Executive Summary

Argidius Foundation

EVALUATION OF THE VARIABLE PAYMENT OBLIGATION (VPO) TRUST PROGRAMME: *A Developmental Evaluation*

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Submitted by Itad

Results in development

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Introduction to this evaluation

This independent evaluation was commissioned by the Argidius Foundation (AF) in cooperation with Enclude Ltd, the programme manager, to assess progress and performance to date of the Variable Payment Obligation Programme (VPOP) which aims to support Latin American (LAC) Small and Growing Businesses (SGBs) to grow and expand while becoming sustainable and competitive in the markets they operate. The evaluation covers VPOP activities from inception until end November 2017. This corresponds to Phase 1 of the programme – a pilot phase designed to test the concept in Nicaragua. The evaluation has a primary focus on learning, given the maturity and status of implementation of the programme.

Context: The VPO Programme

The VPOP, established in 2015, is an innovative market driven initiative that aims to address the lack of access to formal financing by SGBs which are asset-constrained. The programme was officially launched in April 2016 in Nicaragua with: Enclude as the main contractor, and responsible for technical assistance for the loan product; Agora as the Enterprise Growth Services (EGS) delivery partner; the Miller Centre of the University of Santa Clara as an advisor for the loan product and the third party funding mechanism; and Banco de América Central (BAC) as the Local Bank Partner (LBP). The VPOP provides cash flow-based financing, alongside Enterprise Growth Services (EGS) to SGBs with ambition to grow and help them with access to right-fit finance, and to increase their skills and knowledge to that end. The financing is channelled through BAC. The VPOP seeks to demonstrate that bundling an appropriate credit product with adequate EGS, can lower the borrower's risk of default and increase the loan's impact on the business' growth in a financially sustainable manner, and aims to showcase that banks can offer financing based on cash flow rather than collateral.

Key Evaluation Findings

What is the nature and scope of enterprises selected by the VPO Program for support, and how does the VPO Program select enterprises?

The target market for the VPOP is wide and diverse which has resulted in a portfolio of SGBs that is varied in terms of entrepreneurial capacity and business development stage. The VPOP has agreed terms with 10 SGBs for a VPO loan and Enterprises Growth Services (EGS). All beneficiary SGBs are local female owned. Seven out of 10 of the SGBs supported are in the agro-industry sector, two in textiles, and one in education. SGB annual revenues pre-VPOP range between US$70,000 and US$220,000, with employees numbering between seven and 20 full-time equivalent (FTE) (mean = 11 and median = 11). Of these 10, five are *'high venture'* SGBs, who might only be sometimes asset constrained with annual revenues above US$150,000 and clear capacity to grow; three are *'in progress'*, who are asset constrained with annual revenues between US$100,000 and US$150,000, and capacity to grow with support; and two are *'early stage',* who are asset constrained with annual revenues below US$100,000 and have capacity to grow with intensive support.

Agora has been the main driver for creating the pipeline of SGBs. Although its main strategy to source new potential clients has been to leverage on partnerships with other EGS providers such as Thriive and TechnoServe (70% of beneficiary SGBs). Agora has also been proactive in identifying alternative channels, such as other existing business relationships. The 10 SGBs with a loan approved were selected according to the following process: (1) Agora interviewed over 65 potential beneficiary SGBs in Managua, Somoto, Masaya and other locations (either face to face or via a conference call); (2) for those SGBs that passed the initial screening set up by Agora, a credit bureau check followed. Of the 65 companies, 42 SGBs passed the credit bureau check; (3) BAC and Agora visited 36 of those SGBs. For 28% (or 10) of these visited companies, a loan application was submitted by the loan officer and signed off by the SME business head, then submitted to the Bank's Credit Committee. 100% of the submitted applications were approved by the committee.

Beneficiary SGBs so far, fit with key target market selection criteria – SGBs that are asset constrained and have potential for growth.

What are the key bottlenecks/ growth opportunities facing enterprises that are selected, and how do these vary by enterprise and other types?

The evaluation's findings support the notion that access to financing with adequate terms and conditions is the most pressing constraint for aspiring SGBs in Nicaragua. Access to financing is severely hindered by the lack of strong collateral, complex paperwork requirements, and financial institutions' general unease with lending to this sector. SGBs receive limited support from the Government of Nicaragua whose priorities are more oriented towards benefiting larger corporations.

