European Commission: Eur~~o~~os 161,368; CEPI: US$140,000) will focus on activities that will help improve various technical and productive aspects of both the MSEs and their product marketing by the CEPI. These activities are expected to have an impact on: (i) improving the production management and capacity of the participating MSEs; (ii) strengthening MSE skills through practical manufacturing experience to increase the value added to production lines; (iii) improving the aesthetic quality of the apparel by providing advice on design and style; (iv) expanding and diversifying their clientele, in both the local and international markets; (v) strengthening the CEPI's capacity in technical, administrative, and financial performance for the program activities.

In addition, a mid-term and final evaluations will be conducted, the costs of which will be covered by the technical-cooperation funding.

**Environmental and social review:** At its 2 March 2001 meeting, the Committee on Environment and Social Impact reviewed this operation, and its recommendations are reflected in this document.

**Beneficiaries:** The direct beneficiaries of the program will be the approximately 2,000 owners and employees of about 300 micro and small enterprises mainly in the apparel and textile industry. It is estimated that 50% of the MSEs will be operated by women, among whom there is a high percentage of single mothers, unmarried or separated from the fathers. Most MSEs are concentrated in the Cono Sur districts of Lima—low-income and poverty-stricken areas in metropolitan Lima. They are mainly located in the districts of San Juan de Miraflores, Villa María del Triunfo, and Villa El Salvador, and to a lesser extent in the districts of La Victoria, San Luis, and San Juan de Lurigancho. The populations in these zones are part of the wave of migration from small cities or the countryside to the capital, seeking to escape from poverty and improve their standard of living. It is estimated that 80% of the businesses that are CEPI clients have fewer than 10 workers and an average annual net income of US$5,000.

**Risks:**

The program has two main risks. The first *risk* is that the projected sales levels may not be achieved. Even after the CEPI increased its client base from four to 16 different clients in recent years, 70% of its sales were still to a single large buyer (Telefónica del Perú). If the CEPI does not obtain the contracts for the projected orders, the goals of income increases for the MSEs and self-sustainability of the CEPI may be jeopardized. *Mitigating factor:* The technical-cooperation funding will support various activities designed to diversify the clientele by identifying the market niches with the most potential and developing the tools necessary to expand and market the production capacity of the CEPI network in such markets, including market research, trade missions, publicity and marketing, and the development of new designs and collections.

The second *risk* is that the increase in MSE sales through the CEPI may increase their dependence on the CEPI to the extent that it might act as a monopsonist buyer. *Mitigating factor*: The CEPI does not demand exclusivity and the MSEs are free to sell their products to any buyer. For the majority of the CEPI's MSE clients, subcontracting with the CEPI represents between 30 and 70% of their total sales. The training activities and technical assistance offered by the CEPI to the MSEs will help them improve their technical capacity to produce new and improved products, and to enhance their skills to find new markets, market their products, and negotiate with other clients. Moreover, the CEPI will promote the participation of the MSEs in fairs and business tours, and will give them production orders for low volumes. Regarding pricing, the CEPI will share all the cost and pricing information on each order with the subcontracted MSEs in a transparent manner, and it will pay them competitive prices to keep them as suppliers. Therefore, the CEPI's support to its clients will help the MSEs diversify their markets instead of making them dependent on subcontracting, and is designed to build business relationships based on mutual trust. To monitor performance and measure the expected impact, the program evaluations will include an analysis of: (i) changes in the breakdown of sales in a representative sample of the CEPI's MSE clients and the information on the MSEs' satisfaction with the breakdown of their sales; and (ii) changes in the CEPI's spreads and its cost structure. The semiannual reports will also include information on the CEPI spreads and the marketing fund lending rates. The CEPI and the Bank's Country Office will use this information to take the measures necessary to reduce this risk if necessary.

**The government's and the Bank's strategy:**

The program activities are consistent with the priorities of the Bank's strategy with Peru (GN-2205, 25 April 2002) in that they will: (i) provide financial and nonfinancial services to micro and small enterprises to improve their competitiveness and to increase their involvement in national and international markets; and (ii) create opportunities to increase revenue for low-income micro and small enterprise entrepreneurs.

The operation is also consistent with the parameters of the Social Entrepreneurship Program because its end-beneficiaries will be owners and employees of micro and small apparel and textile enterprises in depressed urban areas, whose income will be increased by expanding and improving their production and linkage with markets.

**Rationale:**

This project is justified because: (i) it will increase the opportunities to improve income and stabilize employment in marginal areas of the country; (ii) the apparel subsector represents a significant productive activity among MSEs in the country; (iii) it uses highly business- and market-oriented mechanisms to generate sustainable benefits for participating MSEs; and (iv) it is a sustainable model to offer business services to MSEs that could be replicated in other countries or sectors.

