USAID
DEL PUEBLO DE LOS ESTADOS UNIDOS DE AMÉRICA

EXPRO El Salvador
Programa de Promoción de Exportaciones para las Micro, Pequeñas y Medianas Empresas

EFFECTIVE FINANCING FOR EXPORTING MSMEs
A Crucial Need for El Salvador's Development

NOTA: San Salvador 7 de Julio de 2005. Este documento es propietario únicamente de quien lo organiza. Este documento es propietario únicamente de quien lo organiza. Este documento es propietario únicamente de quien lo organiza.Este documento es propietario únicamente de quien lo organiza.

Export Promotion for Micro, Small and Medium Enterprises El Salvador (USAID/EXPRO)

Contract No.: PCE-I-00-98-00016-00 T/O 833

Project Period: July 2003 – March 2006

USAID Mission: USAID El Salvador Office of Economic Growth

Project Contractor: Nathan Associates Inc.

Project Summary: USAID/EXPRO aims to reactivate the economy of El Salvador by increasing income generated from exports of micro, small, and medium enterprises (MSMEs). Project objectives include (1) strengthening the Ministry of Economy's institutional export and trade policy capacity; (2) improving access to trade and export information; (3) increasing the competitiveness of Salvadoran businesses; (4) expanding business contracts and sales; (5) strengthening the Salvadoran export services sector; and (6) establishing strategic business alliances. Nathan Associates, in collaboration with AG International, DAI, and JE Austin, is providing technical, commercial assistance, and training to support government and private sector export promotion efforts; improving the productive capacities of MSMEs striving to access international markets; and assisting Salvadoran companies in developing and increasing export sales by at least $20 million at project completion on March 31, 2006. USAID/EXPRO is also providing technical assistance and training to make export promotion initiatives more effective and to improve product development, operational efficiency, business development services, and the production scale of Salvadoran MSMEs so they can enter international markets, enjoy market continuity, maximize profitability, and face less risk of failure.

Date of Publication: March 2006

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I.1 Background: El Salvador and MSMES Role

It could be said that El Salvador, a small country with limited natural resources, marked by years of civil wars, devastating earthquakes, deforestation, overpopulation and other nagging development problems could claim an economic handicap.

Yet the country enjoys a dynamic state with relatively modern management, and a well developed national infrastructure (airports, highways, and communications). It also enjoys a thriving private sector and entrepreneur class, long dominated by the larger enterprises (Hilasal, Sigma, Taca ..etc...) which have led regional expansion and set a development path followed by many other enterprises. On the other side of the private sector spectrum, the flourishing micro enterprise, with its large informal framework, has provided a way of life and economic survival for millions of Salvadorians.

In the middle, the small and medium enterprises (SME or MSMES), while more formal institutions than micros and obviously less powerful than large businesses, have had their growth potential thwarted by limited access to adequate financing – a situation reflecting systemic bank constraints but also often influenced by MSMES' own weaknesses and inability to deliver bank-acceptable projects for financing.

During the 90s, the Governments' development plans were mostly focused on national reconstruction, following the Peace Treaties signed with the guerillas. Programs included Reconstruction of the State and its Resources (1992-1995), Control of the Macro economy: (1995-1999), Investment on National Infrastructure and Education (1999-2003) and Focus on Multinational Investments and exports (1996-2003).

More recently, the Salvadorian Government turned to MSMEs and adopted a five-year plan (2004-2009) aimed at social improvement, and continued support to MIMSMES (the Micro, Small, and Medium Enterprises). The Government's plan is based on fifteen points, in a concerted effort to harmonize policies and institutions that support MSMEs; addressing issues from structured financial support to the promotion of governmental purchases from MSMES. Recent accomplishments include redirecting the activities of a state-owned bank, to support MIMSMES, and enacting laws and promoting a new institution to provide guarantees for MSME financing (see section II.1).

I.2 MSMES: Definition, Numbers, Financial Survey

In El Salvador, the key official institution dedicated to the Micro, Small and Medium Enterprise is CONAMYPE (see www.conamype.gob.sv). CONAMYPE and other Salvadorian institutions have attempted to define micro, small and medium enterprises using a wide array of criterions including sales, employment, and assets, as summarized in the table below:

Table 1 *Criteria for the Classification of Small and Medium Enterprise*

Institution	Small Enterprise			Medium Enterprise		
	Assets	**Sales**	**Employees**	**Assets**	**Sales**	**Employees**
CONAMYPE		$684,288	50		$4,920m	Up to 100
Swiss Contact		$68,500 - $685,000	11-49		$685,000 - $4.57m	50-200
BMI			5-50			50-100
ANEP/GTZ			11-49			50-99
AMPES	$2,857 - $22,857		6-20	>$22,857		over 20
PROPEMI		Up to $685,000				

After analyzing various definitions of micro, small and medium enterprises, CONAMYPE suggested in 2000 to use the minimum salary as a factor to better apprehend the MSMEs' economic dimension and thus measure MSMEs' annual turnover in terms of number of minimum wages (the minimum wage was US$144/month in November 2004). Using CONAMYPE's definitions, we then adopted the following classification parameters:

- **Medium enterprise:** between 50 and 100 employees and sales not over 4,600,000 US per year
- **Small Enterprise:** up to 50 employees (but more than 5) and sales not over 650,000 USD per year.

Various organizations have tried to estimate the number of MSMEs, an effort hampered by inconsistent sector information and the lack of a formal database. Results have varied from 5,000 (Swisscontact) to 9,000 (FundaMSME) and 12,000

(Digestyc economic survey). The information on Micro enterprises is more reliable with a study made by Digestyc in 1999 showing that there are about 500,000 micro enterprises and 5,000 small enterprises in the country. Unfortunately, there is no data in this study on medium enterprises, how they have evolved or how many of these are exporters. Overall, this situation calls for more studies and reliable statistics on the MSME sector, in order to help policy makers and the many institutions that support the sector.

I.3 Organization and Support to MSMES

Beginning in the early 90s, El Salvador started modernizing/restructuring many public sector institutions in order to support the micro, small and medium enterprises - the so called MIMSMES. These measures were to enhance the potential of Micro and MSMEs to grow at a sustainable long-term rate of at least 4 % p.a., and included:

- Privatization of the banking and telecommunications sectors
- Privatization of several public services including issuing driving licenses, edition of ID cards, decentralization of units issuing passports etc..
- Creation of CENTREX, a center providing support for exports on a digital basis.
- Creation of EXPORTA, a single point to help exporters identify export potential and export channels.
- Creation of FOEX, a fund to promote exports.

Until now, support to MSMES has been focused on developing management skills, increasing competitiveness, and helping find and develop new export markets Many international donors have tried to assist the country in helping develop the MSME sector and enhance the recently created programs. As a result, a broad range of organizations from the public and private sectors, as well as trade associations, donors and thousand of NGOs are assisting the sector, sometimes in an uncoordinated/overlapping fashion - a situation exacerbated by the urgency of strengthening the sector before the TLC with the US comes into effect.

GOVERNMENT INSTITUTIONS

The Ministry of Economy has consistently played a lead role in developing institutions and support programs for MSMES as shown hereafter:

Table 2 *MSME- Government supporting institutions*

Institution	Created	Depending from	Focus
CONAMYPE	1996	Ministry. Of Economy	Political framework and proposal of guidelines to support MSMES
EXPORTA	2004	Ministry. Of Economy	A single one-stop shop where exporters can receive support services such as market and a pre-feasibility study for exports
TRADEPOINT	2002	Exporta	It is an EXPORTA institution., devoted to web-based internet research.
BMI	1996/1997	Ministry. Of Economy	A second-tier bank created by international institutions (BID. BCIE, Central Bank..). Support MSMES' development trough services and financing programs.
CENTROMYPE	1999	ONG private	An institution created by BMI, CENTROMYPE to assist MSMES identify export possibilities and develop business with larger industrial companies.
INSAFORP	1960	Labor Ministry	An institution providing education of workers and technicians and funded through monthly fees paid by all enterprises, assessed on employment levels.
FOEX	2002	Ministry. Of Economy	A fund, initiated with a capital injection from Government proceeds from telecommunications privatization, and more recently with AID funding. FOEX provides grants to exporters – up to $25,000 – with appropriate counterpart funding from the company,

TRADE ASSOCIATIONS

Trade associations have many plans and programs to support MSMES, with a focus on management education and increasing competitiveness, and provide extensive resources to support the sector.

Table 3 *Sample of Trade Associations*

Institutions	Members	Focus
CAMARA DE COMERCIO y INDUSTRIA	1200	Members are enterprises from all sizes, with majority from the MSMES community, particularly commerce sector. Operate various programs to enhance MSMES's management and export plans. The AFIS program supports MSMES with a strategic model for exports developed in collaboration with the Alvizu group, a Spanish consulting firm.
ANEP	500/600	National Association of Private Enterprise, an association of associations. Sponsors the FundaMSME foundation, in alliance with the Swiss organization FUNDES. Support

		MIMSMES with a strong focus on associativity .
AMPES	5,000	Association of MSMEs created in 1988. Manages several programs to enhance MSMEs' competitiveness
ASI	500	Industry association founded in 1958, with about 75% of members being MSMEs. Supports its members with competitiveness programs.
COEXPORT	400	A corporation founded by major exporters, to help penetrate export markets, with a focus on quality and efficiency.

