Swisscontact: The Business Centre Approach in Indonesia and the Philippines
by Rob Hitchins and Alan Gibson, Rio, March 1999

1. INTRODUCTION

Swisscontact (SC) is a Swiss-based NGO working in 18 countries in Asia, Africa, Latin America and Central and Eastern Europe. It designs and implements programmes in three priority fields: vocational education, urban ecology and small enterprise development. The last of these has assumed greater importance in recent years as SC has grown to regard small enterprises as central both to wider economic development and to efforts to improve vocational skills and the environment.

SC's analysis of business development services (BDS) has emerged from this greater commitment to small enterprise development. It originated in its programmes in Peru and Ecuador and from a BDS environment characterised by:

- an inadequate *offer* from BDS suppliers - often being irrelevant and inefficient - and weak demand for BDS from SMEs, usually supported by non-sustainable subsidies from government or donors;

- as a consequence of these two factors - on the supply and demand-side - a poorly functioning BDS market; and

- prevailing support for BDS from government and donors which did not address this the supply-demand inconsistency, and often seemed to strengthen it.

Supported by the Swiss Agency for Development and Cooperation (SDC), SC's response to the above situation has been to develop the business centre approach. In essence, this seeks to use an incentive-based form of support to encourage the development of effective and sustainable, demand-led suppliers of BDS to SMEs. Specifically, by intervening at the meso level, it tries to create sustainable, functioning BDS markets (Box 1 outlines the underpinning rationale for the approach).

Learning from the experience in Latin America in the mid-1990s, SC first began to develop a business centre approach in Indonesia and the Philippines in 1996-97. The programme in Indonesia is focused on Java and by mid-1998 covered eight business centres (at various stages of development); in the Philippines, eight business centres are spread throughout five regions. Table 1 offers a brief outline of each of these.

This case study examines the business centre experience of SC in Indonesia and the Philippines against the preliminary framework of good practice principles agreed by the Committee of Donor Agencies for Small Enterprise Development (1). It describes the approach in detail, especially in Indonesia where it is more developed (and where the experience of three business centres are explored in some depth), but the primary focus is on the issues emerging from the business centre experience which are of wider interest. Its main objective is to identify key lessons and principles of good practice in BDS and, where possible, benchmark performance indicators. The case is structured in nine parts, addressing respectively in Sections 2-8, services, clients, the market, financial viability, the funding mechanism, institutional development, and impact.

Finally, Section 9 outlines some conclusions and the implications for BDS more widely. Appendix I contains background information on the current economic context; Appendix II provides details of SC finance support to business centres; and Appendix III undertakes a more detailed analysis of performance in the three Indonesian business centres highlighted in the case.

Box 1: The business centre approach: the underpinning rationale

The context

The development of a vibrant SME sector requires an environment which provides them with effective, sustainable BDS. This does not usually exist in developing economies. BDS provision tends to be characterised by both its irrelevance to SMEs' reality and its weak long-term sustainability; i.e. the BDS market is not working

The problem

Poorly performing markets for BDS are caused by inadequate service *offers* from BDS suppliers and weak demand from SMEs. Moreover, most donor support for BDS provision has tended not to alleviate this supply-demand mismatch and indeed has often exacerbated the problem.

The principles

Swisscontact believe that:

- market relationships offer the best opportunity for sustainable and effective BDS;
- functioning markets can be stimulated by the development of more effective BDS institutions - the meso level;
- the best BDS suppliers are those which are closest to their clients and have a transactional, business-like relationship with them. BDS institutions therefore need to be entrepreneurial, demand-led and for-profit; and
- in order to encourage BDS suppliers to develop (in terms of their people, products and systems) in this way, donors themselves need to develop a business-like relationship with BDS suppliers.

The services

Swisscontact provides two types of support to BDS institutions (business centres). First and most important is financial support; this may come in a variety of forms but *must* be based on disbursement of funds (payment) against performance targets to provide an appropriate incentive for improvement and the basis for a transactional relationship. Second, and usually less important, is technical support, again in a variety of forms.

Figure 1: Key stages in the business centre process

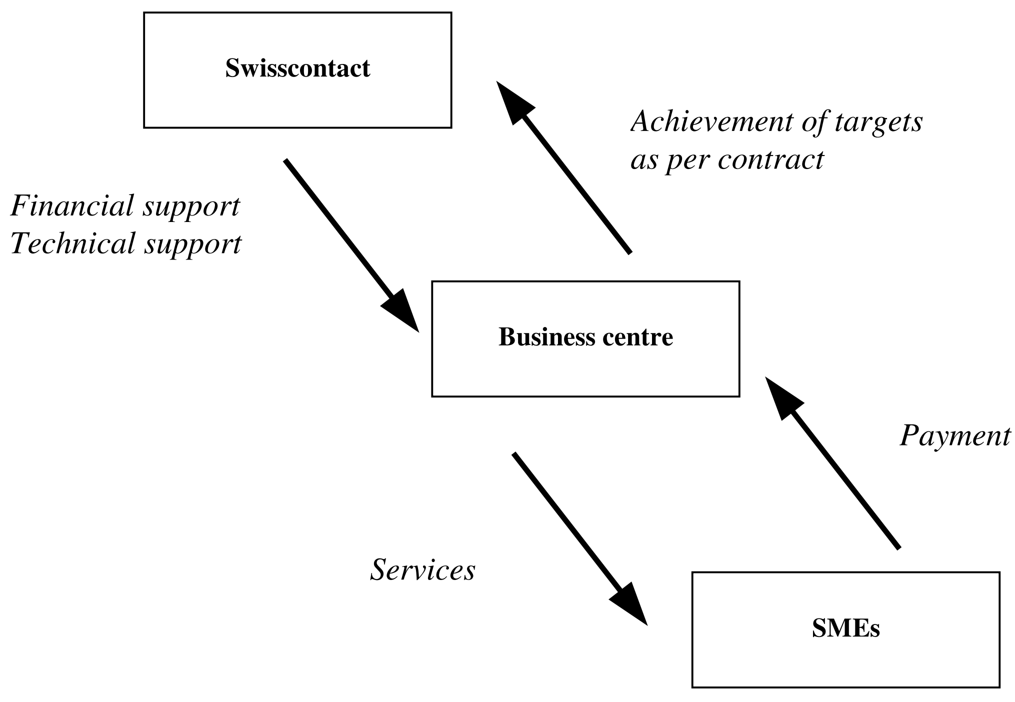

Table 1: Main business centres supported by SC in Indonesia and the Philippines

Name of business centre	Organisation type operating business centre	Main services	Outreach (approx.)
The Philippines			
Jewellery	Small-scale jewellery producers association	Retail outlet for members aimed at offering them higher prices	8-10
Palatan	Women's handicraft and woven products group	Retail outlet and bulk buying service for key inputs	33
IMAB-MPCI	Association of automotive workshop owners, with small to medium-sized businesses	Bulk buying service for main inputs and common service facilities with two machines	24
Fenema	Association of small metal working and engineering workshops	Material credit service plus retail outlet	45
Oro	Chamber of commerce and industry	Training, marketing fairs and "brokering"	200
Baguio SME	Chamber of commerce and industry	Training and office services	30
Timpuyog	Chamber of commerce and industry	Training and office services	25
Laguna	Chamber of commerce and industry	Business registration and training	50
Indonesia			
WPU Bandung	Formerly Swisscontact project office	Technical, management and administrative assistance, access to credit	Approximately 300 clients for project as a whole
Centrama	Formed from a large NGO supporting SME development	Management and administrative assistance, access to credit	
Karmacon	Formed from a private management consulting and accounting firm	Management and administrative assistance, access to credit	
WPU Malang	Formerly Swisscontact project office	Technical, management and administrative assistance, access to credit	
KOPISMA	Association for automotive component parts producing SMEs	Raw material purchase for members, marketing assistance	
Sentra (Y3PI)	Individual	Training services to tourism hospitality organisations	
Spektra	Former NGO	Brokering/market intermediation	
Produksi Bersih Benefita (PBB)	Former Swisscontact staff member specialising in ecologically-sound production processes in workshops	Consultancy for cleaner production and services	

2. SERVICES

Two levels of service[1] need to be distinguished in the business centre approach (as shown in Figure 1):

1. most important, services offered by SC to business centres through their intervention.