**Special contractual conditions:**

Due to the need for working capital to rapidly increase sales and according to projections, the **financing** will be disbursed through the establishment of an advance fund of up to: (i) US$200,000 for the first disbursement; (ii) US$150,000 for the second; and (iii) US$100,000 for the third.

As conditions precedent to the first disbursement of the **financing**, the CEPI must submit the following to the satisfaction of the Bank: (i) the final Credit Regulations that establish the rules for the operation of the marketing fund for the CEPI subcontractors; and (ii) a report demonstrating that total sales completed, in process, and in its order books amount to at least US$650,000.

As a condition precedent to the second disbursement of the **financing**, the CEPI must submit a report to the satisfaction of the Bank showing that total sales completed, in process, and in its order books amount to at least US$800,000.

As a condition precedent to the third disbursement of the **financing**, the CEPI must submit a report to the satisfaction of the Bank showing that total sales completed, in process, and in its order books amount to at least US$1 million.

The **technical-cooperation funding** will be disbursed through the establishment of an advance fund of up to 40% of the total amount of the **technical-cooperation funding**. As conditions precedent to the first disbursement, the CEPI must submit to the satisfaction of the Bank: (i) a work plan for execution of the technical-cooperation funding; and (ii) the terms of reference for hiring consultants for: (a) the preparation of training manuals and provision of technical-assistance services; (b) the first market study; and (c) installation and adaptation of the management accounting system and training for staff in how to use and maintain it.

The advance fund will be replenished once the Bank has made the second disbursement of the financing, in accordance with the conditions described in the main document.

**Reports:** The CEPI must submit an execution plan that includes annual targets for the fulfillment of program objectives and performance. The execution plan must include: (i) a timetable for the performance indicators set forth in the main document and in the logical framework, which will help monitor and supervise program execution; and (ii) a compilation of socioeconomic data on the target group before program startup, in order to assess its impact on the situation of the beneficiaries.

Within 60 days after the end of each semiannual period, the CEPI will submit progress reports to the Bank on the program and the use of the Bank resources. These reports must include: (i) a description of the status of the program execution plan and indicators, and a description of the main results achieved and difficulties encountered by the program in meeting its goals and objectives; (ii) updated performance indicators and program execution plan for the following 12 months, including measures to overcome any obstacles identified; (iii) the benefits transferred to the MSEs, including economic ones, training, and technical assistance in the various areas; (iv) information on the interest rates charged for the marketing fund; (v) information on the CEPI margins in the cost structure of its sales; (vi) the application of funds statement for the Bank resources and counterpart contribution; and (vii) the financial statements of the CEPI. The last of these reports will be the final report and must contain a summary of the progress achieved with respect to the original program objectives.

The Bank will review the content, findings, and recommendations of the reports. If it should encounter any significant deficiencies in program execution, the Bank may

suspend disbursements until the CEPI has taken satisfactory measures to correct such deficiencies.

**Evaluations:** Once the second advance of the financing has been disbursed, a mid-term evaluation will be conducted to assess program progress and to take any corrective measures that may be necessary. This evaluation will measure the fulfillment of the proposed objectives and the degree of fulfillment of the indicators set forth in the logical framework and the main document. The evaluation will assess, among other things: (i) the use and recovery of the marketing fund; (ii) the procedures and tools used in the operation of the marketing fund; (iii) the progress made and objectives achieved in implementing the technical-cooperation funding; (iv) progress in the breakdown of sales in a representative sample of the CEPI's MSE clients and the MSE satisfaction with the breakdown of their sales; (v) the progress of CEPI spreads and cost structure; (vi) progress in the diversification of CEPI business contracts for apparel manufacturing, in both local and international markets; (vii) improvements in the productivity and productive quality of the CEPI's MSE clients; (viii) progress in the institutional strengthening of the CEPI, especially in its management accounting system and the development of new collections; and (ix) lessons learned and recommendations for program improvement and replicability.

With a view to documenting the experience and measuring project impact, a final program evaluation will be conducted once 100% of the financing component has been disbursed. This evaluation will focus on analyzing the: (i) increase in MSE income and assets; (ii) number of MSEs involved in training activities, technical assistance, and marketing; (iii) marketing channels and CEPI sales levels in the local and international markets; (iv) sustainability indicators for the technical assistance, training, and business linkage provided by CEPI; (v) changes in the breakdown of sales in a representative sample of the CEPI's MSE clients and MSE satisfaction with the breakdown of their sales; (vi) changes in the CEPI's spreads and its cost structure; and (vii) lessons learned from the program and the possibility of program replication.

**Exceptions to Bank policy:** None.