FOREIGN INSTITUTIONS

Many foreign government agencies and NGOs support MSMES development.

Table 4 *Sample of Bilateral Agencies*

Institution	Focus
GTZ	German official development agency, active in El Salvador since 1963 Programs support economic development and employment, as well as management of decentralization programs
USAID/EXPRO	Sponsored and funded by USAID, dedicated to promoting exports. Leading organization for supporting exporting MSMES with over 350 MSMES having benefited from USAID/EXPRO programs to access international markets.
JICA	Japanese international cooperation agency involved in a large number of programs including infrastructure reconstruction and support to MSMEs. Helping MSMES to find new export markets particularly in Japan, and supporting the development of consulting activities in key areas.
AGENCIA ESPAÑOLA DE COOPERACIÓN INTERNACIONAL	The Spanish international cooperation agency is very active in El Salvador with many programs in place; helped the Chamber of Commerce develop its AFIS program. Also focuses on decentralization programs and support to exports.

The following table provides an estimate of the number of MSMEs assisted by the institutions mentioned above (MSMEs can draw support form several organizations at the same time):

Table 5 *MSMEs Assisted by Institutions*

Institution	Total MSMEs	Exporting MSMES
EXPORTA	600	400
FOEX	75	75
Cámara de Comercio AFIS	1,200	200
Centromype	300	80

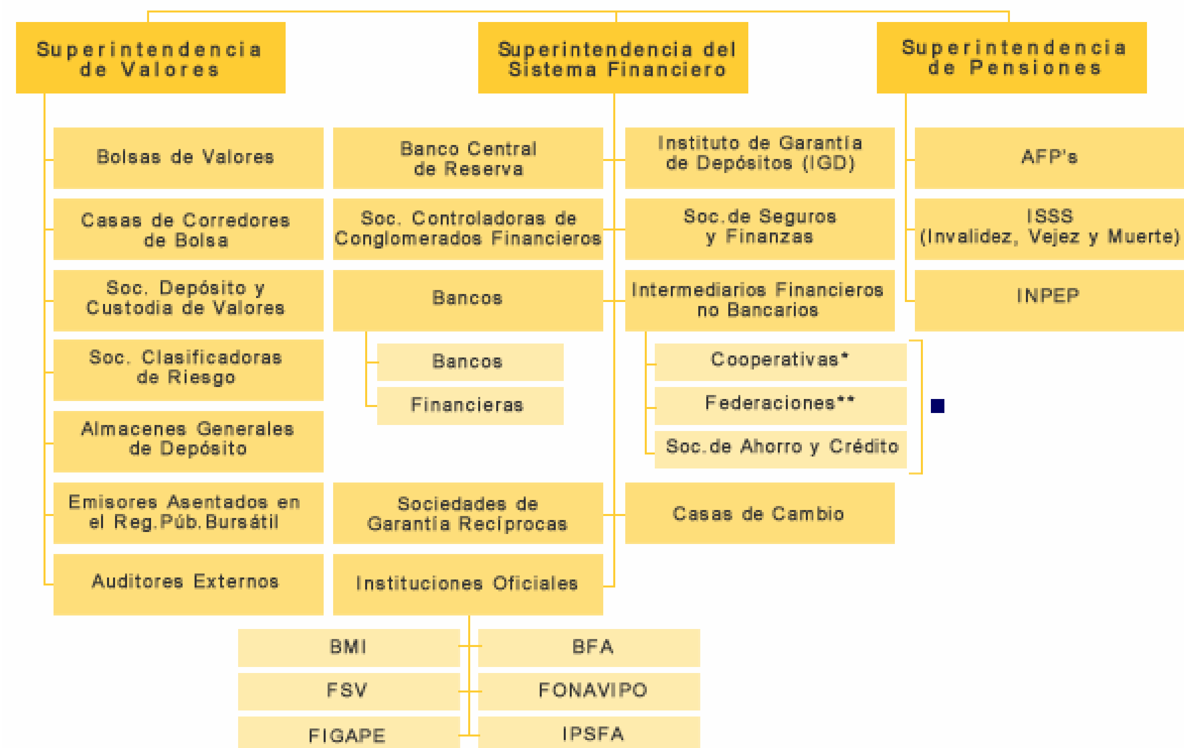
USAID/EXPRO-AID	350	180
FUNDAMSME	600	0
AMPES	5,000	0

I.4 Banking System Overview

FINANCIAL SECTOR STRUCTURE

A public sector institution for decades, the Salvadorian banking system was restructured and privatized after 1988, a reform accompanied with the creation of many regulatory institutions for ad-hoc supervision of the system. Under the current legislation - the Law of Monetary Integration of November 2000 and the Banking Law of September 1999 - the official monetary currency is the US dollar, used for all internal and external transactions. The Banking Law allows banks to invest in enterprises that offer services complementary to their financing products up to the lesser of 50 % of net worth or 10 % of loan portfolio. The organization chart of the sector is shown hereafter:

Exhibit 1 *Organization Chart of the Financial Sector in El Salvador*



The System generally emphasizes conservative policies, with a strong focus on control and supervision (through various regulatory agencies in charge of the banking system, stock market and pension system), and to a much lesser extent on services and support to economic growth.

Exacting loan reserve requirements have led banks to be risk adverse and to shy away from MSMEs financing, which they fear may negatively impact reserve levels and thus returns. Conversely, strict requirements for financial track record and adequate (high-coverage ratio) collateral have discouraged MSMES from seeking bank financing. These policies have hampered the financing of MSMEs, and acted to the detriment of one important source of economic growth for the country.

THE BANKS

The system comprises 14 active banks, with total assets valued at US$11 billion, and some 20 financial institutions. Financial information for major banks is summarized hereafter:

Table 6 *Banks Financial Information at October 31st. 2004 (US$ Million)*

Banks	Total Assets	Cash	Loans	Deposits	Net Worth	Revenues (10 mo)	Net income (10 mo)
Total System, Of which::	11,004	1,176	6,198	6,824	1,088	709	84
Agrícola	3,166	322	1,764	1,925	305	182.2	30.1
Cuscatlan	2,619	294	1,371	1,523	230	177.1	17.8
Salvadoreño	1,848	192	1,052	1,125	189	101.0	12.4
Hipotecario	275	30	140	192	25	16	-0.27
Comercio	1,209	128	793	853	128	77	15
Procredit	114	13	85	276	16	15	0.94
Citibank	216	17	64	94	15	8	-1.4
Scotia bank	418	36	271	276	40	30	1.3

The largest banks are Banco Agrícola and Banco Cuscatlan, which both have products and services supported by the latest banking technology, and cover both the domestic and regional markets. Cuscatlan, a relatively younger and dynamic bank has been leading the sector with innovative products and services. The banks are owned by groups with broad interests in insurance, aviation, shopping malls and other enterprises. Banco Salvadoreño, the oldest bank in El Salvador, is focused on the consumer market; its owners are very active in manufacturing and retail, and have recently entered the real estate business in the region. .

Banco Hipotecario, a public sector bank which has endured financial problems, was recently restructured and recapitalized to focus on the MIMSME sector. Banco Procredit, a new Bank recently formed from the Calpia ONG, is supported/funded by several international organizations; it has extensive expertise and a large clientele in the micro and small enterprise sector. Scotia Bank, the Canadian bank, acquired Banco de Comercio at end 2004.

BANKING SUPPORT TO MSMES

In 2004 the national banking system made a total of US$ 5.1 billion in loans, of which a paltry $326 million – or 6.5 % of total – was directed to small enterprises; medium size enterprises fared somewhat better, with a total of $623 million as shown below:

Table 7 *Loans to SMEs in 2004 (US$ Million)*

Bank	Small Enterprise		Medium Enterprise	
	Amount	%	Amount	%
Banco Agrícola	234.89	72%	105.92	17%
Banco Cuscatlán	11.76	4%	219.97	35%
Banco Comercio	19.13	6%	83.82	13%
Banco Salvadoreño	3.46	1%	102.77	16%
Banco Hipotecario	10.69	3%	34.91	6%
Other banks	46.08	14%	76.14	12%
TOTAL	326.01	100%	623.54	100%

Loans to MSMEs are often onerous and poorly adapted to their needs reflecting (i) High interest rates, due to large spreads over cost of funds applied by the banks to cover the "perceived" risk of MSME lending and (ii) Mostly short term lending, even when applied to long term assets, which unduly constrains early cash flows, affecting operations and access to further lending. This creates a vicious circle where MSMEs are hesitant to borrow and banks to lend, all reflected in the relatively low level of lending to MSMEs –and particularly to the "P" subset -.

