DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

NICARAGUA

SOCIAL ENTREPRENEURSHIP PROGRAM (SEP)

CAPITAL GOODS LEASING FOR MICROENTERPRISE AND SMALL BUSINESS

(NI-S1002)

FINANCING AND NONREIMBURSABLE TECHNICAL-COOPERATION PROPOSAL

CAPITAL GOODS LEASING FOR MICROENTERPRISE AND SMALL BUSINESS

(NI-S1002)

EXECUTIVE SUMMARY

Executing agency: Financiera Arrendadora Centroamericana S.A. (FINARCA)

Amount and source:

	IDB (US$)	Local (US$)	Total (US$)
Financing:	500,000	500,000	1,000,000
Nonreimbursable technical cooperation:	125,000	137,000	262,000
Total:	625,000	637,000	1,262,000

Resources will be drawn from the net income of the Fund for Special Operations (FSO).

Financial terms and conditions:

Amortization period:	8 years
Grace period:	3 years
Interest rate:	5% in US$
Disbursement period (financing):	36 months
Execution period (financing):	30 months

The grace period will apply solely to the amortization of principal, not interest. The loan will be denominated in U.S. dollars.

Problem to be addressed: Because of the absence of medium- and long-term microfinance products that offer the smallest companies sufficient credit with realistic collateral, many small businesses and microenterprises, particularly in the manufacturing and services sectors, encounter major obstacles in financing capital goods. Companies that cannot obtain new equipment, machinery, and tools are forced to work in ways that are often rudimentary, ineffective, or obsolete. Most microenterprises and small businesses in industries identified as priority sectors (wood and furniture, leather and footwear, dairy products, handcrafts, and hospitality and tourism) are unable to finance modernization efforts and will continue to be affected by low levels of competitiveness.

Objectives: The project's general objective is to help raise incomes and create jobs in small businesses and microenterprises in six of the country's departmental capitals through the introduction of a new financial

instrument (financial leasing) that will fund capital goods to increase their productivity.

The project's seeks to: (i) facilitate and expand the access of 300 small businesses and microenterprises in Masaya, Granada, León, Chinandega, Matagalpa, and Estelí to medium- to long-term financing for capital expenditures and building their businesses; and (ii) strengthen FINARCA so it can provide the microenterprise and small business sector with a competitive product in an efficient, effective, and sustainable fashion.

Description: The project has two components: (i) a reimbursable financing component; and (ii) a technical cooperation component. The financing component will support the creation of a leasing program to meet the medium- and long-term investment needs of small businesses and microenterprises in six departmental capitals. In addition, the nonreimbursable technical cooperation component will support technical and operational strengthening of FINARCA, so it can provide the microenterprise and small-business sector with a new product.

Financing component: (Bank: US$500,000; Local: US$500,000): The financing component resources will be used to establish **a leasing program for microenterprises and small businesses**. These funds will enable FINARCA to offer the sector a new instrument for financing capital goods purchases (equipment, machinery, and other productive assets), so that a minimum of 300 low-income microenterprise and small-business owners can modernize, expand, or build up their workshops or other productive and service activities. The Bank's resources will be supplemented by FINARCA's own funds in an equal amount (US$500,000), for a total of US$1 million available exclusively for the microleasing product during the project execution period.

FINARCA will develop financial leasing products in amounts ranging from US$3,000 to US$8,000 with 1- to 4-year terms and interest rates of 16% to 24%. These will be available to small businesses and microenterprises with up to 15 employees and US$20,000 in total assets.

Technical cooperation component: (Bank: US$125,000; Local: US$137,000). The objectives of the technical cooperation component are to: (i) design, test, launch, and improve new financial leasing products that are attractive to the microenterprise and small-business target group, and sustainable for FINARCA; and (ii) introduce at FINARCA the financial technology, operating methods, management processes, computer systems, and strategies

necessary for the efficient development of products for areas and sectors identified as priorities.

The main technical cooperation activities are to: (i) conduct specific market studies to broaden and deepen market intelligence and identify the specific product features sought by microenterprises and small businesses; (ii) develop a business plan for the FINAPED program; (iii) hire a microleasing specialist to help design the product, make the necessary amendments to the Microleasing Regulations, transfer lending technology to FINARCA, prepare the operating manuals (organization and methods), develop and implement a technology package for client evaluation and monitoring, and train staff members in the use of such instruments; (iv) develop and implement systems for portfolio management, cash flow, and customer monitoring and impact, tailored to the target market; (v) undertake activities to promote the new product; (vi) provide cofinancing for purchases of small equipment, (vii) provide training opportunities for FINARCA staff members in better microfinance practice and technical exchanges with other leasing programs aimed at microenterprises and small businesses; (viii) conduct project evaluations and audits; (ix) disseminate project outcomes and lessons learned; and (x) cofinance the incremental costs of project supervision and execution during the new product launch phase.

