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MEXICO

SOCIAL ENTREPRENEURSHIP PROGRAM FINANCING AND TECHNICAL COOPERATION PROPOSAL

DEVELOPMENT OF REPAIR SERVICE MICROENTERPRISES

(SP/TC-02-12-03-9)

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EXECUTIVE SUMMARY

Executing agency: Segunda Suela S.A. de C.V.

Amount and source:	European Commission	US\$*	Euros
	Financing:	400,000	347,600
	Technical cooperation:	185,000	160,765
	Local contribution:	<u>139,000</u>	<u>120,791</u>
	Total:	724,000	629,156

The funds will be drawn from the European Economic Community's Special Fund for Microenterprise Financing, administered by the IDB. The Bank will account for commitment of these resources in euros (€).

* Exchange rate: US\$1.00 = €0.869 (as of 5 November 2003).

Terms:

Amortization period:	10 years
Grace period:	4 years
Execution period:	42 months
Disbursement period:	48 months
Interest rate in real terms	3%

The grace period will apply only to amortization of the financing, not the interest. Payment of maintenance of value will be added to the interest rate (3%). The maintenance-of-value payment will be based on the annualized consumer price index (CPI) for the prior six months, as reported by the Bank of Mexico. The obligation will be denominated in local currency.

Problem to be addressed: Shoe repair and other repair services including needlework, locksmiths, and comparable activities ("repair services") are cottage-industry microenterprises that traditionally have provided jobs and income for numerous people in Mexico, where an estimated 50,000 such repair shops operate.

Currently, most of these repair shops operate as family-run subsistence microenterprises with low levels of productivity and slim

profit margins. Despite the vast market for shoe repair services, few shops have built up enough assets to generate a surplus and operate as a business. In all, only an estimated 1,200 repair shops use or apply modern methods to any extent and operate as permanent neighborhood establishments. Even fewer (around 200) have introduced modern methods and machinery to meet growing demand for fast service.

The problems facing shoe repair microenterprises can be summarized as follows: (i) **Inadequate and obsolete technology and equipment.** Most repair services microentrepreneurs are self-employed and operate in run-down premises poorly suited to their work, using obsolete machinery. They generally lack the financial means to adopt modern work methods and technology that would enable them to increase productivity and meet new challenges and demand as they emerge in the marketplace. Rather, they are forced to use tools and equipment that are often rudimentary and not up to the task. The vast majority have no assets to secure a bank loan in the amount and timeframe required to purchase modern tools and machinery. This limits their ability to meet market demand, as witness the small number of shops that use or apply modern methods. (ii) **Lack of business and marketing skills.** Because they do their work by hand for the most part, repair services microentrepreneurs are tradespeople who like to work alone and possess limited marketing skills to promote their services. Many of them serve only long-standing customers built up over time. Very few adopt and advertise trade names or employ effective marketing to expand their customer base. These factors conspire to keep output and, therefore, profit margins down for the average cottage-industry shoe repair shop. (iii) **Lack of financing.** People with low incomes who repair shoes or work as locksmiths or needleworkers cannot get good locations for their shops, because they lack the financial assets to secure a lease in a shopping center. They cannot purchase modern machinery to deliver better service and raise productivity, because Mexican banks do not serve their market segment. Microfinance institutions do exist in some urban areas, but most offer financing for working capital, not the fixed assets most in demand by the repair services segment. There are also too few microfinance institutions to serve the Mexican market. Without financing, repair service workers often have trouble competing in today's market. (iv) **Weak technical and managerial capacity.** Shoe repairmen are often unfamiliar with basic management, accounting, and inventory management methods, making it difficult for them to run their operations as businesses. Despite a reputation as very good craftspeople and specialists in their trade, many have not been exposed to new materials and products coming onto the market or techniques for working with them. This

affects productivity, speed, and service quality, thereby limiting their business opportunities.

Objectives:

The project's **broad objective** is to raise the incomes of providers of cottage-industry shoe and garment repair services, locksmiths, and comparable activities by helping them become viable owners of microenterprises with profitable, modern workshops.

The project's **specific objectives** are: (i) to facilitate access to financing for repair services microentrepreneurs, so they can invest in fixed assets and obtain working capital to grow their businesses; (ii) to set up a social subsidy and training system, so these microentrepreneurs can learn the skills they need to market their services and run their businesses; and (iii) to strengthen Segunda Suela, so it can support and provide financial services to these microentrepreneurs.

Description:

The project will have two components: (i) a reimbursable financing component to fund financial leases and loans to meet the investment and working capital needs of repair services microentrepreneurs; and (ii) a nonreimbursable technical cooperation component aimed at enhancing: (a) the competitiveness and efficiency of microenterprise workshops, and (b) Segunda Suela's capacity to support microentrepreneurs, build a sustainable business providing social subsidies and financial leasing services, and manage and execute the project.

