

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

ECUADOR

SOCIAL ENTREPRENEURSHIP PROGRAM

**NEW MARKET NICHEs FOR TEXTILE MICROENTERPRISES
IN OTAVALO**

(EC-S1001)

EXECUTIVE SUMMARY

This document was prepared by the project team consisting of Fermín Vivanco (SDS/MSM), Project Team Leader; Maria Ariano (RE1/SO1), Deputy Project Team Leader; Edgar Carvajal (COF/CEC); Juan Carlos Pérez-Segnini (LEG/OPR); and Leyda Fajardo (LEG/OPR).

I. BASIC PROJECT INFORMATION

A. Executing agency

- 1.1 World Vision International – Ecuador (WVI-E)

B. Amount and source of financing

		IDB	WVI-E	Total
Reimbursable financing:	US\$	250,000	50,000	300,000
Technical-cooperation funds:	US\$	210,000	144,000	354,000
Total:	US\$	460,000	194,000	654,000

Source:

Net income from the Fund for Special Operations (FSO)

C. Terms and conditions

Amortization period:	10 years
Grace period:	3 years
Interest rate:	2% per annum
Currency:	United States dollars

- 1.2 The execution period for the Bank's reimbursable financing of US\$250,000 will be 36 months and the disbursement period will be 42 months. The execution period for the Bank's nonreimbursable technical-cooperation operation of US\$210,000 will be 48 months and the disbursement period will be 54 months.

D. Statement of nonobjection

- 1.3 The Ecuadorian government has given its nonobjection to the financing of this project.

E. The problem

- 1.4 **Socioeconomic context.** The primary economic activity of the indigenous community in Otavalo, which constitutes most of the population, is the production and sale of handwoven textiles. The canton of Otavalo has one of the highest rates of poverty in the country, with gross poverty in the outlying communities. The majority of companies in the textile production chain are microenterprises and small businesses, most of which are family owned and operated. There are an estimated 6,000 indigenous micro- and small-scale textile weavers in the canton. A

recent study¹ indicates that 28% of the microenterprises take in less than US\$100 in revenue per month and 19% bring in up to US\$200. The level of education attained by these weavers is very limited. Of those surveyed, 22% were illiterate and 35% did not complete primary school.

- 1.5 Despite these challenging socioeconomic conditions, the small garment-making artisans have competitive advantages that could enable them to generate more income by raising the profit margins on items they currently produce and entering new, more profitable market niches. These advantages include the tradition of family-run garment-making businesses, the concentration of companies, a strong cultural identity, a budding enthusiasm for competition through cooperation, business contacts abroad, and the achievements of several successful garment-makers, who serve as a model for the community. However, these advantages have not resulted in permanent gains due to the following problems:
- 1.6 The **inferior quality of the products**, and especially of the raw materials, designs, and the finishing, limits the businesses to selling in a saturated downscale market with slim profit margins: (i) more than two thirds of workshops do not use natural raw materials, which prevents them from breaking into a niche that is more demanding in that regard; (ii) nearly 70% of the garment-makers fail to update their product design or do so only sporadically, although this is critical in the case of jackets and sweaters; and (iii) production processes are not standardized or subject to quality control. The producers' ongoing inability to address these problems derives from the fact that they have no contact with their end customers.
- 1.7 **Reliance on a few middlemen.** The garment-makers rely on a few middlemen to sell their products, supply them with raw materials, and show them new designs. Of those surveyed, 66.5% rely on three or fewer middlemen. This dependence is one of the reasons the prices indigenous artisans receive for their products remain low. Together with the lack of financing, this situation perpetuates an informal maquila system in which the middleman who contracts weaving and sewing services is the sole provider of inputs and is only buying the artisan's labor. In this informal maquila system, small businesses are unable to acquire any know-how from the market.
- 1.8 **Low export margins.** Although it is estimated that nearly 80% of the products made in Otavalo are exported, handcrafted items are marketed without any differentiation or identification of origin. This restricts the export options to downscale markets in Latin America, the United States, and Europe. Because the possibility of raising prices in this segment of the market is negligible, the middlemen have no interest in using more expensive raw materials or investing in

¹ All of the data on textile microenterprises in Otavalo comes from a 2003 study conducted by the Instituto de Investigaciones Socioeconómicas y Tecnológicas [Institute for Socioeconomic and Technological Research] (INSOTEC) and financed by the Bank's Norwegian Development Fund. See technical files.

designs. The artisans' dependence on only a few middlemen (66.5% of the producers surveyed rely on three or fewer buyers) exacerbates the problem.