From the perspective of BAC, the appeal of lending to the SGB market segment is limited by a number of factors including: (1) Market context and environment: **Legal framework** for SGBs is out of date and perceived as unclear; **Tax system** does not create incentives for SGBs to grow; (2) SGB-specific: **Higher risks** associated with making loans to SGBs, linked to l**imited repayment culture** by SGBs – trigged by the Government of Nicaragua when in 2008 it encouraged MSMEs to default on their debt obligations to the microfinanciers, and **deficient or lack of sound accounting systems** by SGBs that hinders banks' ability to undertake due diligence.

From the perspective of the SGBs, a range of bottlenecks concerning access to financing in addition to those cited from BAC include: (1) Market context and environment: **Legal barriers to accessing collateral** (such as, personal or business, property and land) limiting SGB access to attractive lending rates; (2) Finance provider-specific: **Lack of flexibility** for repayments under working capital constraints; **Cultural barriers** such as lack of mutual trust by the financial sector and SGBs; and (3) SGB-specific: **Lack of knowledge** by SGBs about financial service providers and products offered.

SGBs mentioned other **non-financial issues** which are constraining their growth ambitions, specifically: (1) Market context and environment: Limited **access to sector relevant information and connections** to increase their customer offer – i.e. market studies; **High transactions costs** when exporting goods out of the country; **Unfair competition** from the informal sector—as they do not have any official obligations – i.e. payment of taxes; and (2) SGB-specific: Difficulty to **attract skilled personnel** by SGBs – given limited remuneration packages they can offer.

The extent to which the SGBs' growth ambitions are inhibited vary according to their entrepreneurial capacity and business development stage, i.e. whether they are 'high venture', 'in-progress' or 'early stage'.

What is the nature, scope, and costs of the support provided by the VPO Program to these enterprises and how aligned are these with the bottlenecks and opportunities?

The cashflow-based debt finance product expected limited collateral requirements (i.e. guarantors and pledge over assets). Other main general features of the loan are: **Value:** between US$12,500 and US$50,000 (minimum of 25% of SGB annual sales); **Purpose:** capital expenditure (capex) around 80% and working capital around 20%; **Term:** 5 years; **Terms and Conditions, interest rate:** scalable; from 12% during the first two years, annually increasing by 2% until year 5 – to incentive early repayment of the loan; **Terms and Conditions, disbursement fee:** 1.25%; EGS fee at disbursement (of capital amount): 4%; annual monitoring and evaluation fee (of outstanding amount): 1.75%.

EGS is designed to help the entrepreneurs better manage this capital infusion to their SGBs, to provide support in loan monitoring and to increase skills and knowledge of the SGBs. These EGS are arranged flexibly, selecting from eight modules, which are delivered via a group or class approach and/or through individual one-to-one sessions, responding to the stated needs of the selected SGBs. Modules comprise Cash flow; Accounting;

Marketing; Sales; Strategy and Key Performance Indicators (KPIs); Quality; Productivity; and Communications and Negotiations skills. To date, EGS modules Strategy and KPIs, Communication and Negotiation Skills, Productivity, and Quality have not been delivered or only delivered to one or two SGBs.

The cost of EGS services delivered by Agora totals US$177,661. Comparing this cost of delivery with revenues collected (US$10,285), observe that costs outweigh revenues by a large extent. Since inception, 29% of the costs has been allocated to pipeline development and appraisal of loan application, and 22% has been allocated to module development and design. These costs will be decreasing during 2018, as pipeline efforts are taken over by BAC and module design will be mostly completed, while costs allocated to BDS delivery will increase.

Current services provided by the VPOP – particularly financing – overall, address the most pressing needs of the SGBs. **The cashflow-based debt finance product** enables SGBs to access sufficient finance with adequate terms and conditions, enabling them to undertake their priority investments and working capital against their business plans. Crucially for SGBs, the debt servicing (interest and principal repayment) is based on cash flow generated during the preceding month – so SGBs can adjust repayments according to their revenue fluctuations. Additionally there is no need to provide a mortgage-based collateral to secure the financing, which is significant to most of the SGBs who are asset constrained, with a few unwilling to put up their property as collateral.

EGS are generally seen as complementary to financing and are meeting the needs of the beneficiary SGBs, helping to facilitate the achievement of their business and investment plans. The relevance, level and type of EGS very much depends on the stage of development of the SGB: *Less mature SGBs* acknowledge the demand for EGS services provided by the programme structured in modules, providing basic information on cash flow, accounting, sales and marketing. *More mature SGBs* (that have already benefited from other EGS initiatives in Nicaragua) demand flexible EGS that are tailor-made to their sector and market, as well as practical support in accessing and negotiating with potential clients.