To maximize their profit/return, banks naturally tend to use their cheaper sources of funds (deposits in particular) and shy away from other resources at their disposal – unless compelled to do so. Although BMI, a second-tier bank, makes available funding at attractive interest rates (4% to 6%) , it finds limited takers for its funding –a total of US$ 28 million in 2004 -, as illustrated below:

Table 8 *BMI Loans to MSMES through Banking System - 2004 (US$ 000)*

Bank	Small Enterprise	Medium Enterprise	Total
Banco Americano	40	2,050	2,090
Banco Comercio	1,715	444	2,159
Banco Cuscatlan	68	6,796	6,864
Banco de America Central	0	848	848
Banco Fomento	770	296	1,066
Banco Hipotecario	5,257	2,007	7,264
Banco Promerica	0	896	896
Banco Salvadoreño	173	4,146	4,318
FEDECREDITO	2,149	220	2,369
TOTAL	10,172	17,703	27,875

I.5 Actual Barriers and Problems Faced by MSMES

MSMES' access to the banking system is complex and fraught with obstacles. A summary of difficulties and obstacles encountered by lenders and borrowers, based on the team's interviews with banks and with a sample of exporting MSMES is shown below:

BANKS VIEWS OF MSMES

- No formal accounting in place; financial accounts not reliable and often geared to minimize any fiscal liability.
- Systematic tax evasion.
- Owners often lack the capacity to structure/present a bankable investment project.
- Lack of long-term business strategy, often focused on short term operations/survival.
- High debt level/leverage, limiting ability to contract additional loans.
- All MSMEs' assets available are already pledged, with no further adequate collateral to support lending.

MSMES VIEWS OF BANKS

The dozen MSMES visited provided of broad spectrum of companies and included: new businesses (less than one year) to well established ones (over 10 years); MSMEs with annual revenues from below $50K to over $2.5M; businesses with rapid (recent) growth and others with slow growth; well organized to poorly organized businesses; a broad range of sectors from food products, to furniture, decorative art, musical instruments and fertilizers; ..etc.. A few examples illustrate the potential, but also the constraints and obstacles to MSME financing:

- Carozzi Lamps: Pro: A great idea and a great product with world market potential Con: new enterprise with no financial record and limited collateral
- Guitarras Piche: Pro: Existing businesses with a good product and potential for export Con: No management structure, limited vision of product/market potential.
- Artesanias del Rey, Panas: MSMES which are already exporting successfully Con: Restrained by lack of financing and track record.
- Suchil: Pro: Established small business with a great product/market, already exporting to US and Europe Con: Poor management and organization, no formal business plan to support financing.
- Pavos SA: Pro: Established business with good product and attractive product potential Con: Export and growth constrained by limited production facility, requiring relatively large capital expenditure and external financing.
- Aprainores: Pro: Established business with good quality product and successful export Con: High production cost, high debt level

Issues and concerns voiced by MSMEs regarding their relationships/perception of banks include:

- Cultural distrust, i.e. banks are owned by well established an powerful groups, and seen more inclined to assist and favor larger enterprises
- Until recently, banks had limited interest in mechanisms supporting MSME financing (such as guarantee schemes), since they could often access cheap funding from international sources
- Overemphasis on collateral which severely restricts bank financing to MSMEs, even to companies with attractive projects and strong cash flow potential.

- The fear that MSMEs' projects be copied/stolen by the bank.

I.6 Conclusion: A Gap in MSME Financing

In conclusion, the analyses made in the previous sections indicate that despite the institutions and mechanisms in place to support the MSME sector, there is still a large unfulfilled financing need, particularly to the small/medium size MIMSME subset. While the micro and larger enterprises are reasonably well served by banks and financial institutions, the financing gap to the "small" enterprise is a major deterrent to the development and growth of a sector which constitutes a traditional economic and employment backbone for a developing country.

Such financing will need to take into account MSMES' defining characteristics – i.e. their strengths and weaknesses – as summarized below:

STRENGTHS AND OPPORTUNITIES

- **Innovation strength:** A majority of MSMEs show great innovation in their product, design or technology, generally geared to niche markets- locally or abroad

- **Business ability:** Although not formally articulated, many entrepreneurs – particularly those with a higher level of education - have clear objectives and long term business strategy

- **Growth potential:** Several relatively new businesses had clear potential for rapid growth, with adequate coaching and if reasonable financing were to be made available

WEAKNESSES AND CONSTRAINTS

- **Maturity:** Many MSMES – even older ones - still operate informally, requiring both time and external support to bring their business vision, organization, management and systems at the minimum level required for financing.

- **Funding access:** Limited access and processing delays for financing (rather than cost) are major obstacles resulting in inefficient MSME operations and haphazard growth.

- **Complex financial needs:** The (mostly) short term structure of debt carried by many MSMEs overburdens their immediate cash flows and restricts contracting further financing; also MSMEs' investment and working capital needs often require a "quantum" jump in financing amount, in relation to current sales/cash flows.1

- **Inadequate support:** Despite the many "support" institutions, the assistance is often inadequate and/or bureaucratic; there is a need for more long-term coordination and mentoring, with a "one-stop shopping" approach, for efficient help.

II A FUND FOR EXPORTING MSMES

II.1 MSME Financing: Highlights of Recent Initiatives

Government Authorities have supported many initiatives, in collaboration with international, bilateral and multilateral agencies, to assist MSMEs' development (see section I.3). In the financial area, several recent initiatives illustrate promising approaches:

RECIPROCAL GUARANTEES- SOCIEDAD DE GARANTIAS RECIPROCAS (SGR)

Spearheaded by the Banco Multisectorial de Inversiones (BMI), a public sector bank, a novel and associative scheme for so-called "Garantias Reciprocas", was developed. This scheme originated in Spain several decades ago and rapidly mushroomed and diversified, with dozens of SGR functioning today successfully. It has also been widely adopted in other industrial countries (with hundreds of SGR operating in Europe including Germany, France and Italy, with combined guarantees over 20 billion euros), as well as in developing countries, including Argentina and Chile in Latin America.

With the support of the Spanish Development Agency, BMI worked closely with Iberaval, one of the prominent SGR companies in Spain, to develop the necessary legal environment as well as organization, procedures, and systems (including the Servifin software from SGRSoft SL) to set up the SGR. A new law establishing the SGR framework was enacted in 2001, and Garantias y Servicios SGR S.A de C.V. (thereafter SGR) was subsequently formed and started operations in September 2004.

Established with an initial capital of $3.8 million, SGR shareholding is composed of (i) "protecting" shareholders ("socios protectores") accounting for 90% of capital and including BMI (49%), CABEI (22%) and a dozen of the largest banks and

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[1] This is for example the case of several companies having recently secured export contracts with Walmart in the US, and faced with large w/c and equipment financing needs.

Salvadorian companies and (ii) participating shareholders ("socios participes") accounting for the remaining 10%, and currently including over 150 MSMEs. SGR's Board of Directors comprises 8 members (and 8 alternates), equally divided between members representing "protectores" and "participes".

SGR is geared to provide 100% first demand financial guarantees, in an amount not exceeding 5% of its capital and reserves (currently about $175,000). It can also provide a variety of other guarantees, including commercial (third party equipment supplier for instance) and technical guarantees. At December 2005, SGR had granted some 300 guarantees for a total of about $10 million (average of about $30,000/client). SGR expects to serve some 500-600 clients and assist a total of 2000-3000 clients over the next five years.

PRIVATE EQUITY FUND

Jointly sponsored by FOMIN (IDB Group) and Norfund (Norwegian Investment Fund for Developing Countries), CASEIF was established as a private equity fund in 2000. With a capital of $25 million, CASEIF was to take equity participations (minimum $250,000, maximum $1.5 million) for up to 49% stake in MSMEs' capital (with sales below $3 million and less than 100 employees). Investments are expected to yield returns of 20-25% and exit arrangements are negotiated with owners, previous to closing each transaction.

For a number of reasons, many identified in previous sections, progress has been slow in identifying suitable opportunities and so far the fund has been slow in closing deals.

BANCO HIPOTECARIO (BH)

With an eighty years history and a past marked by several financial upheavals, this public sector bank has recently reoriented its business strategy - and is currently restructuring its capital and operations - to substantially focus on the financing of MSMEs. To develop its MSME strategy and plans, necessary know-how was obtained from BanColombia a well-established private Colombian bank with important MSME financing activities and expertise. BH has set an ambitious market objective of reaching some 18,000 MSMES over the next five years. As BH is in the midst of reorganizing its personnel structure and gearing up for new operations, it is too early to assess the realism of such objectives.

USAID GUARANTEE SCHEME

With a six-year track record in establishing over 80 guarantee schemes in developing countries, USAID recently set up its so-called Development Credit Authority (DCA) in El Salvador. DCA has been successfully implemented in 11 Latin American countries, including neighboring Guatemala, Costa Rica and Honduras, encompassing over 30 guarantee operations. Under this scheme, DCA typically provides a guarantee for 50% of a bank portfolio; guarantee fees include upfront fees (15 to 200 BP) and an annual utilization fee (25 to 200 BP)

The DCA Guarantee scheme was approved mid -2005 for two banks, Banco Salvadoreno and Banco Procredito; USAID is guaranteeing up to 50% of qualified credits extended to MSMEs. Terms to final borrowers are per negotiation with clients and prevailing bank practices and policies, although it is hoped that the guarantee will increase the flow of credit to MSMEs with limited collateral, including -but not limited to- small companies that export.

PROPEMI

PROPEMI is a program sponsored and managed by FUSADES, the Salvadoran Foundation for Economic and Social Development, an economic and social think-tank for the private sector. PROPEMI is geared to provide financing to micro and small enterprises, having lent some $150 million over the past 10 years. The average loan is $5,000, typically for working capital purposes.

In parallel FUSADES has been assessing the feasibility, and possible mechanisms, for attracting equity capital for investment projects, from well-off Salvadorans residing abroad and in the country.