2. services offered by business centres to their SME clients.

[1] While it is not usual for intervening agencies to talk of what they do as "services", "products" or an "offer" these are appropriate terms here(and are used interchangeably); SC itself needs to play a business-like role for the business centre approach to be successful and has to perceive of its work in these terms.

2.1 Swisscontact services to business centres

SC support for the development of business centres is based on two related services: financial and technical support. The precise nature of this support varies between the Philippines and Indonesia and has also evolved through different stages of development. In some instances these have become relatively complex arrangements and it is not desirable to probe the minutiae of them here (Appendix II does provide more detail). However, in every case, the support has a number of key characteristics:

- <u>A contract-based relationship:</u> in Indonesia this is a detailed document, based on a business proposal by the business centre; in the Philippines this is a brief memorandum of understanding supplemented by an annually-agreed work plan.

- <u>Finance-based incentives:</u> this is the heart of the intervention. Criteria for incentives vary: in the Philippines, gross profit for specific products is used; in Indonesia, incentives have been offered at an institutional (rather than product) level, although this is now changing. In all cases to date, incentives are non-repayable grants.

- <u>Other financial support:</u> SC's offer may also involve support for initial investment and pre-operational costs, usually on a shared basis. Again, these are non-repayable grants.

- <u>Time-bound:</u> financial support is limited to a particular time period: 1-3 years in Indonesia; 3-5 years in the Philippines but with exit provisions if "the deal" is not working.

- <u>Financial limits:</u> this is an evolving picture and complicated by the different types of financial support offered. In the Philippines, the financial range is $4-15,000 per annum; in Indonesia, where different types of support and relationship have been developed, the range extends from £16,000 to $50,000 on an annualised basis.

- <u>Non-financial technical support:</u> this may take the form of, for example, skills training, new product ideas or "one-to-one" counselling support. Recent training in Indonesia includes business plan preparation, gender analysis, CEFE and in-house training for consultants. Payment is usually not required for these services.

Table 2 summarises the main characteristics of SC's offer to business centres in Indonesia and the Philippines. SC's experience is still relatively young[2] and continuous learning and development is given a high priority. Efforts to enhance effectiveness focus on how to become better at simulating the business-like relationship between SC and business centres. Indeed, especially in Indonesia, SC's learning objective is leading them to examine private sector models of business investment, such as venture capital companies. Among the key drivers of change in SC's offer appear to be the following:

1. <u>Ownership and commitment:</u> giving less and demanding more from business centre partners as signals of their commitment to the endeavour. This has implications for the scale (especially proportion of costs/investments covered) and method (more emphasis on incentives) of support. In particular, the sense of ownership of the

[2] Although in both countries Swisscontact arrived at the business centre approach through their experience of other types of intervention.

people running business centres (see Box 2) is likely to be strengthened if they have a direct financial stake in the organisation.

2. Partner selection: the nature of Swisscontact's offer and of its partner business centres are inherently related; partner selection (see section 7) and service offer need to be considered together. For example, selecting and developing business centres based on an existing capacity may allow reduced emphasis on technical support.

3. Time-scale: again related to the level of development of partner organisations, there is a dilemma here between ensuring that a relationship is of sufficient duration to *make a difference* and that it is not of such a length that the pressure to change is diluted and an insidious dependence takes over.

4. "Unnatural" funding flows: financial support for business centres is often "front-end loaded" when initial investment and operational cost support is given. This can create a relatively heavy overhead burden early in the business centre's life - perhaps earlier and bigger than would be normal in a commercial situation. Apart from reducing the scale of initial support, one idea being considered here to mitigate this problem is to deliver support in the form of equipment supplied on a leasing basis from SC.

Table 2: Core characteristics of the Swisscontact offer to business centres

	Indonesia			The Philippines	
Phase	**I**	**II**	**III**	**I**	**II**
Basis for financial support	Actual income	Targeted against actual income	Contribution margin	Gross profit	New scheme (not yet finalised)
Time period	2-3 years; 7 % quarterly increase in self-financing until 70% achieved	1-2 years	1-2 years	3 year agreements but commitment to five years support	Reducing time scales
Incentive-base	Self-financing ratio – revenue against expenditure, which has to increase 7% per quarter. Payments made against performance.	Actual self-financing ratio against target. Payments agreed in advance and disbursed if target achieved	Self-financing ratio is based on contribution of gross profit to overhead.	Gross profit on individual products - up to 100% offered	Similar to earlier system
Investment	2 business centres (WPUs) were part of original project. Transfer of project assets to new entities.	Matching investment between Swisscontact and operator up to $50,000 each.	Equipment supplied on a lease basis. Transferred to business centre based on performance	Matching investment (50:50 basis)	Similar to earlier system
Pre-operational support	Not relevant - pre-operational WPUs were Swisscontact	As part of investment	Working capital paid as cash advance	Up to 100% for first 6 months; reducing 25% in 6 month steps	Possibly reduced timescale
Technical support	Skills and product-specific training; one-to-one advice	Skills and product-specific training; one-to-one advice	Skills and product-specific training; one-to-one advice	Major emphasis: regular visits, study tours and joint-planning	Similar support within transactional framework
Total amount (approx. financial support only)	$17-23,000 per annum	$33-50,000 per annum	Not yet clear	$4-15,000 per annum (average of $12,000)	Possibly increasing average size

5. Improving technical support: this is generally outside the transactional rationale which underpins the financial arrangement; i.e. it is offered without anything in return. Without a clear transactional basis to the technical support relationship, confusion can arise over its real purpose (capacity-building against accountability). Ideas for change here include allocating business centres a particular amount of time for technical assistance and SC taking equity in business centres, thus giving their advice - as co-owners - greater business legitimacy.

6. Tightening the relationship: critical to the approach is the role of SC; it has to be business-like both in relation to its capacity and its orientation. This can be difficult because, although it is seeking to be *like* a business, it is not, of course, a business! In particular, the firmness to tightly enforce agreements, especially in a time of crisis, has not always been evident. Yet the logic of the approach compels them to be firm and practical.

Box 2: Key players in business centre ownership
Ownership is a critical issue in the business centre approach, not only in the legal sense but - as important - in the psychological sense of who *runs*, *believes* in and is *committed* to it. There are three main "players" with some claim to ownership.

Operator: SC enters into a contract with a second party - the operator - to form a business centre. Each party provides equal investment and a degree of on-going support. Operators are generally a larger organisation, such as a consulting firm or NGO, with experience in the field in which the business centre will operate. The operator is either the 100% owner or, in Indonesia, sometimes the co-owner with the business centre management.

Business centre management: business centre management is responsible for the running of the business centre. They are seen as a distinctive entity in Indonesia, less formally in the Philippines. In practice they usually do not make significant financial investments in the business centre although in one scheme, SC investment in the business centre is transferred to business centre management as their shareholding.

Swisscontact: as a foreign NGO, SC is not permitted to have a shareholding in the business centres, despite making significant investment; its contribution is effectively a grant. However the contractual relationship between SC and the operator gives SC a strong interest in the business centres' development.

2.2 Business centre services to SMEs

The business centre approach is neither service or sector specific[3]. Business centres offer services which they feel best fit within their core competency and meet clients' demand. SC does not seek to guide prescriptively the type of services which business centres offer; the primary focus is on the development of institutions which are responsive to demand and will thus offer services which emerge from the market.

Not surprisingly, therefore, business centres offer a broad range of services. In Indonesia, these increasingly fall within the categories of management training and consulting (Table 3). Originally, business centres offered more technical services in specific sectors. For example, one of the first business centres, WPU Bandung, offered technical consultancy services in the automotive and machine component sub-sector. However, their experience was that SMEs could access this knowledge at no charge from competitors, buyers, suppliers or trade associations. Generally, the constraint which business centres are targeting is related to management and administrative skills and systems, problems which become more acute as SMEs seek to develop.

In the Philippines, business centres fall in two categories: *business* and *trade* centres. The former delivers services similar to those in Indonesia - business services and training - but with a particular emphasis on market access services (such as trade exhibitions). Trade business centres are engaged primarily in retail, supply and hire services in particular sectors (such as jewellery, woven products and automotive workshops), often in direct competition with other commercial organisations.