- 1.9 **Limited production and business management technology.** In Otavalo, 66.7% of textile shops use obsolete, wooden looms that are generally worth less than US\$200. In the identified areas, only 12.5% of shops have metal looms, and 20.8%, representing the larger operations, use electric machines. Assigning costs and setting prices is another one of the producers' major weaknesses, even though they operate in a maquila system. In general, they accept the price set by the middlemen, which is almost always a wholesale price. This weakness has been aggravated by very limited access to training and advisory services (fewer than 15% of shops).
- 1.10 **Limited access to credit.** Only 14% of the artisans surveyed have received credit in the past two years, and generally these have been the larger shops. The financial institutions offering microcredit in Otavalo include Banco Solidario, Sociedad Financiera Ecuatorial, Cooperativa Chuchui, Banco Centro Mundo, and Cooperativa Atuntaqui. Access to credit is limited for the following reasons: (i) the financial institutions and producers do not have an established relationship; and (ii) the slim profit margins do not provide the capacity to repay loans for equipment or technological improvements. As a result of their limited access to credit, the small entrepreneurs cannot finance working capital, which prevents them from breaking free of the informal maquila system, limits their investments in technology, and, in general, perpetuates their dependence on middlemen and the production of garments for downscale markets.
- 1.11 **Unrepresentative trade associations and a limited culture of business linkage.** The most well known artisan and merchant associations in Otavalo are the Unión de Artesanos Indígenas del Mercado Centenario de Otavalo [Union of Indigenous Artisans of the Otavalo Centenary Market] (UNAIMCO) and the Cámara Artesanal de Otavalo [Otavalo Board of Trade for Handmade Products] (CADEO). These organizations are influenced by the economically more powerful businessmen who also belong to the "networks" that sell abroad, while low-income microentrepreneurs and artisans who work in the maquila system are not represented, in part because they have not developed a culture of horizontal business linkages for production and marketing purposes.
- 1.12 **Beneficiaries.** In Ecuador, businesses are classified as microenterprises if they have less than US\$20,000 in capital and employ fewer than 10 workers. The proposed project will target microentrepreneurs in the poorest rural communities of the canton of Otavalo who make and sell textiles.
- 1.13 Based on an assessment of household expenses, shop expenses, shop size, and technical level of the shops, of the 22 communities in Otavalo canton, the following were found to have the least favorable indicators and were thus designated as areas for priority attention: Arias Ucu, Gualapuro, Ilumán, Quichinche, San Luis de

Agualongo, Quinchuquí, Carabuela, Cotama, La Bolsa, Peguche, Pinsaqué, and San Martín. Residents of these communities will account for 70% of the beneficiaries of the technical-cooperation component and 50% of the beneficiaries of the reimbursable component. Members of other communities may participate in the project, provided that their microenterprises meet project requirements.

- 1.14 In the case of the credit component, microentrepreneurs in the areas mentioned above who pursue other economic activities may also participate in the project. Their involvement will spread the risk of loan losses, as suggested by the lessons learned from projects of this kind.

II. THE PROJECT

A. Objectives

- 2.1 The main objective of the proposed project is to sustainably increase the income of garment-making microentrepreneurs in the poorest communities in the canton of Otavalo.
- 2.2 The specific goals of the project are to: (i) create new opportunities in international and domestic markets for products made by the target group; (ii) improve the quality and diversity of products made by artisans and their business management; (iii) encourage low-income indigenous artisans to link up for production purposes; and (iv) facilitate access to credit in order to increase and enhance the production capacity and quality of microenterprises in the textile sector.