II.2 Constraints of Financing/Investing in SMEs: A Broader View

In developed countries, most SMEs obtain formal financing from banks using assets and real property as collateral against bank loans; early-stage SMEs may also finance startup costs with credit card debt or soft loans from family and friends. However, these sources of SME finance are limited in a developing country like El Salvador, where SME investment largely relies on equity from the savings of the owner and his/her family and reinvested profits. Suitable institutional financing for SMEs faces numerous challenges, in particular:

Lack of collateral. While bank lending may be available, the lack of collateral discourages banks from collateralized lending other than to the largest concerns.

High cost of appraisal. Without sufficient security for collateralized lending, lenders must rely on the strength of a company's projected cash flow to service debt, which entails considerably more due diligence and higher costs than collateral-based lending. This leads banks again to focus on the largest borrowers, to amortize upfront costs over a larger investment amount.

High cost of investment. SMEs are usually managed by an owner-operator with good technical/operational skills but often lacking financial or business skills. SMEs' small size means that the time/costs associated with identifying, processing, negotiating with owners (particularly pricing/exit arrangements), and monitoring an investment are very high relative to the investment size, making most SMEs potential returns unattractive for investors.

Limited upside. The majority of SMEs are "lifestyle" businesses providing a steady income to owners who have limited interest in rapid growth or in selling their company to a third-party. Consequently, the smaller SMEs offer limited upside potential for investors and are rarely of interest to private equity funds, which prefer approaching the larger SMEs.

Lack of control. Owner-managers typically are reluctant to give up a substantial share of ownership to external investors for fear of losing control of the business. While in developed countries investment instruments can be structured to balance control rights, this situation would be more novel and possibly difficult to structure/enforce in El Salvador.

II.3 A Sample of International Experience in SME finance

Many international developments organizations (IFC, IDB, MIF etc..) have tried to tackle the complexity and difficulty of providing financing to SMEs, particularly to the "S" (small) subset of SMEs. Some financial organizations, with track record and expertise in fund management for the SME sector have provided support and know how to the Multilateral and Bilateral Financial Institutions, in designing and managing such funds. Overall, the activities of such institutions illustrate a broad diversity of approaches, roles and products, and provide a useful experience/expertise to draw upon in designing a Salvadorian MSME financing scheme:

SMALL ENTERPRISE ASSISTANCE FUND (SEAF)

Created in 1989, SEAF has invested in more than 20 countries around the world with a strong initial focus on Central and Eastern Europe. Today it operates through an international network of offices in Central and Eastern Europe, Latin America, and Asia and has over $150 million under management in some 20 funds, with a portfolio of over 200 companies. Capital sources include multilateral and bilateral financial institutions, private foundations, local pension funds, insurance companies, and other investors.

SEAF Funds provide direct financing to locally established enterprises in amounts ranging from about USD 1- 2 million per deal in earlier funds to approximately USD 5 million more recently. Investments are made primarily through structured equity participations, in partnership with local entrepreneurs and senior management. Investments are often combined with quasi-equity financial instruments and subordinated debt, and usually include defined investment liquidity protections ("exit rights").

Together with on-the-ground presence, Technical Assistance (TA) is central to SEAF's mode of operation and can include (i) Internal assistance from the local SEAF staff including budget and accounting management, cost controls, operational management and inventory management, advice on appropriate business strategy etc., (ii) Assistance through its own specialized Business Support Units which provide more globally oriented support and perspective reaching outside the fund's local marketplace and (iii) Assistance via experienced and specialized industry consultants, utilizing the expertise of volunteer consultancy organizations such as Fundes, the Netherlands Management Cooperation Programme (NMCP), the International Executive Services Corps (IESC), ECTI, the French senior volunteer consultant service etc...

AUREOS CAPITAL

Aureos was formed in 2001 as a joint venture between CDC Capital Partners ("CDC") and Norfund (Norway) to take over the management of CDC sponsored SME funds and create/manage new SME private equity funds in emerging markets. These included 14 country funds (total committed capital $170 million) under management in Central America, Sub-Saharan Africa, South Asia and Pacific Islands, that made investments typically between US$200,000 and US$2 million.

Aureos closed its first new fund in Central America in 2002, having raised US$33 million for investment in SMEs in the region. Focused on Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama and the Dominican Republic the fund strives for typical deal sizes in the US$500,000 to US$5 million range.

Since then, Aureos closed several other funds (total commitment over $100 million) targeting SMEs in Sub-Saharan Africa and developed several funds in Asia bringing Aureos' total capital under management to over US$400 million, with operations from over 20 offices worldwide.

SHOREBANK ADVISORY SERVICES (SAS)

Created in 1988, SAS is the consulting arm of Shorebank Corporation, a Chicago-based development Bank company established (1973) to reverse negative investment trends in minority urban communities or resource dependent rural communities.

SAS International has worked in 30 emerging economies, with banks, microfinance entities, credit unions, cooperatives, NGOs, and others that seek to reach entrepreneurs perceived to be too small, too risky, or too new to interest conventional financial institutions. It specializes in the design and management of projects to strengthen financial intermediaries focused on SMEs and emphasizes training and capacity building for lenders, managers and boards of partner institutions.

SAS has worked with Multilateral, bilateral and local financial institutions to set up new funds, most recently in Mexico (quasi equity and self liquidating instruments) and in Argentina (debt fund), where it also took operational responsibilities as fund manager, or member of the loan committee. SAS also has a good knowledge of the El Salvador financing environment as it tried several years ago to design/set up an SME fund sponsored by IDB's FOMIN, a project which was eventually postponed for lack of support by local banks.

BUSINESS PARTNERS LIMITED (BP)

BP is a specialized investment group, providing debt and equity financing, mentorship and property management services to SMEs in South Africa. Since its inception in 1981, BP has developed an effective process for evaluating, structuring and monitoring investments in SMEs. The process minimizes the cost of processing small investments with little upside potential and aligns the interest of investment staff to maximize value from the investments[2]. The process also provides critical support and mentoring to the investees, incorporating a technical assistance program in its services.

Today the organization has 295 employees in a network of 22 branch offices. BP made some 30,000 investments since inception, for a total of about US$1 billion, with ongoing annual investment commitments in the $75 million range; the organization has been constantly profitable. BP offers a broad range of products including:

- **Equity partner:** designed for entrepreneurs with an established profitable venture, but with no/insufficient loan collateral: Shareholders loan with an

[2] BP's operating strengths also include a sophisticated and extensive database providing local and international business company information as well as detailed benchmark parameters for practically any business.

equity component, typically a significant minority stake; priced to earn return of 16-19% over prime rate.

- **Risk partner or Royalty partner:** designed for entrepreneurs with viable lifestyle business, but limited capital and security: Investment structured as loan with an unsecured risk portion, itself compensated by shares or a royalty calculated on turnover; priced to earn return of 15% over prime rate.

- **Loan Partner***:* a fully secured senior loan product; priced to earn return at about prime rate.

BP's Mentors program is an integral part of BP's services, providing entrepreneurs with advice/expertise from a wide range of experienced mentors and consultants (a roster of 600 members today). Mentoring focuses on key SME weaknesses such as lack of management competence, poor bookkeeping and financial management, sales and marketing issues and staffing problems. Services are paid upfront by BP, but eventually repaid by SME clients, as part of their contractual arrangement.

BP recently ventured on the international scene, entering joint venture arrangements with IFC, and forming a subsidiary – Business partner International, BPI - to manage two funds in Madagascar ($10 million) and Kenya ($15 million). If successful, IFC and BP plan to create similar funds in other countries, including Latin America. Highlights of these two funds:

- **Fund managers (FM)***:* BPI to own and operate separately staffed and incorporated local fund management teams. Fund management team composed of 3-4 professional staff.

- **Clientele target:** Under capitalized and under collateralized SMEs

- **Expected deal size:** Kenya $120-170,000 ; Madagascar $50-150,000

- **Product:** Quasi equity and debt instruments predominantly self liquidating instruments; typically amortization of up to 5 years , interest rate at about prime rate, and royalty on sales, or income participation, and/or shares. Target ROR in the 20% range.

- **Technical assistance (TA):** Integral and mandatory part of the finance package and representing in average 20% of the cost of the financing. Alongside the fund, a Technical Assistance facility, funded by donors and managed by the FM, will provide assistance on items such as MIS, market research, quality assurance processes, staff training etc.. TA funding will be through a subordinated non-interest bearing loan, to be repaid by investee after all secured debts and/or investment are paid.

II.4 Objectives and Characteristics of the SME Fund

Given the broad financing needs of MSMEs, from debt to equity and everything in between, several alternative schemes where initially envisaged. A first approach was focused on debt finance through a "co financing" package involving a fund (structured through a Fideicomiso) together with one (or possibly several) Salvadorian commercial banks; the guarantee schemes mentioned above (see section II.1) were to support such financing. While this approach was investigated, and a possible structure designed (see annex 3), it was felt that a focus on equity/quasi-equity through a more "classic" fund approach may address more efficiently MSMEs' needs and be faster to implement.

The expected small size of average investments/financing for each MSME, a situation somewhat similar to that faced by IFC/Business partners with their African funds (see section II.3), required focusing on an arrangement/structure that would ensure the fund's financial sustainability. For this reason, an "alliance" with a local financial institution already involved with MSMEs was felt as prerequisite for the Fund's viability, i.e. to facilitate the Fund's funding, deal sourcing, processing, and eventually lowering operating costs.