Table 3: Sources of revenue in Indonesian business centres (%[4])

	WPU Bandung	Centrama	Karmacon
Technical training	6%		
Management training	3%	91%	8%
Consulting/access to credit	28%		92%
Other business activities	21%	5%	
Non-SME income	42%	4%	

[3] With the exception of trade business centres in the Philippines although there are questions here over the potentially distorting effect on markets.
[4] Represents payments for services directly from SMEs, indirectly via intermediary organisations and also non-SME related services, including those undertaken for SC.

One key test for business centres' responsiveness to demand is their product development behaviour. The Asian financial crisis in 1997-98 - which severely affected business centres in Indonesia - has concentrated efforts on generating revenue for survival, resulting in discernible change to product portfolios and selling approach: under pressure, business centres have innovated. For example, one business centre perceived a definite market opportunity to provide specific services to SMEs in "right-sizing" - assisting enterprises with inevitable restructuring and staff reduction programmes. More commonly (see Box 3), business centres have been drawn to larger organisations related to government who subsidise SME development services. Thus, motivated by the compelling need to survive and in a context of widespread intervention in the market, business centres may develop services and market relationships which are not directly with SMEs but rather via an intermediary institution. Whether this is an issue of concern is examined in Section 9.

Box 3: Selling via larger institutions in Indonesia
Centrama has moved away from the product portfolio envisaged in its original business plan. As yet they have not established a fixed new range of products and services, they are still in a 'survival-only' stage. However one of their conscious strategies has been to develop relationships with large institutions, particularly a major university in Surabaya, Institut Teknologi Sepuluh Nopember Surabaya (ITS). The rationale behind this new selling policy is that by providing a packet of workshop, training, and consultancy to ITS Centrama will:

- overcome the difficulties it has experienced in selling services direct to SMEs due to reduced "purchasing power"; ITS pays the full cost of services to Centrama but passes on less than 50% of these costs to participants;
- minimise the risk of preparing training material and promoting courses – the onus to 'fill' the training course lies with the institution; and
- reduce the cost of delivering training for the business centre, as ITS underwrites the cost of training facilities, refreshments and so on.

One of the purposes of technical assistance offered by Swisscontact is to assist business centres to develop new products. In the Philippines, SC have supported the development of management training materials by a specialist institution while in Indonesia SC support has allowed business centres access to "standard" products such as CEFE. Overall, however, it is business centres themselves who take the lead role in product development; SC's role is of secondary importance[5].

3. THE CLIENT BASE

The clear priority in the business centre approach is to create effective, demand-led and sustainable BDS providers, i.e. it is an approach to institutional development. It is assumed that in developing an effective and sustainable BDS provider, SC's support is reaching and benefiting SMEs. This is a critical assumption; namely that by supporting the supply-side (business centres) the demand-side (SMEs) will inevitably be assisted. What happens *beyond* the institution, therefore, is <u>not</u> the immediate focus of SC; generally there is little attempt to restrict activity to particular sectors or services.

However, while this is the overall position, clearly it is a simplification of reality. SC and its principal donor SDC are fundamentally concerned with the situation of SMEs

[5] In Peru, SC is pursuing a more systematic approach to product development and is seeking to establish "2nd tier" support institutions in the BDS "industry" who provide services to business centres. A key role in Peru is franchising training methodologies from abroad.

and the people that are affected by them (employees, households, consumers etc.). From a development perspective, business centres are principally a means to an end. In practice, SC does need to have an understanding of the kind of changes which are caused by its intervention.

3.1 Size

SC's target group of enterprises with whom business centres should work is defined in both Indonesia and the Philippines. In the former, it is businesses with a turnover of $50,000-$2m and 5-100 employees; in the Philippines it is businesses with assets of $5,000-$2m and 5-50 employees. In practice, this stipulation is not followed rigidly. Some business centres do work with start-up and micro businesses - especially the trade business centres in the Philippines and those business centres in both countries that have contracts with government or university institutions to deliver services to start-ups. However, the general client base is well above the micro level, reflecting these businesses' relatively greater:

- willingness to pay for services;
- capacity to make use of services; and
- complexity of operations (and therefore need for services).

3.2 Sector

As with services, there is no overall sector orientation in the client base. Clients of business centres include, for example, SMEs engaged in computer software, automotive repair and maintenance, jewellery manufacture, woven handicraft production, small-scale finance, timber, catering and component assembly.

3.3 Gender

Gender equity is a fundamental principle of SC and each programme aims to integrate this commitment into its work. In the Philippines for example, every business centre agreement has a small gender component financed fully by SC. However, in practice, the majority of SME clients of business centres are not owned by women. Indeed, since business centres deal (mainly) with existing businesses and most of these are owned by men, the preponderance of men-owned SMEs in business centres' client group is not surprising. How a gender commitment can manifest itself in a practical manner within the business centre approach remains a significant challenge for SC.

3.4 Poverty

Most SME clients of business centres are clearly beyond the poverty limit although their employees may be within it. However, SC argue that this kind of intervention does lead to poverty reduction since the development of a vibrant and competitive SME sector is crucial for economic development and employment creation.

3.5 Outreach

Detailed figures for numbers of SME clients reached are not collected systematically by business centres so there is some conjecture involved in estimating outreach. Moreover, great caution should be attached to outreach figures since the nature of contact may be very different depending on the service. For example, Oro Business centre in the Philippines undertakes short training programmes and organises trade fairs with significant number of SMEs. Karmacon business centre in Indonesia offers intensive consultancy services for a small number of more advanced and more medium-sized businesses. In the Philippines, client outreach figures per business centre range from more than 200 to less than 10. Notwithstanding the potentially misleading nature of these figures, it is valuable to have an *idea* of the scale of outreach from business centres. Best estimates for the Philippines are that around 400 SMEs are or have been clients of 8 business centres; in Indonesia, from 8 business centres, the equivalent figure is around 300 SMEs (although services here are more intensive).

4. THE MARKET

All business centres undertake market analyses as part of their original business plan. While the diversity of business centre activity outlined earlier warns against generalising over precise market conditions, two clear characteristics are in evidence: the influence of government and commercial competition.

4.1 The all-pervasive government influence

The influence of state and non-profit organisations is dominant for BDS services such as training, counselling and consulting. One manifestation of this presence is a skewed pricing structure in which most services are offered with very high subsidies, free or - in the most extreme cases in Indonesia - with incentive payments for attendance! A variety of government initiatives have been made to support SME development; for example, state owned enterprises have to form linkages with SMEs and contribute 1-5% of profits to SME development and the large-scale private sector are encouraged to follow a similar practice. Accompanying this official structure of support, an unhealthy culture and practice of corruption and largesse has arisen which taints the wider BDS market.

In the Philippines there is a longer history of enterprise development support and it is embedded strongly in government policy. Unfortunately, this commitment to SME development does not manifest itself in policy *clarity*. The focal points of government schemes are first, the Department of Trade and Industry (DTI) and, second, Small and Medium Enterprise Development (SMED) Councils in every province who are charged with playing a "facilitating and co-ordinating role in SME development". In reality, however, there is a bewildering array of schemes available (potentially) to SMEs, many of questionable efficacy and still less underpinning rationale. Amidst this confusion of activity, one trend is discernible, namely the gradual withdrawal of direct provision by government and its intention to work more with private BDS providers. Moreover, to add to this picture, as in Indonesia, donor agencies acting with or without government are active.

All of the above activity creates a distorted, "unnatural" market for BDS. Indeed, this is a defining feature of most business centres' market situation and one which they cannot ignore. Certainly for some business centres such as WPU Bandung the availability of free or cheap services is perceived as a serious competitive threat. For others (Karmacon), the preponderance of free activity offers an opportunity to market themselves as professional providers of high quality, relevant services at an appropriate price (in contrast to amateur, low quality, irrelevant subsidised providers). For others (especially in the Philippines) government supported schemes provides an opportunity for revenue at lower risk than when dealing with SMEs directly.

The complicated, "messy", distorted nature of the BDS market is therefore a reality for business centres which they need to confront. The experience to date shows that there are threats and opportunities emerging from this market which are influential in shaping the offer of business centres. Indeed, the original rationale for business centres, framed in terms of “free” sustainable markets, perhaps underestimated the extent to which newly-developed business centres would still have to work within a highly imperfect market place.