The Bank's country and sector strategy:

The Bank's new country strategy with Nicaragua as set out in country paper GN-2230-1 (of 5 February 2003) contains three strategic approaches, two of which are: (i) economic growth through gains in competitiveness and output; and (ii) the productivity of the poorest segments of the population. These approaches give the highest priority to social and productive investments that can promote the growth of small businesses and benefit the poorest groups. They are geared toward the generation of income, job creation, and short-term positive impact. The present proposal is compatible with the Bank's country strategy in that it directly impacts productivity, job creation, and the income of the beneficiary families.

The operation also complements loan NI-0167 "Global Multisector Credit Program," executed by Financiera Nicaragüense de Inversiones (FNI), which seeks to expand the supply of medium- and long-term financing to small and medium-sized enterprises by refinancing the portfolios of supervised financial institutions. Although in principle FINARCA would be eligible to receive resources from that loan for underwriting financial lease operations, it is highly unlikely to seek funding under the terms of this loan in order to expand into a higher-risk market segment than its traditional market among the medium-sized and large companies of Managua. Consequently, the proceeds of this operation will generate significant added value by encouraging

adaptation of the financial leasing product to the microenterprise and small-business segment, expanding its availability to the departmental capitals, and providing the demonstration effect with a model that could be replicated in other countries to increase access to medium- and long-term financing by those nations' smallest companies.

Coordination with other official development agencies: During the analysis and design of the operation, the project team consulted several international cooperation agencies working with the country's microfinance sector, with a view to coordinating their efforts and finding areas where this operation and those agencies' activities could complement one another. Through the Interagency Commission for Small Business and Microenterprise (CI-PYME), on which the main international organizations involved with Nicaragua's microenterprise and small business sector are represented, the project team determined that the new Nicaraguan microleasing instrument needed to be tested and developed as an alternative tool for sector capitalization and productivity. Agreement was also reached that during execution the Bank would try to coordinate the project activities with those of the other institutions.

Environmental and social review: The Committee on Environment and Social Impact (CESI) reviewed the project at meeting 03/37 of 10 October 2003, and resolved that FINARCA: (i) is to comply with the new environmental and social guidelines for microfinance operations developed by SDS/MSM; and (ii) is not to fund operations on the list of highly polluting activities.

Beneficiaries: The direct beneficiaries will be some 300 small businesses and microenterprises, which will earn higher income through productivity gains after purchasing productive capital goods. The target market for this financing is companies with 3 to 15 employees and total assets of up to US$20,000 in the departments of Masaya, Granada, León, Chinandega, Matagalpa, and Estelí. Both going concerns and new startups will be eligible for financing, provided that the analysis conducted by FINARCA loan officers indicates excellent potential for success. In addition, an estimated 200-plus additional people will be *indirect* beneficiaries of the program, when they are hired by businesses that receive financing to enhance production capacity and business development under the project.

Risks: The first risk that FINARCA may encounter is its *limited knowledge of its customer profile and its possible failure to adapt its procedures, installed capacity, management structure, and culture to handling a high volume of small transactions*. To date, FINARCA has mainly specialized in corporate clients, as its loan amounts show. This has guaranteed it adequate information for its operations and allowed it to develop an operational and administrative structure appropriate to a clientele of that type. However, the project's target clients come from

a very different stratum, which could lead to *risks associated with adaptation, processing, and methods* in FINARCA's operations, interfering with smooth project implementation and leading to low indicator performance for loan placement (particularly customer numbers), collections (*evaluation and monitoring risks*), and a tendency to concentrate on larger operations (amounts close to the maximum allowed) to the detriment of smaller companies. To mitigate these risks, the technical cooperation component will fund the following at the start of the project: (i) specific market studies to broaden and deepen the information available on the profile of customer demand for the product; and (ii) a specialized consulting assignment to transfer to FINARCA the necessary knowledge and skills for microleasing operations, so that best practices in microfinancing can be developed and implemented in terms of lending technology, procedures, administrative processes, and systems, and the product tailored to microenterprises and small businesses.

Another, related risk is a *lack of familiarity with the mechanics of leasing in the target market* (microenterprises and small businesses) because such instruments have not existed for these companies in Nicaragua. This could result in slow growth in the microleasing portfolio and unexpected delays in securing program sustainability. Although the projections for portfolio growth were based on conservative preliminary estimates of demand, using the information available on the market and the levels of demand gauged by FINARCA sales staff and partner equipment suppliers, such risk will be mitigated through the following microleasing promotion and dissemination activities under the project: (i) a public campaign to promote the new products in the identified markets, using printed materials (pamphlets), radio advertisements, and promotional events to disseminate and publicize the leasing mechanism and its benefits for small businesses and microenterprises; and (ii) leveraging existing partnerships with companies that supply equipment and machinery needed by microenterprises and small businesses in the priority sectors, using those companies' sales forces as a mechanism for publicizing microleasing.