1. Reimbursable financing component (Bank: US\$400,000; local counterpart: US\$30,000). The proceeds of this component will be used to set up of financing program to develop repair services microenterprises, which will be administered by Segunda Suela. The program will finance purchases of fixed assets (plant and equipment) and working capital needs (tools, supplies, materials, and inventory), to help microentrepreneurs set up, upgrade, or expand their repair shops. Financing for purchases of plant and equipment will be extended in the form of financial leases. Microentrepreneurs will finance purchases of supplies through working capital loans of up to US\$80,000 under this component. Financial leases for plant and equipment will have a term of up to three years with monthly payments. Microentrepreneurs will put up their own assets as collateral, and the amount will be up to a 70% loan-to-value ratio or US\$10,000, whichever is less. Working capital loans will be for smaller amounts up to US\$1,000 with a term of up to six months.

2. Technical cooperation component (Bank: US\$166,000; local counterpart: US\$109,000). The proceeds of this component will be used for: (i) training and support to microentrepreneurs as they

improve efficiency, management, and competitiveness at their shops; and (ii) institutional strengthening of Segunda Suela and project management support.

The project will assist microentrepreneurs in better managing their workshop businesses by funding technical assistance and training: (i) to develop training manuals on business administration, operations, and work habits tailored to the needs of shoe and garment repair services and locksmiths; (ii) to update and/or adapt technical and operating manuals on social subsidies, making them more user-friendly and instructive, and incorporating information on new methods and modules on occupational safety and health and the environment; (iii) to purchase licenses and adapt a standardized point-of-sale accounting system that will make it easier for microentrepreneurs to keep accounting records and manage cash flow and inventory; (iv) to design and implement a technical and management training program for microentrepreneurs based on the project manuals, incorporating occupational safety and health and environmental issues; (v) to conduct gender awareness workshops promoting the hiring of women as tradespeople; and (vi) to improve promotional and advertising tools, and train microentrepreneurs in business strategies for attracting customers for the services their workshop provides.

In terms of institutional strengthening of Segunda Suela, the project will fund (i) actions to strengthen its lending operations area, such as developing manuals and reengineering internal operating procedures, implementing an integrated portfolio management system, delivering technical assistance to enhance the development, evaluation, and monitoring of its financial leasing and working capital loan portfolio, and providing training on the management of financial leases and payroll loans; and (ii) actions to support its management structure, so that the model can be implemented in a sustainable manner, including development of a methodology for setting prices that will ensure the sustainability of services relating to social subsidies. Capacity building will also be funded, to assist Segunda Suela in implementing and monitoring the project activities.

**Environmental
and social
review:**

The Committee on Environment and Social Impact (CESI) reviewed this operation on 28 February 2003. Its recommendations were taken into account in preparing this proposal for financing and technical cooperation.

Beneficiaries:

The direct beneficiaries will be approximately 185 providers of repair services and their families, whose income will increase through higher sales resulting from the use and application of modern methods in their workshops, better business management skills and ability to

deliver quality service to customers, and better marketing of their services. These tradespeople will become microentrepreneurs and owners of some 95 modern repair shops, each with two or three owner-operators. Approximately 33% of the beneficiaries will be women. The microentrepreneurs will benefit from a system of social subsidies and work methods that will make them more efficient and able to deliver higher-quality services. They will also receive financing for modern machinery and other fixed assets that will enable them to increase output and quality. They will be better located (at shopping centers and elsewhere), and will share responsibilities with other microentrepreneurs in the same workshop. They will benefit from a modern accounting system and receive training to improve their management and service. As an added benefit, an enhanced financial leasing model involving social subsidies for repair services is expected to yield know-how that can be replicated in other countries.

Risks:

The project carries the following risks: (i) *Risk*: Strategic location, such as in shopping centers and high-traffic areas, is a key marketing factor for the services that repair shops provide. Segunda Suela has successfully assisted microentrepreneurs who receive social subsidies in this regard. As the scale of its operations increases considerably under the project, there is a risk of not finding enough commercial space to site the repair shops. *Mitigating factor*: The technical cooperation operation will mitigate this risk by helping to finance a detailed business plan that lays out a strategy and steps for identifying suitable locations for repair shops. Local counterpart funds will also be used to improve tools for promoting and publicizing the social subsidies. (ii) *Risk*: Tradespeople may be slow to adopt work methods and systems, thereby delaying expected gains in efficiency and competitiveness and dragging down performance indicators. *Mitigating factor*: New and updated versions of technical, operating, and management manuals are planned, as are a training program and specialized technical assistance to aid tradespeople in adopting the work methods being encouraged through social subsidies. (iii) *Risk*: Asymmetrical negotiating power between Segunda Suela, as provider of financing and services, and the microentrepreneurs who are the project beneficiaries may lead to more advantageous financial leasing terms for Segunda Suela. *Mitigating factor*: This risk is believed to be small, inasmuch as Segunda Suela developed social subsidies on its own initiative in the past, and subsidized some of the costs itself. To mitigate this risk, the Financing Regulations and the contractual clauses on project execution incorporate such safeguards and monitoring mechanisms as Bank approval for model financial leasing agreements to be used in the project, clear criteria for setting interest rates and fees for loans, caps on fees and commissions that can be

charged on subsidies, and the requirement that progress reports and project evaluations determine by sampling whether the prices paid for equipment are fair.

**The Bank's
country
strategy:**

The Bank's country strategy with Mexico in 2002-2006 (document GN-2181-1 of March 2002) centers around four basic elements: (a) modernization of the social sector and poverty reduction; (b) integration; (c) modernization of the state; and (d) lowering barriers that limit competitiveness and efficient development of the private sector. Under modernization of the social sector and poverty reduction, business development in microenterprise is identified as a targeted area, stressing the need to support initiatives that give Mexican microentrepreneurs greater access to credit and financial resources. Under the heading of lowering barriers that limit competitiveness and efficiency in the private sector, moreover, the strategy notes the importance of helping microenterprises grow by supporting efficient lending systems. The proposed project fits into this country strategy by supporting innovative ways of delivering financing and technical and marketing support to microentrepreneurs engaged in cottage-industry shoe and garment repair.

**Coordination
with other
official
development
agencies:**

No other institutions are working in Mexico's repair sector. The project team has informed other international agencies, including USAID and UNDP, of the scope of the project.

Rationale:

The project is consistent with the policy direction of the Social Entrepreneurship Program, and complies with the criteria laid down in documents GN-138-3 and GP-75-9 of 23 November 1998. The project is also expected: (i) to have a substantial impact on the income and assets of microentrepreneurs who practice trades and their families, since they are not being served by any other financial leasing intermediary or subsidy service provider; (ii) to support development of an innovative model for Bank action, which utilizes financial leasing to resolve issues of access to financing for fixed assets faced by microentrepreneurs, as well as social subsidies to help market and improve the quality of services provided by sector tradespeople, yielding important lessons learned for other sector initiatives that could be replicated in other countries in the repair services and other sectors; (iii) to help strengthen a private-sector social entrepreneurship institution with the long-term potential to expand its operations to benefit more repair services microentrepreneurs.

Special contractual clauses:

Once the contract has been signed, the Bank will authorize disbursement of up to US\$4,000, to hire a consultant to assist Segunda Suela in satisfying the special conditions precedent to disbursement of the financing and technical cooperation funding, as well as the General Conditions of the loan contract.

As a condition precedent to disbursement of the remaining project funds, Segunda Suela will provide the Bank with a copy of its audited financial statements for fiscal 2002.

As a condition precedent to disbursement of more than US\$4,000 of the technical cooperation component, Segunda Suela will provide, to the Bank's satisfaction, a project execution plan covering: (i) annual targets for achieving project objectives and outcomes; (ii) a timetable of project activities; and (iii) a disbursement schedule for the project. As a condition precedent to the third disbursement of technical cooperation funds, Segunda Suela will provide, to the Bank's satisfaction, the baseline study findings and proposed performance indicators for the project. As a condition precedent to disbursement of more than 40% of the technical cooperation funding, disbursement of the financing component must have commenced. Segunda Suela will ensure that disbursements and execution of the financing and technical cooperation components are coordinated over the course of the operation, and describe in its progress reports how the two components complement one another.

As a condition precedent to the first disbursement under the reimbursable financing component, Segunda Suela will provide, to the Bank's satisfaction, evidence that: (i) its board of directors has approved and implemented: (a) the Financing Regulations for the project, (b) policies on loan portfolio rating and provisions for bad debts are in line with best practices in microfinance; (ii) a Financial Leasing and Credit Committee has been set up; (iii) the account executive and portfolio officer have been hired; and (iv) a separate bank account has been opened for the financing program, in which financing component disbursements and principal and interest recovered are to be deposited and capitalized under the financing program. The following must also be provided, to the Bank's satisfaction: (i) the model financial leasing and working capital loan agreements to be used in operations financed with component proceeds; and (ii) the reference interest rate stated in the Financing Regulations.