4.2 Commercial competition

In the Philippines, trade business centres, operated by small membership associations, are concerned mainly with providing services which are directly in competition with existing private sector players. For example, the jewellery association has set up a retail operation, Palatan weavers have a retail unit and a bulk buying service and the IMAB-MPCI operate a common machine service facility. In these cases, the competitive offer from business centres is often based on their closeness to their clients (their members), a price advantage (low margins) and highly favourable terms (generous credit). For other business centres, while private sector competition may exist, it is often oblique and a secondary concern to the influence of the government and/or donors. Some business centres in Indonesia, as part of their development of a portfolio of services, are also moving into activities which are also more directly competitive with commercial companies.

Market interventions by donors are, of course, always fraught with peril and - from a purist perspective - usually distort in some way! Abstract discussions of what is and is not a valid intervention to remedy market (or state) deficiencies can descend into a blur of detail. Nonetheless, it is important that business centres are justified in relation to an overall analysis of the market situation. The underlying logic of the approach is to try and commercialise business development services for SMEs which otherwise would be delivered ineffectively, supported by unsustainable subsidies; it is concerned with developing a working market in services for SMEs. Given this, it is not clear why business centres are being supported in markets which are, to a considerable degree, functioning[6].

5. FINANCIAL VIABILITY

The guiding rationale of the business centre approach is that, through developing an appropriate relationship between donor and business centre, an institution will be developed which offers services which SMEs demand. Financial information is at the heart of the business centre approach providing a window on:

- business centres’ performance in relation to these service and institutional objectives; and
- a *proxy* indicator of the impact they are having on their clients.

Both in Indonesia and the Philippines, a strong emphasis is placed on transparent financial reporting. In Indonesia, each business centre is required to submit standardised monthly financial statements; similarly in the Philippines, monthly statements are required, supplemented by quarterly audits and more detailed bi-annual reports by an independent accountant. However, since the nature of the financial relationship is different in each country, the reporting information is also different. In particular, in Indonesia, there is no requirement that direct costs of service provision is reported nor does SC impose any system of internal controls. It is the aggregate picture which is of interest; business centres, it is assumed, make rational choices regarding the optimal allocation of inputs and the pricing of products in order to achieve these aggregate

[6] Indeed, the SC experience in Peru warns specifically against supporting services of this kind.

financial targets. In the Philippines, more detailed information is required because the financial agreement based on much more than a broad, aggregate picture. For both countries, however, financial viability is ultimately concerned with the inter-related components of services and institution.

5.1 Services

In the Philippines, financial incentives are offered against records of gross profit for key services; it is therefore important that prices at least cover direct costs. Gross profit margins vary between business centres and products; marketing trade fairs at the Oro business centre have a margin of 300-400%; the common service facility offered by IMAB-MPCI makes less than 20%. Salary costs are all treated as overheads and indeed overheads tend to account for more than half of all costs. Certainly, in many instances, are not sufficient to cover overheads.

In Indonesia, while all business centres have developed business plans that provide information about the input and delivery costs of most products, they do not maintain product-specific cost centres or comprehensive input records. On an operational basis, business centres often seem to have a 'rule of thumb' for the breakeven price of their products. All business centres are committed to charging fees for services and at the very least appear to be charging direct-cost covering prices. As with the Philippines, it is less clear that pricing takes account of the overhead cost burden although, as self-financing targets become more demanding, this should happen.

5.2 Institution
The core, bottom-line indicator of business centre performance is financial sustainability[7]. Business centre performance by this criterion is summarised in Table 4 (Appendix III gives a more detailed financial analysis of business centres in Indonesia). It is clear that around half the business centres are in considerable financial difficulty and the other half are showing signs of progressing towards higher sustainability. Centrama in Indonesia has suffered from the effects of the prevailing financial crisis and has failed to achieve targets for several months (35% self-financing against a target of 70% - 80%). In the Philippines, in Timpuyog, Jewellery and Baguio SME there is very little activity; in IMAB-MPCI and Fenema real revenue collection from members is far behind the reported value - and there are serious cash flow problems.

The two most successful business centres according to these figures are Palatan and Karmacon - organisations at polar extremes in the business centre spectrum. The former stems from a semi-voluntary (and therefore with low overheads) women's group of weavers and handicraft producers supported to set up their own retail unit and bulk buying operation; it is the bulk buying operation - made possible by SC provided capital - which is the key to their success. Karmacon, in contrast, springs from a large consultancy group, supported to develop a specialised unit to provide services to a smaller set of clients than they previously addressed but who, nonetheless, have considerable purchasing power; per client, Karmacon generates $295, four times more than WPU Bandung and 20 times greater than Centrama.

Table 4: Financial sustainability performance of business centres[8]

Business Centre	% financial sustainability*
Indonesia	
WPU Bandung	45
Centrama	35
Karmacon	125
Philippines	
Jewellery	15
Palatan	150
Fenema	35
IMAB-MPCI	80
Baguio SME	20
Timpuyog	10
Oro	60
Laguna	45

* (most recent approx. figures)

6. FUNDING MECHANISM

The SC business centre programme in Indonesia is supported entirely by SDC and was established in October 1996. The initial phase will finish in December 1998. The business centre component is part of a broader based project comprising components for

[7] The definition of this indicator is varies slightly; in the Philippines it is gross profit against overheads; in Indonesia it has been income against total expenditure but now is similar to the Philippines.
[8] Calculated using the most recent figures for the Philippines (mainly first quarter 1998 data) and the average figure in the first five months of 1998 for Indonesia; Indonesian figures are given only for three business centres.

enterprise development, professional and vocational training and environment protection. The budget for the business centre component is \$ 530,000 out of a project total of \$ 1.71m; approximately 30% of total project budget. Including its share of management costs, the business centre programme accounts for approximately \$590,000 over three years.

The programme in the Philippines is supported principally by SDC with a smaller proportion coming from other sources. Its current phase of funding is also finishing at the end of 1998. The proportion of the budget allocated to business centres has grown since 1996; in 1998 it accounted for around 45% of the budget and including its share of management costs this was equivalent to approximately \$280,000.

7. INSTITUTIONAL ANALYSIS

The business centre approach is not only concerned with the development of financially sustainable meso level BDS providers but with their broader institutional development; with the development of the skills, knowledge, systems and linkages which will permit business centres to be sustainable in the long-term. To some extent, business centres' record on financial sustainability (Table 4) is an indication of their degree of institutional development and in the long-term it could be argued that all institutional development factors are subsumed within this indicator. However, it is important that those specific aspects of institutional development which appear to impinge on performance are identified. For business centres, four aspects of institutional development are relevant: ownership, capacity, systems and linkages[9].

7.1 Ownership

Just as with SMEs themselves, the issue of ownership - legal and personal - is central to the performance of business centres. It is this quality of personal ownership or commitment which confers on SMEs (and business centres) their distinctive entrepreneurial character and energy. Strong personal ownership is not, in itself, sufficient for success but it is a pre-condition (4)

In this light, it is self-evident that the most successful business centres - such as Oro - are run by people with a strong sense of ownership. Several other issues affect the degree to which ownership is strongly present in a business centre:

- <u>The split between operator and business centre management:</u> the approach followed in both countries has encouraged a split between those who legally own the business centre (the operator) and those who run it (the management). Selection processes have not generally given enough priority to those who will run a business centre.

- <u>SC support as "interference":</u> in seeking to offer useful advice to business centres, SC support can sometimes be perceived as unwelcome interference and even undermine people's personal sense of business centre ownership. Without the guidance offered by a transactional relationship, in both Indonesia and the Philippines, there are examples of SC's advice being interpreted as outside their genuine scope of responsibility (Box 4).

[9] There are other "frameworks" for institutional assessment - for example the growth framework of Durham University Business School (2) and the SEEP institutional development (3) framework; the headings used here borrow from these and other sources.

- Selection processes: in general, business centres in Indonesia exhibit a much stronger sense of ownership than those in the Philippines. One reason for this is that they are generally of a higher level of capacity. However, another key factor is the selection process - through a detailed tendering procedure - which demands that they devote considerable resources in time and money (a fee is charged for tender submission) to the development of a plan in which they believe. Business centres previously did not have to go through this demanding process.