B. Description

- 2.3 The proposed project will help at least 300 indigenous microentrepreneurs increase their options for marketing handwoven textile products and will grant an estimated 1,500 loans for working capital or fixed assets to at least 500 microentrepreneurs in the first three years of the project.

1. Technical-cooperation component (Bank US\$210,000; local counterpart US\$144,000)

- 2.4 This component seeks to raise the income of the beneficiary textile weavers and garment makers through activities to create opportunities in domestic and international markets and improve and organize the production of items for which there is demand.
- 2.5 **Creation and operation of a new marketing company.** To address the problems of dependence on a few middlemen, low profit margins, the lack of representation in trade associations, and the limited culture of business linkage, the

technical-cooperation component calls for the creation of a company, Shuyana,² in which WVI-E and the project beneficiaries will participate individually or through trade associations. The project will provide partial financing for the company's working capital and staff: a manager and an advisor/expert on fashion markets.

- 2.6 Shuyana will (i) develop **marketing strategies** to place the project beneficiaries' improved products in international fair-trade (or alternative-trade) fashion markets; (ii) **serve foreign and local customers** so that the producers gain experience in dealing with the end customer and diversify their sales channels; (iii) undertake **projects for organizing and managing production linkages** in response to commercial demands; and (iv) provide the entrepreneurs with training and advisory services to improve product quality through a department specifically created for such purpose.
- 2.7 **Stronger working networks and project dissemination.** The technical-cooperation component will also provide financing for: (i) a diagnostic assessment to (a) identify the middlemen and how they might be affected by the appearance of the new marketing company and (b) develop strategies for working together with these middlemen to minimize conflicts; (ii) **activities to promote the project and attract beneficiaries**; the executing agency will be responsible for conducting activities (workshops, visits) to inform all previously identified microentrepreneurs of the nature of the project; (iii) **support for production linkages**; motivational and training workshops will be held for indigenous artisans in each community to boost self-esteem, promote teamwork, encourage business linkages, improve management of community organizations, and build leadership; (iv) **strengthening the technical skills of project staff**; in areas such as services for artisan microenterprises, the marketing of handmade products, export procedures, production management, and project management; (v) **institutional strengthening of the executing agency**; efforts will be made to improve the methodologies employed by WVI-E for microlending and for training credit advisors in the WVI-E office in Otavalo; and (vi) **dissemination of results**; WVI-E will disseminate project outcomes over the course of project execution. This will also serve to promote the project to artisans who could join the project and to the community in general.

2. Reimbursable financing component (Bank US\$250,000; local counterpart US\$50,000)

- 2.8 The proposed project will finance: (i) a US\$250,000 lending program that will grant some 1,500 loans for working capital, mainly to purchase raw materials and inputs (wool and yarn), and for fixed assets, to replace and purchase new equipment and machinery; and (ii) a US\$50,000 startup fund to be invested in the initial working capital of the marketing company.

² "Hope" in Quechua.

- 2.9 Loans will be extended to individuals or groups (solidarity or village banking groups), depending on the applicants' specific needs and situations. It is estimated that individuals will receive loans of up to US\$5,000 and groups will receive loans of up to US\$10,000. The maximum term will be 12 months for working capital loans and 24 months for fixed asset loans. The amount and term of specific loans will be based on the applicant's ability to pay and on references.
- 2.10 The loan program will be managed by the Fondo de Desarrollo Microempresarial [Microenterprise Development Fund] (FODEMI), a specialized microfinance organization created and controlled by WVI-E that acts as its specialized microfinance arm. To implement this component, WVI-E will transfer funds to FODEMI at the same interest rate applied by the Bank, i.e. 2%. FODEMI, in turn, will charge project beneficiaries the same interest rate it charges other borrowers. This rate, 14.6%, is similar to that charged by other area microfinance institutions. For 85% of FODEMI's clients, informal lenders charging rates of more than 10% a month are their only financing option, since they cannot meet the requirements of other entities.
- 2.11 The reimbursable financing component will include US\$50,000 in counterpart funds. WVI-E may lend these funds to microentrepreneurs to buy shares in the marketing company and/or it may invest in the marketing company directly. In either event, the marketing company will use the cash from the startup fund as its working capital. After four years, the artisans will hold at least 20% of the company's equity.