Various conversations with BMI and SGR's management have confirmed an in-principle interest of the BMI/SGR group, in supporting the Fund organization, operation and also participating in its funding. Consequently it is proposed to establish a SME Fund that will provide an efficient vehicle to deliver finance and technical assistance to export-oriented Salvadorian SMEs, in a commercially sustainable manner, while generating an acceptable return to the Fund Investors. The Fund is to fulfill such objectives largely by:

1. Structuring most investments as self-liquidating quasi-equity instruments, that do not necessarily require full collateralization and that address MSMEs' diverse needs in particular:

- Varied funding needs: Usually for both ST (working capital) and long term (facility, equipment needs but also investments in marketing and other intangible assets).
- Debt refinancing: Many MSMEs indebted with ST financing are overburdened with disproportionate debt servicing obligations in relation to current cash flow.
- MSME optimum growth often requires a quantum jump in funding size, in relation to the company's expected short term cash flows and may require

extended grace period, graduated repayment schedule in the product's design etc..

2. Capitalizing on BMI's already active role in the MSME sector and its in-principle interest in supporting the Fund. BMI's SGR has developed a track record in providing guarantees for MSME financing, and an expertise in sourcing deals, conducting due diligence, assessing risks, portfolio monitoring/supervision and developing a MSME information database ..etc.. A cooperation arrangement between the Fund and SGR, to provide due diligence support and/or other services, for a fee to be determined, will improve cost efficiencies and ensure the scheme is financially viable.

3. Using best-in-class and proven structure, products, and processing and monitoring systems by partnering/contracting with one of the foreign institutions mentioned above (or possibly other) to provide services in designing the fund and assist (or be engaged) in building the fund staff and the Fund management/operation.

4. Setting up and managing a Technical Assistance Facility (TAF) as integral part of the Fund's concept. TAF will provide technical support and advice to investee companies, both at the initial stage to help selected MSMEs mature/develop bankable business/projects, and after investment are made to help investees grow for the mutual benefit of investor/investee.

The TAF scheme is to be similar to BP's model (see section.II.3) where potential investees would be required to contract technical assistance. TAF would pay upfront for the assistance while MSMEs would contractually reimburse TAF – wholly or partially – for such services over time. To be financially feasible, this scheme will require initial concessionary grant funding, as was the case with the IFC/BP funds in Africa.

It is expected that USAID/EXPRO would play a key role in this area, through a "preferred" relationship with the Fund/TAF. USAID/EXPRO could provide technical assistance either for its own account or through coordination of third party services; terms of compensation would need to be negotiated. Overall TAF would subcontract services from professional firms (auditors, legal, marketing, business strategy, IT .etc..) and qualified consultants (all with top credentials/track records, particularly with MSME activities) while maintaining a supervision/monitoring role. To carry this assistance in an organized/efficient fashion, long term alliances would be formed with such firms and consultants

II.5 Funding

Designed on a pilot basis, the scheme is contemplated at a "reasonable" $12 million size. The funding is contemplated as Public- Private Partnership, through a mix of debt and equity funding, suggested as follows (see detailed Term Sheet in annex 4):

- A $ 5 million BMI loan with possible terms as follows: 8-10 year loan with up to 4 year grace period at BMI's premium interest rate (% interbank-rate); the loan would be senior to the equity. BMI has indicated in-principle willingness to consider such a loan.

- A $ 7 million equity investment from private and institutional investors in El Salvador (pension fund, wealthy investors) and foreign International Financial Institutions. Institutions. A group of two or three such institutions could provide such equity, and could include the likes of DEG, KfW, IIC or MIF who were approached and indicated in-principle interest, subject to further structuring and due diligence. Other institutions, particularly active with MSME issues, could include Norfund and FMO.

- If appropriate and timely, an additional equity source could be considered - namely foreign remittances – with a mechanism to selectively channel funds originating from Salvadorian workers residing in the United States and/or successful Salvadorians entrepreneurs wishing to invest back in their country's development.

- In parallel, grant funding will be necessary to jump-start the Technical Assistance Fund (TAF). Depending on the role which USAID/EXPRO would play in managing or coordinating TAF activities, USAID could directly - or indirectly – provide a major portion of such grant funding. In addition, other sources such as the European Community, KFW, among several institutions, could be also approached for funding.

II.6 Fund Operation

II.6.1 MSME INVESTEE SELECTION

It is estimated that there are over 10,000 MSMES in EL Salvador. MSME selection criteria would aim to rapidly start operations by choosing on the "easier"/"larger" deals. After six months or so of operation, those criteria could be reviewed and "expanded" as appropriate, to include a larger number of candidates. MSMEs would be selected based on the following main criteria:

- Export Business: Existing MSMEs already exporting or with strong (confirmed) export growth potential; clearly identified niche market and demonstrated competitive edge.

- Reasonable business vision, management ability to develop an overall business concept.
- Adequate legal structure and quality financial information
- Reasonably identifiable cash flow prospects resulting from the contemplated financing
- Some collateral available (from a “broad” range of acceptable collaterals)
- Deal size

II.6.2 THE FINANCING PROCESS

Three main phases are typically involved in the financing/investment process:

(i) Preparation Phase, where the Fund sources/screens potential deals from a broad universe of MSMEs, at various levels of business “maturity” and definition of investment project and financing needs. After initial screening by the Fund, and once minimum investment criteria (see section.II.6.1) are satisfied, the MSME is entered into a Potential Project Pipeline (PPP).

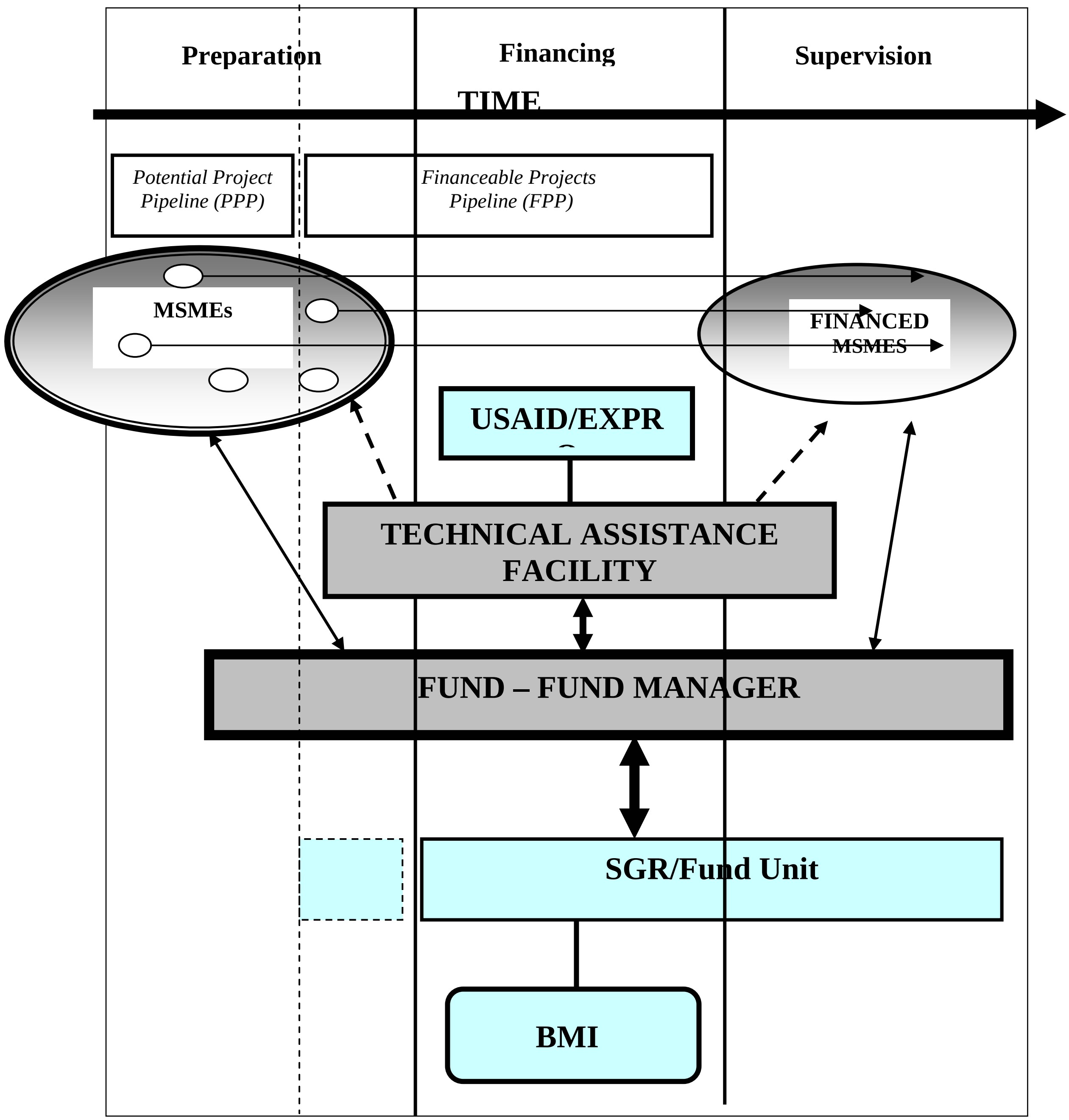
PPP Projects are then assisted (mentored) - as appropriate with TAF support - to structure their enterprise and its finances, improve their management/systems, progressively refine their business vision and plans, and eventually prepare a professional business plan. They eventually reach the stage for inclusion in the Financeable Projects Pipeline (FPP).