- Working with large organisations: in both countries, business centres are sometimes part of larger organisations such as chambers of commerce or consultancy businesses. In these situations, it is important that the business centre is able to establish its own entity rather than be submerged within the bigger organisation.

- Working with associations: business centres in the Philippines which have emerged from membership associations face competing ownership pressures. On the one hand, members (their clients) want them to deliver good services at the most favourable terms; on the other business centre management want to charge prices which will allow them to pursue genuine financial sustainability in the longer-term. Usually, the former pressure - the short-term perspective - appears to win to the detriment of the business centre.

Box 4: Ownership perils for business centres
A number of incidents highlight some of the potential impacts arising from lack of clarity over ownership.

The split between ownership and management: Baguio SME business centre is the idea of one local business person. An ex-president of the local chamber of commerce, he is a dynamic and influential business leader and chairs the business centre. Unfortunately, he has little time to devote to the management of the business centre. Staff are quite junior and inexperienced, with little decision-making responsibility or capacity to innovate or deliver services. In the void between ownership and management, the business centre is sinking.

SC interference into business centre "space": two incidents between SC and WPU Bandung highlight potential problems when responsibilities are ill-defined and people feel unable to take ownership over *their* business centre:

- SC felt that WPU Bandung was drifting away from its target group; WPU Bandung believe its main responsibility (not least to SC) was to ensure the financial sustainability of the organisation; focusing on clients that represent the strongest sources of revenue was therefore - for the business centre - a valid strategy;
- WPU Bandung had received positive feedback from clients about their business plans and credit proposals - an important product for them. Swisscontact felt that the standard of these was inadequate and that remedial action was needed. WPU Bandung management felt that they were not in control.

Who controls associations?: among the main services which IMAB-MPCI has established for its members - automotive workshops - are a bulk buying operation for material inputs and a common service facility (a pipe bending machine). The prices charged by the business centre scarcely allow for a 10-20% margin, far below competitors' prices. Moreover 90% of all bills are not paid within 30 days of sale and the highest debts are attributable to the main office bearers of the association. While association members are happy to see the business centre pursuing business practices which are completely unsustainable (and which they would not countenance in their own business) the business centre staff - who report to the association office bearers and have little input into price and credit decisions - cannot hope to develop sustainable organisation.

7.2 Capacity

Capacity includes not only the skills and knowledge of business centres but also their orientation or culture, especially the extent to which this is sufficiently business-focused to be able to develop as a demand-led business centre.

In Indonesia, all business centres exhibit relatively high levels of technical capacity and commitment to human resource development. All business centres had staff with educational backgrounds of bachelor degree or higher. Staff training was budgeted for in all cases and access to training has been reasonable; either in-house, through SC or from external sources. Staff numbers are usually 5-6 permanent staff, 2-3 of which are fee-generating. The level of small business experience is relatively limited, although some staff had worked in the private sector, e.g. banking, before joining the business centres. Business centres develop and deliver services directly and also sub-contract where appropriate.

In the Philippines, the situation is more mixed. Most trade business centres deliver services directly but often they have little experience in doing so and their approach to pricing and marketing reveals this weakness. Business centres offering training and consulting often have a limited administrative capacity and no or very little ability to deliver services directly. Staff numbers are usually smaller than in Indonesia with 2-4 staff and often a noticeable voluntary input. As in Indonesia, resources from SC are allocated specifically to human resource development and, in addition, much of SC's one-to-one technical assistance is aimed at developing people.

Three preliminary points emerge from the above:

1. business centres are more successful when they have an *offer*, a specific product which they know how to deliver and know SMEs want. Weak business centres, especially in the Philippines, usually don't have a strong offer. The most recent thinking in SC Indonesia emphasises the importance of working with individuals with an offer as the core around which business centres may be developed.

2. while sub-contracting is a valid means of delivering services generally, business centres which have no capacity to deliver may be perceived (and act) as rather empty facilitating "shells"; and

3. business centres are more likely to be successful if they have a capacity to deliver services and a strong business instinct from the outset on which they can build. Business centres at a start-up stage of development - and new to business - are less likely to be successful.

7.3 Systems

Being relatively 'young' organisations with low levels of staff and activity, management systems in business centres are not fully developed. In many respects this reflects the experience of most small enterprises where systems develop from experience and to meet a tangible need, not through a rigid external reporting mechanism. Three types of system can be mentioned.

<u>Measurement of inputs and cost</u>

While SC's approach is based around very tight monitoring and analysis of financial performance, similarly rigorous systems of cost control and measurement have not yet been introduced within business centres. In the Philippines, where business centres are smaller and the incentive system is based around detailed analysis of income and expenditure figures, this is less problematic. However, in Indonesia where the recording and measurement of inputs for product development and delivery was analysed in some depth in the business plans, detailed product-based measurement is not undertaken. To a considerable degree, this reflects SC's focus on self-financing targets for aggregate income, rather than for profitability and also their view that internal systems are essentially the concern of the business centre.

<u>Measurement of impact</u>

SC are explicit in their approach to measuring impact. Business centres are businesses; the underpinning indicator of performance is therefore financial. Furthermore, measuring impact - changes which take place in SME clients - imposes a burden on business centres, in terms of time and cost. Client information and data can be an important resource for businesses, in terms of developing networks, selling services and assessing demand and market trends. However, most business centres either do not perceive benefits from this information or do not have the capacity to collect and use it; there is a sense that this kind of information is really the concern of SC.

<u>Remuneration and rewards</u>

A few business centres have developed or are planning to develop performance-related components in their reward systems but it is certainly too early to assess their impact on overall business centre performance. A variety of systems are proposed:

- personal performance – either through clients ‘delivered’ or fee generated;
- specific activity bonus – a bonus paid to those delivering a given service, e.g. a training course;
- institutional performance – either in the form of profit related bonus or a dividend for shareholders.

7.4 Linkages

Business centres in Indonesia tend to have relatively developed networks reflecting the fact that they often have been active in their area of interest for some time. These networks include venture capital companies, universities, state-owned firms and co-operatives, chambers of commerce and the NGO sector. In the Philippines, business centres operated by chambers of commerce usually also have strong supply-side networks, indeed they are often represented on SMED councils and other SME development fora. Trade business centres, although being less well connected, are still often aware of the opportunities from government schemes. In neither country are linkages significant constraints on business centre development.

7.5 The cost of the institutional development process

It is still relatively early in the development of business centres to make categorical statements on the cost of their development. In all the business centres supported by SC in Indonesia and the Philippines, financial and/or technical assistance is still being given; business centre development is not completed. The analysis is still fluid; it is premature to assert that $x of inputs gives a “developed” self-financing centre. Nor is it easy to give average per annum figures; support is front-end loaded; business centres are different; and support may cease if targets are not met. With these caveats, the following can be said about the cost of business centre institutional development:

- Direct per annum costs of financial support to the donor (SC) vary between approximately $12,000 in the Philippines and $35,000 in Indonesia (in Peru, the comparable figure is $20,000).

- Significant differences in the proposed duration of support mean that the total amount per business centre also varies. In the Philippines over three years it is likely to be $20,000-25,000; in Indonesia (and Peru) approximately $60,000.

- SC does not break down the value of its technical support to business centres. This is likely to be around 25-50% of total financial support. Nor is there any attempt to apportion related overheads to specific business centres. Figures from the Philippines suggest that the ratio of financial support to technical support and overheads is approximately 1:1.5. In Indonesia and Peru it is probably closer to 1:1 since larger amounts are given per business centre.

- The total cost of reaching SMEs (the business centre clients) to SC is around $600-700 per SME. However, as with all the above figures, their apparently relatively high expense can be misleading. The rationale for the business centre approach is that by investing (money and time) in a short period, long-term sustainability is achieved. Should this happen per annum cost figures are spread over a longer period and therefore should be much lower.