C. Sustainability and results of the financial analysis

- 2.12 **Sustainability.** The proposed project is feasible in socioeconomic terms due to the expressed and real need of microentrepreneurs in Otavalo for better placement conditions for their textiles (quantity, quality, and profit margins). Increases in income derived from improved profit margins, knowledge transfer, and access to financing will create opportunities for consolidating and creating jobs in the garment sector.
- 2.13 **Results of the financial analysis.** The financial projections for Shuyana indicate that the company could break even in the third year of operation and turn a profit in subsequent years. The company is expected to post gross sales of US\$50,000 during the first year, US\$150,000 during the second year, US\$240,000 during the third year, and US\$320,000 during the fourth year. The financial analysis suggests that, with the support of technical-cooperation resources during project execution, Shuyana may remain profitable after project completion, creating jobs and generating additional income for the beneficiaries.
- 2.14 The projections for the loan program indicate that the project will generate enough earnings to fund the program during the three-year grace period and maintain a

portfolio balance of US\$300,000 when the amortization period begins. In order to guarantee the feasibility of loan operations, loan recipients will be charged an interest rate that covers the program's operating and financial costs.

D. Expected outcomes and benefits

- 2.15 The proposed project will yield the following outcomes for beneficiaries: (i) a company to sell their products and coordinate production; (ii) the production and marketing of garments of a quality consistent with the demands of the target market niches; (iii) business linkages for organizing production to fill orders channeled through the marketing company; (iv) access to training and advisory services that will help the beneficiaries meet market requirements; (v) access to financing to improve production conditions in the communities directly and indirectly involved in the project; and (vi) increasing shareholdings in the marketing company.
- 2.16 The project indicators presented in the logical framework show expected project outcomes and the expected benefits for the participating microentrepreneurs in Otavalo.

E. Bank strategy

- 2.17 The 3 December 2001 Ecuador country paper points to the importance of reducing poverty, particularly among the indigenous population. The proposed project will directly benefit low-income, primarily indigenous owners of microenterprises and small businesses, thereby supporting one of the priority sectors identified by the Bank in the fight against poverty.

F. Cooperation with other international donor agencies

- 2.18 The microenterprise expert at the IDB Country Office in Ecuador is participating in the "Economic Fabric" coordinating committee, along with representatives of the World Bank, the European Commission, the Andean Development Corporation, and bilateral donor agencies such as the United States Agency for International Development, the Spanish Agency for International Cooperation, and others. Information about the IDB's social entrepreneurship projects in Ecuador is being presented at this forum.

G. Summary of the environmental and social review

- 2.19 At its meeting of 3 October 2003, the Committee on Environment and Social Impact reviewed the proposed operation and made the following two recommendations: (i) explain the role of cultural capital in the project objectives; and (ii) ensure that nontoxic dyes are used in the textile activities to be financed. With respect to cultural capital, the creation of the marketing company, Shuyana, as an independent legal entity in which project beneficiaries will participate as shareholders will improve the beneficiaries' control over their cultural assets,

particularly their designs. The recommendation on nontoxic dyes has been factored into the plan of operations and the Operating Regulations.

H. Special conditions

- 2.20 As a condition precedent to the first disbursement of the reimbursable financing, WVI-E will submit to the satisfaction of the Bank: (i) the Operating Regulations and the Loan Regulations, approved by its board of directors; and (ii) evidence of the appointment of an individual responsible for managing the project.
- 2.21 As a condition precedent to disbursing more than 20% of technical-cooperation resources, WVI-E will submit to the satisfaction of the Bank: (i) a baseline study to be used to develop a system of monitoring indicators; (ii) evidence that the marketing company and its board of directors have been established; and (iii) evidence of the disbursement of at least 100 microloans.
- 2.22 As a condition precedent to disbursing more than 60% of technical-cooperation resources, WVI-E will submit evidence that 500 microloans have been granted and the marketing company is in operation.