(ii) Financing Phase, where the Fund conducts due diligence on the MSME and its project and financing needs, with the objective of structuring a bankable project with a feasible financial plan and appropriate financing, negotiating terms of the financing/investment, closing the transaction (signing of legal documents), and effecting first disbursement.

(iii) Supervision/follow-up/divestment starts upon first disbursement of the financing and lasts until investment has been fully repaid/divested.

The following diagram schematically shows the various parties/entities involved in this process; their position on the “timeline” roughly indicates when their involvement starts and when it ends; the diagram highlights the particular “alliance” role played by BMI and USAID/EXPRO.

Exhibit 2 *Financing Process Diagram*



II.6.3 OPERATIONAL RESPONSIBILITIES

Further details on the responsibilities and activities of the Fund Manager, the SGR unit, and the TAF for each processing phase are shown in the following table:

Table 9 *MSME Fund - Operational responsibilities*

Entities: Phases	FUND Fund Manager	SGR/Fund Unit	Technical Assistance Facility (TAF)
Preparation	1. Project Identification/ screening monitoring		
	2. Inclusion in Potential Project Pipeline (PPP)		2. Strengthen business vision, assess markets, improve mgt.
	3. Coordinate preparation of BP		3. Assist in preparing BP
	4. Inclusion in Financeable Project Pipeline (FPP)		
	5. Project referred to SGR Unit for processing	5. Acknowledge referral	
Financing		1. Due diligence/appraisal	
	2. Fund consulted, as needed, on deal structuring	2. Structuring of deal and financial product	
		3. Risk assessment /mitigation; pricing	
		4. Term Sheet (TS) preparation, negotiation; draft legal agreement (LA)	
	5. Deal Approval (specific or no objection)	5. Presentation for approval	
		6. Finalize LA	
	7. Sign LA		
		8. Satisfy CODs	
		9. Instructions to disburse	
	10. Disburse		

Follow-up & Supervision	1. Treasury management, disbursements repayments		
	2. Follow-up/monitoring; review of project progress report		2. Assistance with strategic planning, management, accounting systems, etc
	3. Identify potential problem projects	3. Handle problem loans; rescheduling, restructuring	
	4. Fund consulted, as needed, on workout activities		
	5. Identify/generate potential repeat business		
	6. Periodic assessment of results and fine-tuning of "norms"		
	7. Divestment of investment .etc.		

II.7 Implementation Next Steps

Numerous tasks will need to be carried out to further develop/structure the proposed scheme and proceed with initial implementation. These include the following:

- Confirm initial design concepts, clarify legal aspects
- Discussions with BMI and SGR to confirm definite interest in funding and specific role(s) for operations; define possible terms of the BMI loan and compensation arrangements for the SGR unit support.
- Identify possible (international) "partner(s)" for the management of the Fund.
- Confirm funding sources, possible amounts and terms, for the equity investment portion of the Fund (from International organizations and/or domestic sources/investors).
- Discuss and confirm role(s) of USAID/EXPRO in the scheme, and possibility of direct/indirect grant funding from AID for the TAF
- Identify, as appropriate, other sources of grant funding for the TAF

- Identify firms/consultants which could provide broad range of services under contract with the TAF; discuss compensation arrangements.

- Clarify issues/policies with Government authorities and Supervision de Bancos, as applicable

- Refine MSME selection criteria; build initial MSME/project pipeline; set up initial selection parameters for pipeline

- Design/define financial products to be offered by Fund

- Develop Fund and TAF financial projections, prepare business plan

ANNEX I

LIST OF CONTACTED ORGANIZATIONS

GOVERNMENT INSTITUTIONS

Ministerio de Economia: Yolanda Mayora de Gavidia, Ministra

Centromype: Lucy Murillo Quijada, Gerente Tecnica

PROESA: Isabel Muyshondt, CAFTA Advisor

FOEX: Alvaro Almeida, Gerente Financiero

PROFESSIONAL SERVICES FIRMS, EDUCATION INSTITUTIONS

Equifax Centroamérica: Rafael Belloso Lara, Gerente de Ventas

Consultores y Capacitadores SA: Jose Daniel Villamariona, Gerente General

Escuela Superior de Economia y Negocios: Daniel Wisecarver, Director Academico y& Saul Ovidio Palomares, Coordinador Centro Emprendedor

Moran Mendez Y Asociados: Luis Alonso Moran, Socio

Deloitte & Touche: Ricardo Morales Cardoza, Socio

B&P Abogados Asoc.: Alfonso Pinedo Claude, Socio

SALVADORIAN BANKS, FINANCIAL INSTITUTIONS

Banco Multisectorial de Inversiones, BMI: Roger Alfaro Araujo, Director de Negocios, Garantia y Servicios, SGR SA &Victoria Gutierrez de Mejia, Gerente General

Banco Agrícola: Rodolfo R. Schildknecht, President, Cesibel de Duran, Gerente Mediana Empresa & Ana Marina de Carazo, Gerente de Creditos Banca Micro & Pequena Empresa

Banco Cuscatlan: Federico Figueroa, Ejecutivo Fiduciario & Oscar Jose Santamaría , Gerente general Valores Cuscatlan

Banco Hipotecario, BH: Jorge Roberto Navarro, Presidente, Luis Mora, Asistente de la Presidencia, Carlos Albero Ruiz, Gerente de Mercadeo & Marleny Deras de Amaya, Gerente Banca MSME

Banco Salvadoreño

Banco Procredit: Silke Maria Muffelmann, General Manager

Banco Americano: Marlena Posada de Gomez, Vicepresidente Ejecutivo & Nora Evelyn Gutierrez, Gerente de Creditos

Lafise: Sandra Maria Munguia, Directora

LAAD: Pedro Aycicena Lehnhoff, Investment Manager & Calos Ravelo

FUSADES: Alvaro Ernesto Guatemala, Director Ejecutivo, Gustavo Adolfo Quinonez, Subdirector PROPEMI & Emma Arauz, Director Trade and Investment Service Center

Superintendencia del Sistema Financiero: William Ernesto Duran, Intendente de Supervisión

(ex) FundaMSME: Carlos Romero

Asafondos: Guillermo Aceto Marini, Director

TRADE ASSOCIATIONS

Asociación Nacional de la Empresa Privada (ANEP): Eduardo Onate Muyshondt, Director

Camara de Comercio e Industria de El Salvador: Elena Maria de Alfaro, Presidente

American Chamber of Commerce, AmCham: David Huezo, President

MSMES

ARTyCo: Guadalupe de Artiga, Owner and General Manager

Panhas: Irma de Papini, Gerente Administrativo

Muebles Molina: Jorge Molina, Gerente general

Pavos SA: Enrique Alberto Flores, Director Gerente

Industrias Lya: Vicente Trigueros Quiñónez

Gevesa: Ernesto Quiñónez Sol, presidente

Red Art: Carmen de Rusconi

Artesanos del Rey: Kreysa de Commandari

Aprainores: Vicente Carranza Alfaro, Gerente

Shuchil: Matilde Carillo de Palomo, Gerente

Huisil

Max Piche: Salvador Espinosa, Owner

Carozzi Lamps: Ricardo Paggi

INTERNATIONAL ORGANIZATIONS, FUNDS, NGOS

DEG: Michael Beetz, Vice president Latin America, Thomas Kessler, Manager & Hendrick Luhl, Director

KfW: Martin Habel, Project Manager

IFC (World Bank Group): Simon Andrews, Senior Investment Officer – Private Equity and Investment Funds, Peter Tropper, Principal Funds Specialist – Private Equity and Investment Funds, Richard Rutherford, Senior Investment Officer, Anita Bhatia, Manager SME/TA & Harold Rosen, Director

IIC (IDB Group): Sotero Arizu, Principal Investment Officer, Diego Noseda, Counsel & Jorge Roldan, Division Chief

Multilateral Investment Fund, MIF (IDB Group): Susana Garcia-Robles, Investment Officer

USAID: Alison Eskesen, Investment Officer & Carlos E. Arce, Gerente Comercio y Desarollo Empresarial

Institute fro SME Finance: Tom Gibson, President

Shorebank Advisory Services: Lauren Moser, Senior Managing Director & Lyubomira Buresch, Senior Consultant

Small Enterprise Assistance Funds (SEAF): Roger Leeds, Board Director & Minchau Nguyen, Senior Vice President

Aureos

ANNEX II

SME DEBT FUND – HIGHLIGHTS OF DESIGN AND CHARACTERISTICS

DESIGN CONSIDERATIONS

The Scheme was designed with the following key objectives:

1. *Reasonable Control of Operations*
- Direct financing to MSMEs rather than second tier operation
- Selection of "finance vehicle" providing flexibility from current tight supervision regulations: Fideicomiso

2. *Integrated Approach addressing MSMEs' financing and technical assistance needs:*
- Coordinate/foster the "maturation" of selected MSMEs to bring projects to bankable stage (i.e. increase potential deal flow).
- Diversity of finance products (debt and quasi equity, short/long term, refinance .etc..).
- Integrate technical assistance/supervision of MSME operations through life of financing; USAID/USAID/EXPRO to play an important role there.