8. IMPACT

One of the inevitable tensions facing SC in its support for SeCens is that while it emphasises a business orientation, it does have an underlying development *raison d'etre*[10]. The former position asserts that SME clients' willingness to pay a market price for services can be taken as a reasonable proxy measure for impact. If a business centre achieves financial and institutional sustainability it can be assumed that it is doing so because clients' assessment of the benefits for their business is positive. However, the latter position states that as an organisation using development resources ultimately for development ends, impact from SC's input - cannot rely solely on *bottom-line*, financial business criteria but also assess changes in SME performance. Yet, it is <u>not</u> reasonable to expect business-orientated business centres to invest scarce resources in monitoring essentially for SC's, and not the business centre's, purpose.

There has been no detailed impact assessment on SME clients of business centres. Anecdotally, there are many examples of positive client feedback. Clearly, the onus for improving data lies with SC and if business centres are to be involved (and they are in a position to measure basic data) this would have to be incorporated into contractual agreements with them (and possibly they would have to be paid to do so).

Perhaps more problematic, at an institutional level, current approaches to do not seek to measure a baseline of business centre development at the start of their relationship with SC. Throughout the analysis, therefore, there is a tacit assumption that business centre development can be attributed to SC inputs and is truly *additional*.

9. CONCLUSIONS AND IMPLICATIONS

In a comparatively short period of time, SC's business centre approach has become recognised as an innovative and potentially influential technique of intervention at the meso level in BDS. Originally developed in Latin America, the approach has been changed further in Asia, especially in the action research programme in Indonesia, and in a context socio-economic turbulence, is generating considerable both substantial impact on business centres and new insights into the process. From the experience, a number of achievements and lessons emerge as well as fundamental issues relating more broadly to BDS.

[10] This mirrors arguments in the microfinance sphere.

9.1 Achievements

1. The development of an innovative approach to donor support of BDS provision
   This has been perhaps the most noteworthy achievement of the SMEP intervention: its commitment to learning and innovation has produced a tight, incentive-based arrangement that has openly set out to address the core global problems of sustainability and effectiveness in BDS.

2. The development of market-based, business-like BDS providers
   Business centres may represent a new and potentially more effective type of BDS provider, one which is more appropriately business-like than traditional development partners, as manifested in for example:
   - relatively high levels of financial sustainability (among some centres);
   - a high motivation to generate revenue;
   - margin-making and relevant products that SMEs are prepared to pay for; and
   - a strong sense of identity as a commercial entity; not a time-bound project

3. The development of an approach built on measurement of financial performance
   SC has begun to learn appropriate lessons from the success of microfinance and from business itself; financial information can be both the core indicator of performance and tool to drive change and development.

9.2 Lessons

Four major lessons emerge from the SC's experience so far, although as innovation continues, and the evolution of the approach proceeds, SC openly acknowledge that the learning process here is still young.

1. Choosing appropriate partners: trying to transform a project entity or NGO into a fully-fledged commercial organisation is difficult and business associations are probably not suitable partners. The approach appears to be most successful when it breaks with "traditional" partners and brings in those from a business background. A rigorous selection process is critical to success of the approach.

2. The importance of the individual: investing in people: SC has come to recognise the central importance of the individual who drives and believes in the business centre. Previous approaches failed to appreciate the distinctive energy and entrepreneurial drive which owner-managers bring and indeed created unhelpful divisions between those who own and those who manage; as with any small business investment, business centre success is about investing in good people.

3. Developing a business-like support mechanism: the support mechanism - the services supplied by SC to business centres - needs to reflect as closely as possible commercial practice: it should be contractual; mutually beneficial; simple to administer; and transparent and concrete from the outset. Careful consideration needs to be given to the intended purpose of a specific funding mechanism. It is not sufficient to simply make funding conditional; the nature of that conditionality is fundamental to business centre development; and the targets established must as far as possible mirror the conditions faced by a small enterprise.

4. Challenging donor skills and culture: the implementation of the business centre approach requires a very business-oriented culture from all the parties involved, not

least donors! Indeed, for them, the development of people with the right skills (especially financial), appropriate business instincts and hard-nosed realism is particularly challenging. Just as business centres can only be successful if they have a suitable *offer* to their SME clients, donor agencies can only be successful in pursuing this approach if they have an appropriate *offer* for those business centres. The business centre approach is concerned with the (active) delivery of services rather than (more passive) disbursement of funds.

9.3 Issues

Given the innovative nature of SC's approach it is not surprising that there are a number of important issues which remain substantially unresolved.

How much should we measure to maintain the business-development rationale?

Inherent to the business centre approach is a belief that the worlds of business and development - so often regarded as polar opposites - are closely related. Business skills and disciplines and the development of functioning BDS markets are building blocks on which development objectives are being pursued. One of the key challenges posed by this alliance of business and development objectives is with regard to measurement. There are two key issues here:

- Avoiding distortion: the imposition of onerous administrative and monitoring systems, backed up with significant financial and technical resources, can distort an organisation's cost base and revenue earning capacity. A key lesson from microfinance is that systems of measurement need to be appropriate (in terms of technology, scale and cost) to the level of an organisation's development and activity. This lesson is equally relevant to BDS.

- Getting the right balance: while it may be inappropriate to expect business centres to assess impact, SC has to be concerned with wider impact and outreach. Donor agencies represent a variety of stakeholders, such as governments and taxpayers, and cannot simply stop at being concerned with the 'bottom line'. Getting the right balance here may involve, for example, commissioning external organisations to monitor or pay business centres to undertake this service.

How to build business-like BDS organisations through donor support

This is the essence of the challenge being faced in this approach. How can a sustainable business centre - a business - be created from a process which, despite the advanced and business-like funding mechanism, at its core remains a donor-beneficiary intervention? Under this heading numerous issues arise including:

- How can technical support for product and skills development be included as part of the overall transactional relationship?

- How can a stronger sense of ownership be develop with those who are running business centres, for example by encouraging personal investment to expose them to the risks (and rewards) of ownership?

- How to avoid the creation of "bloated" cost structures which always bear the hallmark of donors rather than business?

Creating a conducive environment for BDS market development

It is clear that BDS "markets" are shaped substantially by often ill-conceived and scattered government and donor intervention. In this context, business centres seeking to maximise revenue will - logically - move towards institutions who offer the most revenue earning potential. There are major risks here: any form of transactional relationship may be weakened, overall effectiveness reduced and dependence on uncertain sources of funds (government budgets) increased. In the longer-term, as with microfinance, the business centre approach is most likely to be successful when governments and donors collaborate on developing a more detailed picture of the meso level for BDS. Attempts to create sustainable BDS markets may easily be undermined by ill-considered interventions.

Working with the private sector

A direct corollary of working with new types of partner is facing the challenge of engaging with established private sector enterprises (such as consulting firms and accountants). The approach is analogous with the experience of microfinance in attempting to focus commercial companies downwards towards SMEs (downscaling), as opposed to developing services from the bottom upwards via NGOs (upgrading).

This is an approach which is justified but brings with it risks. Obviously, as established organisations with systems and services, the rationale for working with them must be clear from the outset. In particular, donors need to be clear that:

- there will be *additional* impact from their intervention - for example, a new client group or new services; and
- support will not simply *displace* investment for activities that the private sector was already undertaking or planning to undertake.

References

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3) Edgcomb, E., Cawley, J., (eds), (1993); *An institutional guide for enterprise development organisations*, The Small Enterprise Education and Promotion Network (SEEP).

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APPENDIX I: The Economic Context

Indonesia

Over the past three decades Indonesia has emerged as one of South East Asia's 'tiger cubs', experiencing annual GDP growth in the region 6 – 8% per annum and an increase in per capita income from US$70 (1969) to approximately US$ 1,000 (1995). This strong economic performance has been built upon a vibrant industrial sector, especially manufacturing, strong export performance and an emerging service sector catering to the needs of modern business and a swelling middle class. However the benefits of growth have not been uniformly distributed across the country and income disparities have risen dramatically. Growth has been heavily skewed towards a limited number of geographic regions and has been dominated by a relatively small number of large and politically well-connected firms.

There are approximately 35 million private enterprises in Indonesia, 98% of which are micro- and small-sized[11]. However despite employing approximately 60% of the workforce, they contribute to only 7% of value-added[12]. Therefore a priority of the government has been the development of the SME sector through BDS to improve the productivity of SMEs, enabling them to make a greater contribution to national output and generate greater returns for their owners and employees.