Regarding the sustainability of services, the pilot has demonstrated that there is demand for the VPO product, and although it has higher transaction costs than an average SME or corporate loan, it is a profitable business for BAC. In addition, the VPO product is contributing towards supporting the bank in tapping an SME sub-segment of the market – SGBs with strong potential to grow but that still do not have a reference bank. At present the delivery of EGS is not profitable for the VPOP, and hence not on course to be financially sustainable. Given the varying levels of maturity and capacity of beneficiary SGBs, Agora has not been able to follow the standardised EGS delivery approach as planned but has incurred additional costs to adapt the model to the demand, capacity and skills of each beneficiary SGB.

The bank is in the process of mainstreaming the VPO product with a view to continue to target a commercially viable SME sub-segment and exploit product cross-selling opportunities. Since BAC started advertising the product on its website a few months ago, 10 requests for information about the VPOP have been received. Given the context in which the product has been introduced, this suggests that there is indeed demand for the VPOP in Nicaragua – albeit the market is currently small.

Do the services provided by the VPO Program create value for enterprises? What evidence, quantitively as well as qualitatively, can the VPO Program and the enterprises point to supporting the notion that the VPO Program services make a difference for key performance indicators?

Effects from the VPOP observed and captured against KPIs should be considered as tentative, given effects are still emerging and small sample size. Specifically:

Changes in SGBs business and management practices: the seven SGBs claimed that EGS delivered through the programme has contributed to reinforced marketing processes; and a high proportion of SGBs believe that the VPOP has helped them improve their accounting and financial processes.

Changes in SGB performance: 86% of SGBs report that their operational efficiency has improved; 86% of SGBs also claim that they have improved the quality of their products as a result of the programme.

Changes in financial performance and employment: Overall, the results of the analysis of company performance are mixed – some have increased and some have decreased, and at this point, change in financial performance for the seven SGBs in the sample cannot be attributed solely to the VPOP. Overall in the sample of seven, there has been a 16% increase in revenue, 15% increase in profits, and 27% increase in employment (from 81 to 103 staff). For the other three SGBs that joined the VPOP recently, it is too early to tell.

The additionality of the programme is broadly driven by: (i) the novelty of the product and approach, including packaging of products and services; and (ii) the reach of the programme to asset constrained SGBs. Overall, the **VPOP financing product itself is additional**, both in terms of innovation and reach. Most interviewed SGBs mentioned that without the VPOP financing product they would have financed growth organically using the company profits or personal loans, without seeking alternative sources of financing – thus growing and expanding at a slower pace. **SGBs in Nicaragua have access to a range of free or heavily subsidised EGS offered by governmental and non-governmental organisations**. Against this context, **it could be questioned whether the EGS provided by the programme, as originally designed, is additional for more mature SGBs** that have previously joined capacity building activities with support from public and private institutions, and/or have already established financial and accounting systems. This **is a complex question**, as companies need to constantly engage in continuous learning to evolve, and in some instances, some level of repetition is part of consolidating previously learning acquired. Moreover, to assess additionality stages, types, modes, mediums, and other dynamics at play during the EGS, delivery should be assessed. Agora is deviating from the initial EGS programme to adapt and ensure that the services it provides to mature SGBs are valuable and contribute to enhance their performance.

Albeit there are few **non-governmental organisations** in Nicaragua that offer a combination of financing plus EGS – Thriive and BPN Foundation – these seem to be catering for the needs of early stage SGBs that are committed to grow, but still need to 'get the basic institutional and operational arrangements in order'. **In comparison, the VPOP, perceived as a combination of financing plus EGS, becomes more additional to more established SGBs.** It remains to be seen how this fund – that at present has attracted US$350,000 in financing from investors – will influence the additionality of VPOP.

What is the willingness of enterprises to pay for these types of services in the future?

The VPO credit product is perceived as a commercially viable product by the bank. Interviews with BAC representatives confirmed that the VPO product has begun to contribute towards the profitability of BAC. Even if at a marginal level, the bank is now able to forecast what to expect in terms of portfolio growth for the new product according to realistic scenarios of number of actual borrowers, and their repayment speed in relation to the growing interest rates set up in the VPO loan. In addition, the bank sees the potential the VPO product offers to tap the SME sector, a niche market where there are interesting product cross-selling opportunities.