3. *Banking system integration*
- "Piggyback" on existing (financial) structures to minimize costs; foster evolution of the Salvadorian banking culture, from asset to cash flow based financing
- Capitalize on existing banking liquidity: Foster bank participation in the financing through syndication/risk sharing,
- Utilize guarantee schemes currently being implemented to support MSMES financing.

THE FINANCING PACKAGE

MSMEs financing would be provided through a "syndicated"/"co financing" package, typically involving funding from a "Fund" (substantially funded from

International Financial Organizations – IFI) and a Salvadorian commercial bank, with two components as follows:

1. *The "Fund" Component (FC), typically in an amount of about 50% of the financing package, with typical characteristics as follows:*
    - Broad range of products including Senior long term loan of up to 5-6 years (with adequate grace period), subordinated/quasi equity products (and convertible debt), with equity kicker features

    - Flexible utilization, generally focused on fixed assets capitalization, but can also be used for permanent working capital and intangible assets; other particular features "adapted" to MSME's needs including longer grace period, graduated repayment schedule, etc...

    - Interest rate: Determined for each deal, based on risk assessment .

2. *The Commercial Bank Component (CBC), with an amount of about 50% of the loan package, with characteristics as follows:*
    - Typically (but not necessarily exclusively) short term or medium term loan, geared to working capital needs. As the scheme matures, and banks become more "comfortable" with MSME lending, the scheme would entice banks to lend longer term,

    - Interest rate: Prevailing market rate, based on credit and risk assessment and, if applicable, factoring the guarantees.

Collateral: "Traditional" collateral (i.e. fixed asset mortgage) being a major impediment to MSME financing, the scheme will need flexibility with alternative collaterals providing acceptable risk mitigation: Pledges on machinery/equipment pledge, export receivables, export sales contract, personal guarantees, third party guarantees ..etc..

SCHEMATIC DIAGRAM

Three major parties/vehicles would be involved in the scheme:

1. *The "Fund Implementers"*

To be cost efficient the control/supervision, money flows and loan processing functions have been segregated in different entities:

- The Technical Unit (TU), the equivalent of a Board of Directors, would comprise 3 to 4 members on a part-time basis, representing the

International Financial Institutions (IFI) lenders and possibly local businessmen involved in MSME finance; TU would carry out normative functions, decision making processes linked to loan approval, and overall supervision of operations. Day to day functions would be carried out by a "lean" full-time "Executive Team" (ET) of a few senior professionals and administration support.

- A Trust (Fideicomiso)3, housed with a Bank Trustee (Fiduciario); the Trustee would be initially selected by the TU after a competitive bidding process. Funds would be disbursed by the IFIs into the Fideicomiso, with the Trustee being responsible for managing all treasury operations, under instructions from the TU.

- A Financing Processing Center (FPC), ideally an established unit with appropriate capability/track-record, would be entrusted with the processing of bankable projects identified by the TU. Initial discussions held with BMI/SGR indicate that the professional structure/team of SGR could be contracted to play the FPC role, on an "outsourcing" basis, and under decision-making control of the TU. Processing would include all necessary steps leading to closing a transaction; additional activities could involve processing problem loans.

2. *The participating Salvadorian Bank*

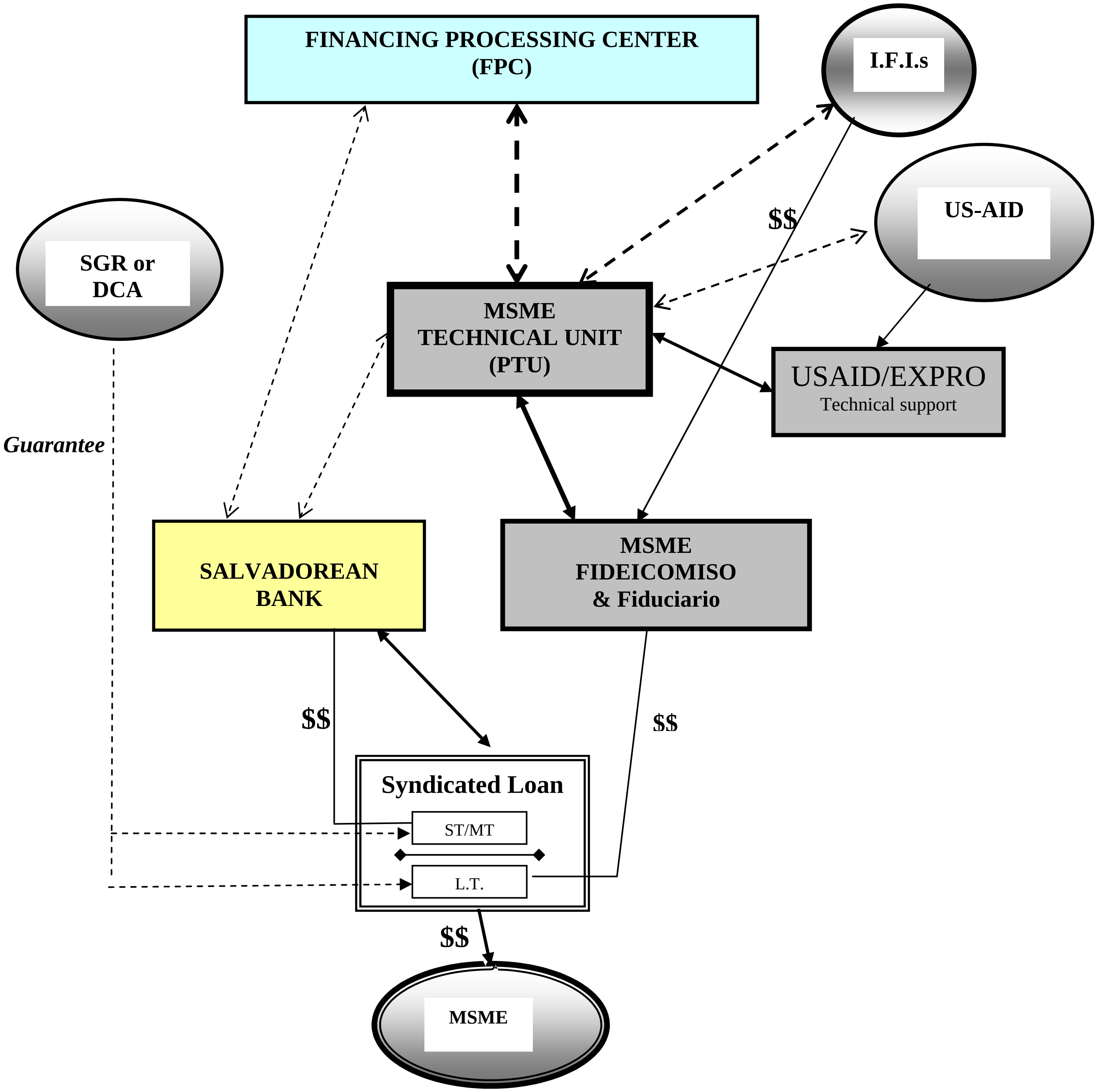
The Salvadorian bank may either be involved at the early stage (bringing the deal to the Fund), or brought in later, once the FPC has initiated project processing. Although the "Fund Implementers" will play a major/lead role in structuring the transactions, it is contemplated that the commercial bank be the lender of record and the Fideicomiso a "participant" in the loan. Thus the bank will manage the overall money flows –in and out – with the MSME client, as well as regular business relationship.

3. *The Guarantors*

Guarantees could include, as appropriate, the SGR guarantee (for up to 100% of the loan package), provided independently of the syndicating bank involved in the transaction, or the USAID/DCA guarantee (for 50% of the commercial bank loan portion).

[3] The Fideicomiso provides a flexible vehicle that could receive the funding and efficiently manage fund flows. There are currently in El Salvador some 70 trusts in operation with total assets in excess of $100 million. Cuscatlan has a strong lead in this business with over 60% of trusts under management, followed by Banco Agricola and Banco Salvadoreno.

The scheme and relationship between its participants is illustrated in the following diagram:



OTHER DESIGN CHARACTERISTICS

TU's Normative, Technical Support role

With the guidance of the IFI lenders, the TU will perform many normative functions to initially establish the scheme. Tasks will include in particular:

- Define eligibility criteria for MSMEs/projects to be considered for inclusion in the Potential Project Pipeline (PPP) and Financeable project Pipeline (FPP)

- Define selection criteria and conduct negotiations for framework agreements for "alliances" with consulting/service firms to be involved in providing technical assistance to MSMEs (business, legal, finance..), including in the preparation of Business Plans.

- Define broad criteria to be used, work to be carried out, and structure of final document, during preparation of Business Plans by third parties

- In coordination with FPC, review/define procedures to conduct deal due diligence and all steps (from deal structuring to negotiations) involved in the Financing processing. Define need for staff training, as applicable. Negotiate framework agreement with FPC.

- Define criteria for selection of Trustee (Fiduciario) and monitor the bidding process

- Define criteria, if any, for commercial banks to "participate" in any "loan package".

Supervision fee: Because of the need for long-term monitoring/supervision of the loan by the TU, an annual supervision fee would be charged to the MSME. Such fee, indirectly supports the concept/objective of MSMEs' associativity, which is part of this scheme's concept

Board Representation: When the loan package includes particular features (broadly equivalent to quasi equity), it is contemplated that arrangements will be made for a TU member (or his representative) to attend MSME Boards as an observer. Aside customary lending prudence, this approach would support MSMEs in their maturation and growth.