The crisis of 1997-98

This case was written against the backdrop of an economic and socio-political crisis in Indonesia, resulting in massive social unrest and the resignation of President Suharto. Pressure on South East Asian currencies from mid-1997 has resulted in marked economic slowdowns throughout the region. In Indonesia this pressure has exposed underlying structural weaknesses in the economy, specifically: high levels of local currency borrowing and unhedged foreign debt; non-performing investments, especially in the property sector; a weak and under-regulated financial sector; and, onerous distortions in the economic structure, resulting from high levels of state intervention and corruption.

The effect on the Indonesian economy has been catastrophic, with the rupiah falling in value by 70% against the dollar. This, coupled with IMF-imposed reform measures, has had a dramatic knock-on effect across the economy: removal of government subsidies on essential goods; escalating prices; rising unemployment; high interest rates and paralysis of the banking sector[13]. Needless to say the effect on businesses of all sizes has been deleterious, with escalating costs, shortages of inputs, restricted access to credit and plummeting domestic demand. Export oriented firms have been unable to take advantage of the depreciation of the rupiah, due to lack of export finance (letters of credit etc.) and lack of container transport (due to effective cessation of import trade).

Most significantly for small- and medium-sized enterprises (SMEs) the pressures on companies of all sizes has meant that informal trade and inter-firm credit systems and sub-contracting networks have collapsed.

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[11] It should be noted that many of these small enterprises (approximately 64%) are in the agricultural sector.
[12] Bank Indonesia / SMEP Project Document October 1996 – December 1998
[13] Bank lending rates have risen to over 60%; the rate of inflation was approximately 10% per month. Basic commodities have risen in price dramatically; for example petrol and diesel price increases of 71% and 40% overnight, respectively.

The Philippines

Like all ASEAN[14] countries the Philippines has experienced sound economic growth in recent years, on average 5-6% per annum. Certainly it has not escaped the ravages of the financial storms that have ravaged most of East Asia since mid-1997 but the Philippines has certainly not been affected to the same extent as most other large East Asian economies, let alone experienced the devastating and destabilising broad-based economic crisis of Indonesia. Basic economic fundamentals are relatively sound:

- although there are significant regional disparities in performance, the domestic economy has not experienced a dramatic contraction;

- inflation is a relatively low 10.5%, higher than 1997 but still within manageable proportions;

- the peso has devalued by around 45% between mid-1997 and 1998 (one reason for inflation's growth) but this is close to the regional norm; and

- short term interest rates are not prohibitive[15].

Against this generally positive background the arrival of a new government in May 1998 headed by President Joseph Estrada, has introduced greater uncertainty. Not the first choice of the business community, there are fears that the liberalising reform, investment in infrastructure and tight economic management which characterised the previous Ramos government period may be threatened. Significant changes in macro-economic policy are <u>not</u> anticipated but there are fears of loss of momentum.

In this context, SMEs are an important part of the economy. They account for 99% of all manufacturing enterprises, and represent 55% of the country's work force, but only 28% of value-added. The challenge is to enhance their economic contribution. There is a long tradition of SME development and support in the Philippines; SME-focused government policy has a much longer history - since the 1960s - than in other developing economies. Most notable in broad array of state-sponsored SME support schemes are the Small and Medium Enterprise Development (SMED) Councils, which operate nationally and at a provincial level to facilitate and co-ordinate SME development efforts. There is also a well-established tradition of indigenous business associations.

Despite the quantity of established and institutionalised support structures for SMEs, there are doubts over the efficacy of such schemes. Indeed, a recent World Bank study strongly questioned the adequacy of existing SME support systems. This, combined with the current Asian financial crisis and lingering uncertainty over the new government's direction and competence means that the climate for SME growth remains adverse.

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[14] Association of South East Asian Nations
[15] *The Economist* Sept. 1998

APPENDIX II: Financial support mechanisms to business centres

Background

The central premise of SC's approach is that the funding mechanism is instrumental in shaping the business centres. Understanding this funding mechanism is crucial to gain insight into the institutional development process of the business centres.

This funding mechanism is transactional, that is to say it is based on a *quid pro quo* relationship between business centres and donor. The rationale for adopting a transactional funding relationship between donor and business centre is that this best simulates the reality of business. By instituting contract-bound financial targets, business centres are exposed to pressures that force them to behave commercially: responsive to clients needs, cost covering, efficient and focused.

Indonesia

The development of this funding system has been an iterative process, reflecting the experiences of both SC and the business centres. The system has altered quite radically since its inception in Indonesia. The essential feature of all schemes is the same. Donor funding is conditional on pre-agreed targets for financial sustainability. All business centres have a contract that defines the conditions under which Swisscontact support will flow. The precise form of this conditionality - how targets are formulated – has evolved considerably over the project period. Changes have been necessary to further refine and mitigate against the still artificial nature of the funding relationship, forcing business centres to behave in a manner that increasingly mirrors the behaviour of a small business.

1. Actual income-based scheme (WPUs)

This was the first scheme used, when SC decided to create to commercial and independent business centres in Malang and Bandung (WPUs). In this scheme SC funding was conditional on the business centres generating sufficient income to cover their costs.

How does it work?

1. *Investment*. The initial SC investment in the business centres consisted of original project inventory transferred to business centres on a loan basis; ownership is transferred to business centres over time depending on performance.

2. *Starting point*. This is the base level of self-financing established for the first quarter of operation. From this point the business centres are expected to increase their level of financial self-sufficiency on a quarterly basis. For WPU Bandung the starting point was 28%; for WPU Malang 14%. Under the actual income scheme, self-financing performance is calculated as the percentage of total expense covered by total operational income (i.e. revenues derived from sale of services excluding interest payments, services provided to SC etc.) and is expressed as a factor as shown in Table 1.

3. From this starting point the business centre is expected to increase its percentage of self-financing by 7% per quarter over the period of the contract (until 70% self-financing is achieved). If the target is achieved SC payment is made. Payment comprises total operational income multiplied by a factor (see Table 1). If the target for self-financing is exceeded the business centres generate a 'profit' due to this

multiplying factor. This profit is limited to a maximum of 40% of business centre salaries paid in the period.

Table 1: Self-financing ratio

Self financing target	Factor
14%	6.14
21%	3.76
28%	2.57
35%	1.86
42%	1.38
49%	1.04
56%	0.79
63%	0.59
70%	0.43
77%	0.30

4. Payments are calculated and paid on a monthly basis upon receipt of financial statements for the previous month and a sales forecast for the ongoing month. Any 'profit' payments are made on a quarterly basis.

A second scheme operates in parallel with this main scheme. This is a bonus scheme that rewards business centres if they achieve growth in revenues deriving from SMEs. This is designed to encourage target group focus. This scheme is calculated on a comparison of percentage revenue derived from SMEs in the previous quarter with percentage revenue derived from SMEs in the on-going quarter (see Table 2). This bonus is paid quarterly and is limited to a maximum of IDR 3m (US$ 300) in a quarter.

Table 2: Incentive scheme for revenue generated from SMEs

Increase in revenue from SMEs	Incentive payment
1.00%	0
1.50%	250,000
2.00%	500,000
2.50%	750,000
3.00%	1,000,000
3.50%	1,250,000
4.00%	1,500,000
4.50%	1,750,000
5.00%	2,000,000
5.50%	2,250,000
6.00%	2,500,000
6.50%	2,750,000
7.00%	3,000,000

Disadvantages of the actual income-based scheme

SC has found that there are a number of disadvantages with the initial scheme and assessing performance using based on actual income.

- The starting point was too low: attainment of targets was too easy for the business centres in the early stages, diminishing the need for focus and efficiency.
- The scheme was over-complicated, making it difficult to administer, reducing clarity and leaving scope for manipulation of ‘loop-holes’.
- It was based on actual performance as opposed to performance against target. Therefore planning was not a priority and business centres were prone to short termism.
- The fixed 7% per quarter increments (‘7% step’) were arbitrary and inconsistent with small business growth patterns.

2. Target income-based scheme (new business centres)

This system was introduced for a tranche of new business centres in mid-1997. Its aim was to make the funding mechanism much more certain and simplified. This new approach had at its core a tender process where interested parties were invited to bid for SC support to develop private sector BDS providers. The interested parties (known as ‘operators’) were required to make a 50% investment and contribute to the start up costs of these business centres. Matching investment is made by SC, as well as operational funding on a contract-based, performance-conditional basis. The new approach set out to address problems encountered with the previous actual-income based approach.