As a condition precedent to disbursements of more than US\$40,000 under the financing component, Segunda Suela will provide, to the Bank's satisfaction, evidence that: (i) the new computerized integrated

accounting and portfolio management system for loans and financial leases is up and running properly; (ii) the Segunda Suela board of directors has approved: (a) a business plan, and (b) a strategy for setting prices and fees for commercial, social, and leather subsidies that demonstrates the financial sustainability of Segunda Suela's operations.

Segunda Suela will charge no fees to microentrepreneurs participating in the social subsidy program.

Reports and evaluations:

Reports. Segunda Suela will deliver to the Bank, within 60 days after the end of each six-month period, progress reports on the project and the use of Bank resources. These reports will include: (i) a description of progress made on the project execution plan and project indicators, noting the principal successes and difficulties encountered in achieving the project targets and objectives; (ii) an updated project execution plan for the next 12 months, including action to be taken to overcome the difficulties identified in the report; (iii) information on benefits delivered to the microentrepreneurs in economic terms and in terms of training and technical assistance in the areas of efficiency, quality, and managing and marketing their businesses; (iv) information on institutional strengthening of Segunda Suela; (v) detailed information on: (a) the terms and conditions of financing granted by Segunda Suela to its customers, including stated and hidden fees and interest rates actually charged on financial leases and loans, the redemption value of financial leases, and the term and other sensitive variables of financial leases and loans; (b) movements in the reference interest rates used in the Financing Regulations; and (c) the purchase price of plant and equipment financed through financial leases to microentrepreneurs, and any profit margin earned by Segunda Suela in the process; (vi) information on fees or other charges to the recipients of social subsidies, along with sales trends; (vii) portfolio performance data on loans and financial leases; (viii) a report on the execution of environmental, occupational health, and gender activities; (ix) a statement of how Bank resources and local counterpart contributions were used; and (x) Segunda Suela's financial statements. The final report will include a summary of initial objectives and indicators that have been achieved, as well as a special paragraph describing lessons learned and the model that was employed in the project, with a view to their potential replication.

The Bank will review the content, outcomes, and recommendations of the progress reports and indicators. In the event of significant project execution shortfalls, the Bank may suspend disbursements until such time as Segunda Suela has taken satisfactory corrective action.

Baseline. Segunda Suela will be responsible for gathering and analyzing relevant data for the ongoing monitoring of project performance indicators and evaluation of project impact. At the start of the project, Segunda Suela will use technical cooperation funding to hire a consultant, who will design a system of indicators to monitor and evaluate project performance and impact, and establish a baseline with initial parameters for indicator measurement to supplement or update those included in the logical framework. The baseline study will establish initial measurements for all indicators listed in the project's logical framework, along with others as deemed necessary. Segunda Suela will submit the proposed baseline parameters and performance indicators to the Bank's Country Office in Mexico for approval, as a condition precedent to the third disbursement of technical cooperation funds. Once approved, these parameters and indicators, together with those listed in the logical framework, will serve as the basis for monitoring project performance. Segunda Suela and the Bank will use the monitoring system and indicators to oversee and evaluate the project. The indicators will be used in progress reports, the midterm review, and final project evaluation.

Evaluations. A *midterm* review will be conducted to assess progress, once 40% of the project resources have been disbursed. This review will measure the extent to which the stated objectives and the indicators in the logical framework and the financing and technical cooperation proposal have been met. Evaluation factors will include: (i) the project's impact on: (a) microentrepreneurs in the repair services sector participating in the project, and (b) their socioeconomic advancement; (ii) performance of the lending program and beneficiaries' access to it; (iii) performance of social subsidies; (iv) Segunda Suela's institutional capabilities and the sustainability of its operations; and (v) the environmental and gender impact of project activities. The midterm review will also look at: (i) the terms on which the executing agency extends financing to microentrepreneurs in comparison with the terms prevailing in the marketplace; (ii) the mechanisms used by shops to purchase plant and equipment; and (iii) the quality and price of plant and equipment, determined by sampling, in order to gauge whether microentrepreneurs are buying at competitive prices.

A *final* project evaluation will be conducted, once 90% of the project resources have been disbursed. This final evaluation will focus on analysis of the strategy executed by Segunda Suela with special attention to: (i) recruiting policy, selection, and pricing of social subsidies; (ii) the terms, conditions, and performance of financing offered to microentrepreneurs; (iii) socioeconomic development of microentrepreneurs, and how their income level has improved; (iv) financial self-sufficiency of social subsidy recipients and Segunda

Suela; and (v) economic and financial indicators for the project. Special emphasis will be placed on determining which aspects of the model can be replicated.