THE SCHEME'S BENEFITS

The scheme would provide attractive benefits to all parties, thus increasing chances of long-term sustainability, as outlined below:

For the Salvadorian Bank:

- Mostly Short term lending: The banks' current/preferred practice today, but with an expectation that over time banks will be enticed into less traditional financing.

- Good profitability: Banks can use their own cheap sources (deposits) of funding to maximize return

- Mitigated risk from (i) a more comprehensive financial package addressing both ST and LT needs and thus ensuring better chance of success for the business (ii) access to guarantee (iii) indirect umbrella, by being associated with international lenders.

- Long-term client monitoring: TU support with loan supervision and client relationship, leading to potential repeat business with same bank.

For the Fiduciario:

- Lucrative service business with no risk

- New additional business: Exposes the bank to potential MSME deals, giving the fiduciario bank an opportunity to participate in loan packages, if it wishes

For the "Fund Implementers":

- Fulfills sponsors' objectives for adequate access to financing by MSMEs, long term sustainability and fostering interest of the banks towards LT lending to MSMEs.

- Normative functions and operations control/monitoring from IFI lenders provided by TU

- Financing processing outsourced to an existing institution, with opportunity to impose norms/procedures in line with IFIs requirements and train FPC staff accordingly

- Separation of the credit activity from the treasury/funds management function.

- Fideicomiso provides needed flexibility vis a vis restrictions of the Superintendencia de Bancos, while service function can be put for open bidding to banks.

ANNEX III

TERM SHEET - SME FUND FOR EXPORTING MSMES

	FUND RATIONALE /OBJECTIVE
	Establish an efficient mechanism/vehicle to deliver finance and technical assistance to export-oriented Salvadorian SMEs, in a commercially sustainable manner, while generating an acceptable return to the Fund Investors. The Fund is to overcome the recognized deficiency of financing to MSME sector (not micros, i.e. businesses with 5-100 employees & annual sales below $4.6 million), due to Restricted access; only short term finance; lack of collateral for exacting mortgage requirements, excluded equipment pledge ...etc The Fund is to overcome such obstacles largely by structuring most investments as self-liquidating quasi-equity instruments, while also providing integrated Technical Assistance (T.A) support to promote MSME growth and development. As a further objective it is hoped/expected that the Fund will contribute to the evolution of the banking culture in El Salvador, from asset-based to cash flow based financing and will expand Salvadoran MSMEs' exports and access benefits provided under Free Trade Agreement with US.
	THE FUND
Amount	US$12 million
Currency	US Dollars
Funding	Public- Private Partnership through a mix of debt and equity funding, suggested as follows: $5 million BMI loan: 8-10 year loan with up to 4 year grace period at BMI's premium rate (% interbank-rate); loan is senior to equity. $7 million equity from private and institutional investors in El Salvador (pension fund, wealthy investors) and foreign International Financial Institutions (KfW, Norfund, MIF...etc...)
Closing	Permissible with commitments totaling $12 million, and subject to typical/usual conditions regarding execution of Fund documents, satisfactory legal opinions, obtaining all necessary registrations, licenses, approvals...
Term of the Fund	Eight years from Closing, with option to extend for up to two additional one-year periods at the discretion of investors.
Investment period	Four years from date of Closing, after which investors will be released from any further obligations for capital contributions (except Fund expenses incl. management fees, and funding transactions approved before end of investment period)

Minimum Investment	$500,000
Capital Contributions	Drawn down as needed during the Investment period, in pro-rata fashion between loan and equity contributions
Technical Assistance to MSMEs (TA)	A "mandatory' feature, for any MSME receiving financing from the fund. Operated as a "Facility", alongside the Fund. TA is to be coordinated by - and integrated in - USAID/EXPRO's program. Such assistance to include USAID/EXPRO's typical export promotion/support activities, but also assistance /mentoring in areas such as: assistance/preparation of business plan and marketing plan, creation/improvement of accounting and management information system and set up of financial controls/procedures, legal assistance for formation and reorganization .etc. (USAID/EXPRO to play lead role, supplemented by other service providers as appropriate).
TA Funding	Contemplated from three sources: USAID/EXPRO's own budget Fee charged to beneficiary MSME, to be paid by MSME in installments over a 2-3 year period Grant funding obtained from foreign donors.
Fund Management (FM)	A specific Management Company (the Fund Manager) to be established in El Salvador. Alternatives for ownership/organization include: An offshoot of BMI/SGR, a subsidiary of BMI, a JV between BMI and the Foreign Advisor, a subsidiary of the Foreign Advisor.
FM Staffing	A team of 3-4 professional staff including a high caliber Chief Investment officer (CIO), seconded by 2 to 3 investment officers. Progressive staffing build-up with only the CIO position filled up at initial stage.
Foreign Advisor (FA)	A firm with expertise and proven track record in the management of equity funds, with relevant experience/know-how with SME finance. Could include a firm such as Shorebank, Business partners, Aureos, SEAF. FA's role for the Fund could include all or part of the following: (i) help in designing, setting up and funding the Fund (ii) managing the Fund (iii) providing staff and systems/procedures training and long-term technical assistance
Investment Committee (IC)	Suggested to comprise three members: The Fund's CIO, a representative of the Foreign Advisor and a representative of the "lead" equity investor. The IC will operate by telephone or by physical meetings; decisions taken by simple majority.
Advisory Board (AB)	Advisory Board to comprise representatives of the lender (BMI) and of the equity investors. AB to meet at least once a year, or as called, with tasks including: review of the Fund's commitments and cash position, review of distributions; review of the Fund's activities, strategy, performance, prospects and setting policy guidance; review significant changes in Fund manager's staffing; review annual audited statements…etc… Members of the AB will be responsible for their own travel and out of

	pocket expenses involved to attend AB meetings.
Management Fee	Suggested between 3% and 5% per annum of the total commitments to the Fund, throughout the life of the Fund
Expenses	The Fund will bear (i) all third-party transaction costs related to purchase, holding or sale of portfolio investments and (ii) all third party costs related to day to day administration of the Fund (incl. auditor fees, registration/filing, legal expenses for normal operations) The Fund Manager will bear all other expenses of the Fund, including salaries of all personnel, all travel, communication and office expenses and all fees/expenses incurred for due diligence of potential investments and for monitoring of realized investments.
Organizational Expenses	Organizational expenses and legal costs associated with the establishment of the Fund to be borne by investors in the Fund (pro- rata between loan and equity investors)
Distributions	Distributions to equity investors to be made only after the end of the Investment Period. Amounts available for distributions - after servicing principal and interest on the BMI loan - to be distributed as follows: (i) 100% to investors in an amount equal to their capital contribution, including the Fund's fees and expenses (ii) 100% to investors, until investors have received a preferred return equal to 5% per annum, compounded annually (iii) 100% to the Fund Manager, until he has received 25% of the distributions made to investors under (ii) (iv) Thereafter, out of any remaining amount, 80% to the investors and 20% to the Fund manager
Legal Counsel	To be designated
Auditors	To be designated
	MSME FINANCING
Investment Policies/ Beneficiaries	Beneficiaries: Exporting MSMEs, or MSMEs with clearly demonstrated export potential; Preference for established MSMEs with expansion projects MSME activity/sector and operations to satisfy a number of criteria (TBD) regarding prohibited activities, environmental and social guidelines, and no speculative investment activities (commodity contracts, forward currency contracts...etc.) No more than 20% of committed capital of the Fund to be invested in a single industrial sector Investment in a single portfolio company not to exceed 10% of the committed capital of the Fund
MSME Financing	Amount: Except under special circumstances, target investment size from \$75, 000 to \$250,000 per deal Investment products: A broad range of products, tailored to match each

	particular MSME need/circumstance and including (but mot limited to:: (i) Straight equity investment -with appropriate exit arrangements – (expected to represent 10%-15% of the Fund's total commitments) (ii) Hybrid equity/debt financing, with many possible different formats, for instance (this financing expected to represent 70%-80% of the Fund's commitments): Equity for about 20% of the total financing; pre-established exit arrangement based on an EBITDA multiple valuation or on compounded US$ return, or multiple of purchase price. Shareholder loan for about 80% of the total financing. Typically a 5-year loan (with 1 year grace) with low interest rate (prime minus XX%), plus kicker in the form of income or royalty participation. If/when available loan secured with partial collateral. (iii) Quasi Equity for 100% of the financing, in the form of a subordinated loan at low interest rate, with return kickers that could include part or all of the following; income participation, royalty on sales and some equity capital (this financing expected to represent 10%-20% of the Fund's commitments). If/when available loan secured with partial collateral. Application of funding: Working capital; pre-export financing including purchase orders financing and factoring; investment project (plant, equipment..), with preference for expansion projects; some refinancing of existing debt, not to exceed 25% of total financing Security/Escrow account: While financing will be based on cash flow parameters rather than collateral parameters, if and as available security may include partial collateral on fixed assets or through (partial) first demand guarantee (from GyS or others). In addition, barring particular circumstances, an escrow account will be set up for each transaction in order to collect/monitor the MSMEs' export proceeds. Technical Assistance: Integrated and mandatory in the Fund's concept, with the expectation for the client to pay all or part of such assistance. TA to provide both supervision of financing and support/mentoring to foster MSME growth. Other features: For deals with equity investment, the Fund will require to have a seat on the MSME's Board; for quasi equity deals, requirement of an observer position on the MSME Board.