I. Reports, evaluations, and audits

- 2.23 **Reports.** WVI-E will submit progress reports to the Bank's Country Office in Ecuador within 30 days of the end of each six-month period and a final report within 60 days of the end of the disbursement period. These reports will analyze the attainment of performance indicators, the findings of the diagnostic assessment of the marketing company's impact on local middlemen (in the second progress report), problems that have arisen during project execution and the steps taken to overcome them, and projections for the subsequent six-month period. At a minimum, the reports will also include:
- 2.24 For the loan component: (i) the number of loans in the area; (ii) information about the beneficiaries, including the percentage of beneficiaries in communities identified as priority areas; (iii) consolidated financial statements and performance indicators for FODEMI; (iv) the interest rates applied by FODEMI for loans it grants under this project and as part of its other activities; (v) the interest rates on loans extended by other alternative financing sources; (vi) information about how FODEMI's financial margin is distributed among operating costs, provisions for loan losses, and profits; and (vii) a summary of the contribution to the startup fund for the marketing company.
- 2.25 For the technical-cooperation component: (i) the volume of sales and contracts negotiated under the project; (ii) the number and characteristics of textile artisans participating in the project, including the percentage of beneficiaries in communities identified as priority areas (see paragraph 1.13); (iii) the terms of negotiation between buyers and the artisans participating in the project, including

the marketing company's margins and its relationship with producers, in order to closely monitor the situation for any signs of monopsony; (iv) delivery of training and technical-assistance activities; (v) the marketing company's financial statements; and (vi) a summary of its cash and in-kind contributions to the project.

- 2.26 **Evaluations.** The Bank will use technical-cooperation funds to conduct a midterm and a final project evaluation. Twenty-four months after the agreement has been signed and when at least 40% of the Bank's contribution has been disbursed, a midterm evaluation will be conducted to assess: (i) fulfillment of the project impact indicators reflecting (a) increases in the income of participating producers with respect to baseline data, (b) the market penetration of the beneficiaries' products in international and upscale markets, (c) the number of producers who own shares of the marketing company, and (d) progress in creating production linkages; (ii) the level of participation of artisans from communities identified as priority areas; (iii) the corporate governance mechanisms that have been implemented and the way in which they protect minority shareholders; and (iv) the lessons learned and recommendations for improving the project.
- 2.27 After 48 months of project execution and when 90% of the Bank's contribution has been disbursed, a final evaluation of the project will be conducted to assess and document: (i) the level of participation among the groups surveyed during the initial evaluation and the project's impact on them; (ii) the impact of accomplishing the specific objectives of the project, as well as the project performance and execution indicators described in the technical files; (iii) the degree to which recommendations made in the midterm evaluation were implemented; and (iv) the lessons learned from the project.
- 2.28 **Audits.** A final audit of the project will be conducted using resources from the Bank's contribution.

J. Risks

- 2.29 The most significant risk to fulfilling the project's specific objective is that middlemen attempt to pressure small-scale artisans not to participate in Shuyana. To mitigate this risk, the proposed project will invite the middlemen to participate in and learn about project activities.
- 2.30 The second risk to the project is that the marketing company and WVI-E fail to create and maintain a climate of trust with the artisans and the international customers as a result of complications or delays in project execution that compromise delivery and payment commitments. To mitigate this risk, Shuyana will have working capital resources and will be able to turn to the experience and support of World Vision International in the international fair-trade channels.

- 2.31 The third risk is that conflicts may arise among the various Shuyana partners as a result of different business approaches, local claims, or expectations regarding the distribution of potential profits. To mitigate this risk, the proposed project will host workshops on the management of business linkages, draft regulations that clearly establish the equity ownership percentages for beneficiaries in each year of the project, and the rights of the different participants.

K. Exceptions to Bank policy

- 2.32 None.