The VPOP as a vehicle to educate SGBs on EGS as a value-added service is perceived as worth paying for and hence contributing towards the sustainability of the EGS ecosystem**.** Some VPOP target SGBs have already gone through several free-of-charge capacity building initiatives, and when these SGBs start receiving VPOP EGS, they stated that they value those charged-for services, provided they are fit-for-purpose. However, some beneficiary SGBs are not aware of how much they pay for EGS. The ET recognises that this a long-term process and EGS providers will need support from donors in the short term to operate.

Conclusions

The pilot has proven that the VPOP business model is valid – proof of concept has been achieved – and products and services provided to SGBs are **overall additional to the Nicaragua market**. It is still too early to reliably assess effects of the pilot on beneficiary SGBs and on delivery partners, however some positive intended effects are starting to emerge in line with the ToC, and some additional unintended positive effects are emerging, along with a few negative. However, changes in financial performance for the seven SGBs in the sample cannot be attributed only to the VPOP as there are other contextual and operating factors contributing to these results. The sustainability of the programme in Nicaragua will be contingent on Enclude, Agora and BAC more effectively institutionalising the programme, formalising governance and management arrangements, successfully scaling-up into an additional country, and incorporating lessons learned from the pilot.

Recommendations to the VPO Programme and the sector

Our Recommendations are intended to facilitate the VPOP to transition from a pilot project in Nicaragua to a regional programme in Central/Latin America region, and to support learning in the sector recommendations. Specifically we recommend:

Targeting of Enterprises

1. Promote a gender-forward approach so non-female led SGBs that fit the VPOP profile can also benefit from the programme contributing towards achieving programme objectives;
2. Prepare communications materials describing the main features and achievements of the VPOP, as well as the role of each partner and include in screening and due diligence process, and promote the VPOP through a well-respected non-governmental organisation;

Technical Services Provision

3. Modify loan origination, by:
    - Ensuring that potential SGB applicants fully understand the terms and conditions of VPO services during the application process – including the fees to pay towards EGS;
    - Updating and standardising the investment plan template, setting clear limits for capex and working capital;
4. Modify the VPO Financial Product, by:
    - Introducing a credit repayment grace period (three months) for SGBs that will be: i) acquiring and importing equipment to Nicaragua or/and ii) refurbishing the production plant to accommodate new equipment with VPOP support;
    - Continuing to ease the asset pledge to capable SGBs;
    - Designing and applying a credit scorecard that reflects the profile of the VPOP target market;
    - Supporting beneficiary SGBs (in-progress or HV) that are performing above the average in terms of: i) loan repayment and; ii) effectively absorbing the capacity building obtained through the EGS with working capital financing;
    - Increasing flexibility and allowing to go beyond the current maximum ratio of revenues to loan value (25%) when the potential borrower is a consolidated SGB with efficient processes and procedures, has a sound investment plan and is financially sound;
5. Modify Provision of EGS services, by:
    - Formalising the provision of EGS with the beneficiary SGB from a MoU to Service Level Agreement (SLA). The MoU currently signed is insufficient and does not define the relationship, rights and obligations of each party;

- For early stage or in progress SGBs, before they can start the loan application process and benefit from financing, they should provide Agora with a business plan;
- Updating the pre-credit report that goes to the credit committee by adding more quantitative analysis on growth expectations by applicant SGBs; and
- Adapting EGS delivery offer to SGBs based on the stage of their development and absorption capacity (early stage, in progress or HV).

Scalability

6. Ensure sufficient resources are available and allocated to allow for effective programme replication/scale up;
7. Avoid launching the programme before the institutional arrangements, operational processes and procedures had been designed and tested;
8. Build on the successful trust-based VPOP working relationship and formalise for scale up;

Partnership selection and partnership structure

9. Clearly define actual roles and responsibilities of each delivery partner based on their capacity, reflected in a regularly updated VPOP Manual;
10. Before engaging investors, define how to integrate them into the VPOP. Charging third party investors with fees to invest their money in the VPOP is an unnecessary barrier. Sharing risks and increasing investable resources into the VPOP could be crucial to boosting the growth of the selected SGBs; and
11. To encourage effective learning uptake, establish a knowledge and information system so lessons learned can be taken across VPOP countries.