- It had a higher starting point – typically around 40%.
- It was based on business plans developed by the new business centres and operators, establishing mutually agreed targets for self-financing. This was to foster a longer term, planning oriented mentality, and to replace the ‘7% step’ with a more natural business growth pattern.
- The system was simplified. Payments from SC were on a fixed, but declining rate basis paid monthly dependent simply on adherence to business plan targets– introducing clarity and certainty.

How does it work?

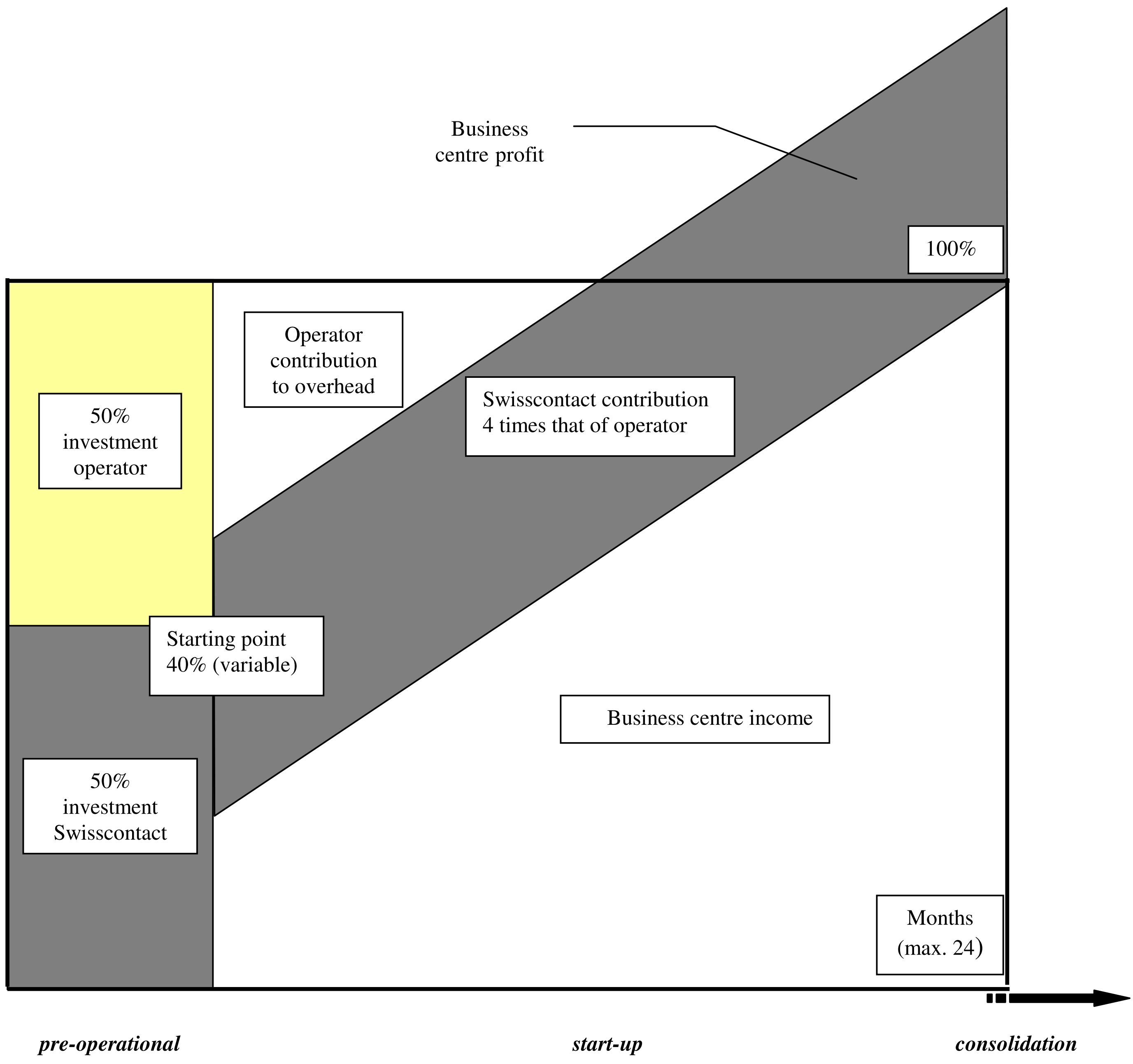
See Figure 1 for a diagrammatic representation.

Pre-operational phase. The operator and Swisscontact each make a 50/50 investment in cash or equipment up to a maximum of US$ 50,000 each. This is the shareholder capital.

Start-up phase. The business centre begins operation. A starting point is established representing the base for measurement of self-financing performance. Contributions to cover the business centres operational deficit are made by Swisscontact (80%) and the operator (20%). The contribution decreases over time in line with business plan targets for achieving financial sustainability.

Consolidation phase. 100% self financing is achieved. At this stage the operator has two choices (1) to withdraw his stake. In this case Swisscontact buys the operator out, transferring 100% ownership to business centre management (shareholder capital remains 100%), or (2) the operator maintains the shareholding, in which case Swisscontact matches the original 50% stake, and increasing management shareholding to 100%. Total shareholder capital is thus 150%.

Figure 1: Financial support scheme - new business centres



3. Contribution margin-based scheme
The most recent refinement to the funding mechanism was to make funding conditional not on income but on contribution to overheads, i.e. based on the contribution margin or gross profit. This change arose in response to the realisation by SC that the early income-based schemes (notably with the WPUs) had a serious weakness. By only measuring total operational income against total expense, the business centres were solely concerned with maximising income, and not contribution services make to covering overhead – the profitability of services and the overall profitability of the organisation. Effectively business centres could sell services with very low or zero margin, because funding disbursements from SC comprised total operational income multiplied by a factor, this 'loss selling' was disguised while the factor remained high. As the factor decreased it became apparent to SC (and the business centres) that services were not making adequate contributions to covering overheads.

The new system disperses funding conditional on the achievement of targets for the contribution that services make to overhead: that is to say the gross profit margin of business centres. Targets are on a 'sliding scale' i.e. the proportion of funding provided declines over time as the business centre achieves increasingly higher levels of financial sustainability. If targets are surpassed a bonus is paid.

The mechanism by which SC supports business centre set-up has also been altered to avoid the heavy 'up-front' investment characteristic in the previous funding schemes. An interest-free cash advance is made to finance working capital requirements and pre-paid expenses. Additional funds are provided as a grant for some set-up costs. Most significantly major items of equipment are purchased by SC and then leased to the business centre. Ownership of these assets is transferred to the business centre as the lease is paid of and if the business centre achieves targets.

The Philippines

The financial support mechanism which has been developed here is different to that of Indonesia in a number of respects, not least its emphasis on detailed costs and revenues. The details of the mechanism are likely to change when a new phase of the programme begins in 1999. The current approach is built around brief letters of understanding between SC and the business centres (for a 3-year period) and jointly agreed annual work plans with detailed budgets. The budgets specify costs and income under different headings and the proposed SC contributions to these. Each party - the business centre and SC - sign the agreed budget. SC allows itself some flexibility in its approach to financial contributions but essentially these are based on the following guidelines:

Operational costs

SC contributions make be up to 100% for the first six months of the business centre's life reducing by at least 25% for the following six months. For business centres with greater capacity, the starting contribution is likely to be less than 100%. Operational costs associated with gender, the environment and human resource development are all paid 100% by SC.

Investment

SC will pay 50% of initial investment costs associated with starting the business centre - for example computers, furniture etc.

Incentives
SC will pay up to a100% incentive on the gross profit achieved for specified business centre services. For particularly profitable services, the incentive is likely to be considerably less than 100%.

In the first year of business centre operations, most financial support from SC will therefore be against costs and investments. Into the second year and beyond, incentive payments will assume more importance. The total SC contribution varies from one business centre to another but has averaged around $12,000 in the first year of operation; subsequent years are likely to have lower contributions as operating cost and investment support decline.

The above system is being revised for the next phase of development, in particular to address concerns over the front-end loading of support, especially the relatively small proportion of total support from incentives in the first year; and the period and scale of support for operational costs.