Finally, there is the risk of the *low level of process automation* within FINARCA (operational management risk). To date FINARCA has been able to manage its operations with a low level of technology, because of the small number and volume of its operations. However, with the expected rapid growth in the volume of small operations following its entry into products for microenterprises and small businesses, there are plans to install a new integrated information system, which has not yet been fully tested. Its installation and fine-tuning could take some time. Under such circumstances, the program

operations could overload the operational work, impacting the project's different indicators and creating major operational difficulties. To mitigate this risk, the technical cooperation component includes funding for the development or purchase of information systems for operations, finance, and monitoring, so that FINARCA can use its current technological tools and resources to manage the microleasing portfolio effectively.

Rationale:

The case for the proposed project is as follows: (i) it will help increase the net income of a group of some 300 owners of microenterprises and small businesses in Nicaragua's departmental capitals; (ii) it will create new permanent jobs in the companies that receive financing; (iii) it will improve the Nicaraguan microenterprise and small-business sector's access to medium and long-term financing that meets their needs, enabling them to become more productive and competitive; (iv) it encourages the development of an innovative intervention model—one that uses financial leasing to solve the problem of access to financing for capital expenditures, faced by small business owners—which will provide important lessons for other sector initiatives that might also be replicated in other countries; and (v) the executing agency, FINARCA, is committed to the sustainable development of a new financial product aimed at the microenterprise and small-business sector and has the capacity to successfully carry out the proposed project activities.

Special contractual clauses:

As conditions precedent to the disbursement of *financing* resources, FINARCA will provide, to the Bank's satisfaction: (i) the findings and recommendations of the consulting assignment to design and implement loan technology and processes for the new microleasing product, which is to be contracted with technical cooperation resources; and (ii) the program's definitive financial leasing regulations, as adopted by the FINARCA board of directors, together with evidence that they have gone into effect.

As conditions precedent to the disbursement of *technical cooperation* resources, FINARCA will provide, to the Bank's satisfaction: (i) the terms of reference for consulting and advisory services to be funded with technical cooperation resources during project year one; (ii) evidence that a manager has been selected for the FINAPED program; and (iii) a project execution plan, including annual goals for achieving project objectives and outcomes. The project execution plan is to include a timetable for meeting the performance indicators set for the project, which will allow supervision and control of the operation's progress.

For disbursement of more than 60% of the *technical cooperation* resources, FINARCA will present the Bank with evidence that it has

approved a minimum of 30 microleasing operations that meet the eligibility criteria contained in the microleasing regulations, as approved.

In light of the need to ensure the liquidity needed for hiring the experts and technicians required for project launch, the Bank will set up a rotating fund of up to 20% of the total amount of project technical cooperation resources, in accordance with the disbursement timetable that FINARCA is to submit to the Bank for approval.

Reports and evaluations:

Reports: FINARCA will deliver *progress reports* to the Bank's Country Office within 60 days after the close of each semiannual period, and a final report within 60 days after the close of the last disbursement period. These reports will contain an analysis of compliance with performance indicators and progress on work plan execution, including: (i) technical cooperation activities completed and their outcomes in terms of project execution; (ii) financial information, statistics, and a narrative from FINARCA on its financial leasing portfolio with small businesses and microenterprises (FINAPED); (iii) information on the conditions applicable to the leasing products on offer (rates, periods, collateral): this information must include details on the actual final cost to the lessee, including commissions, and a comparison of that cost with the rates charged for financial products with similar operating risks offered by other financial intermediaries in the local financial market; (iv) information on compliance with the recommendations vis-à-vis social and environmental aspects of the project; and (v) a summary of the contributions in cash and in kind made by FINARCA at the time of each report. The project reports must present socioeconomic information on the new customers who have joined the program and the changes in incomes and in the companies during execution, in order to monitor the project's impact on customers. The last of these reports will be the final report, which is to contain a summary of achievements in terms of the original objectives.

Evaluations: The Bank will use technical cooperation resources to commission a midterm review and final evaluation of the project. The Bank's Country Office will commission a midterm review 18 months after the first disbursement of technical cooperation resources, to measure the project's impact among its customers and the executing agency. This evaluation will assess such matters as: (i) demand for the new financial leasing products developed with technical cooperation support; (ii) preliminary general trends among the project's customer companies with respect to increases in net income and job creation; (iii) general trends toward self-sustainability of the new products and the microleasing program within FINARCA; and (iv) the effectiveness of the information and monitoring systems put in place.

These will be measured on the basis of the indicators established in the logical framework and table of project performance indicators, as well as the progress reports.

A final evaluation will be conducted 42 months after the first disbursement of technical cooperation resources, to measure and document: (i) the extent to which the objectives have been met; (ii) an analysis of the most successful market niches for placement and recovery; (iii) economic and social indicators on the beneficiary customers; and (iv) the lessons learned and good practices, to be broadly disseminated in Nicaragua and internationally.

Exceptions to Bank policy: None.