Validation Report

Reference Number: PVR-305
Project Number: 36117
Loan Number: 2381
May 2014

Sri Lanka: Small and Medium Enterprise Regional Development Project

Independent Evaluation Department
Asian Development Bank
ABBREVIATIONS

ADB – Asian Development Bank
AWDR – average weighted deposit rate
DMF – design and monitoring framework
MOFP – Ministry of Finance and Planning
PCB – participating commercial bank
PCR – project completion report
PSC – project steering committee

NOTE

In this report, “$” refers to US dollars.

Key Words

asian development bank, credit, ministry of finance and planning, private commercial banks, small and medium-sized enterprises

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I. PROJECT DESCRIPTION

A. Rationale

1. During project preparation, Sri Lanka’s economy was growing at 7.2% per annum. Despite steady economic growth, regional inequality was a major development constraint. For instance, the Western Province, the most developed of the nine provinces, had a gross regional domestic product that was 2–4 times larger than other provinces. The armed conflict then adversely affected business confidence, heightening regional inequality. Limited public sector resources also prompted the need to rely on private investments.

2. The government recognized the need to promote the development of regional small and medium-sized enterprises (SMEs) that foster economic growth and reduce regional inequalities, generating jobs and raising income for a large segment of the population. Regional SMEs comprised 75% of Sri Lanka’s 30,000 registered SMEs. SMEs constituted 96% of industrial establishments and accounted for 36% of industrial jobs.

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1 “Regional” refers to all provinces outside the Western Province.
3. Despite the importance of SMEs, their access to credit, particularly for medium to long term, was a key constraint. The lack of access to credit was greater in provinces outside the Western Province where only 40% of the demand was met. Access to finance was even more difficult for start-up SMEs. On 6 December 2007, the Small and Medium Enterprise Regional Development Project was approved to accelerate the development of SMEs outside the Western Province (regional SMEs) by providing a credit facility for onlending to SMEs.² The project was to improve access to credit and to catalyze the development of SME value-chain clusters that will provide linkages to information, technology, and markets.³

B. Expected Impact

4. The project was expected to narrow regional inequality by enhancing private sector participation in economic development through start-up SMEs, as well as expanding and diversifying existing SMEs. The impact indicators in the design and monitoring framework (DMF) were increased private sector contribution to gross domestic product (GDP); and increased share of SMEs’ private sector activity from mid-2008 to mid-2011, with the annual average incremental output increase amounting to 0.67% of 2005 private sector output.

C. Objectives or Expected Outcome

5. The project’s envisaged outcome was accelerated development of SMEs outside the Western Province by increasing output and generating jobs. The DMF identified two outcome indicators: generation of incremental output in regional SMEs outside of Colombo, Gampaha, and Kalutara, amounting to about $170 million from mid-2008 to mid-2011, with an annual average incremental output increase amounting to 2.0% of 2005 SME output; and increase in job opportunities in regional SMEs outside Colombo, Gampaha, and Kalutara by 50,000 jobs by mid-2011.

D. Components and Outputs

6. The project’s core component was a credit facility for enhancing medium- to long-term financing through participating commercial banks (PCBs) to eligible regional SMEs and SME value-chain clusters. Three components would complement the credit facility: (i) improving PCBs’ corporate governance by enhancing governance structures in risk management and compliance with statutory requirements, (ii) strengthening PCBs’ risk management procedures for their SME lending, and (iii) fostering regional SME bankability by lending to lead firms of the SME value-chain clusters.

E. Provision of Inputs

7. At appraisal, the total project cost was estimated at $88.9 million, of which the Asian Development Bank (ADB) was to finance $50.0 million. The other costs ($48.9 million) were to be financed by PCBs and participating SMEs. At loan closing, $40.4 million of ADB’s loan amount was utilized (80.74%) and the balance of $9.4 million was canceled. Following the project design, the government relented ADB’s loan to PCBs for onlending at an interest rate reflecting their cost of funds plus a spread that covered transaction costs and risks. ADB loan

³ An SME value-chain cluster is an economic grouping that consists of SMEs in a particular sector around a lead firm. These clusters allow for transactional and technological efficiencies to enhance economies of scale.
Disbursements were delayed during the first half of project implementation and expedited only during the second half. Disbursement of PCBs’ loans to SMEs were slow because of (i) poor security in the provinces; (ii) available cheaper credit to SMEs from other development partners; and (iii) the time required to effect withdrawal applications from ADB, which often took 3 months before PCBs received replenishment. To accelerate disbursements and use the full loan amount, the Ministry of Finance and Planning (MOFP) requested ADB to expand the project area to include the Gampaha and Kalutara districts and to extend the project for 1 year to close on 31 June 2011. The request was not granted as it came at a late stage of project implementation, and PCB lending under the project had stopped in June 2011. Hence, the balance of $9.4 million was canceled. The project had no consultant recruitment and procurement.

F. Implementation Arrangements

8. The envisaged implementation arrangement was followed. To oversee project implementation, the MOFP established a project steering committee (PSC) composed of representatives from the MOFP, the Central Bank of Sri Lanka, and the four PCBs. Each PCB established a project implementation unit in its relevant operational department. Implementation arrangements for the project were adequate. All loan covenants were complied with. There was no technical assistance (TA) associated with the project.

9. The loan social covenants required that subprojects financed by the PCBs do not entail any activities that would generate involuntary resettlement, permanent or temporary, including for squatters. The loan was environmentally categorized FI and its environmental covenants required that PCBs establish or update their environment management system in accordance with ADB’s environment management framework and recruit safeguard implementation staff before receiving subloans. The loan social and environmental covenants were complied with (project completion report, Appendix 2).4

II. EVALUATION OF PERFORMANCE AND RATINGS

A. Relevance of Design and Formulation

10. The project completion report (PCR) rated the project relevant. The project was in line with the government’s 10-year National Development Strategy, 2006–2016, which emphasized increasing investment in SMEs and removing barriers to growth. It was consistent with ADB’s country strategy for Sri Lanka, which identified SME and/or private sector development, economic reforms, and reduction of regional development imbalances as priority areas for sustaining pro-poor economic growth.5

11. The project was relevant in addressing the prevailing regional disparity, particularly the lack of access to finance for SMEs outside the Western Province. In design adequacy, the SME value-chain cluster approach was innovative and useful. Linking SMEs with larger lead firms enhanced SMEs’ creditworthiness and improved SMEs’ managerial and operational capability. Channeling the project credit line through the commercial banks was appropriate as this ensured stricter loan screening. However, lack of donor coordination, which would have avoided subsidized interest lending to SMEs, and slow replenishment of funds at PCBs (paras. 14 and 23), affected the channeling of loan funds under the project. Overall, this validation rates the project relevant.

B. Effectiveness in Achieving Project Outcome

12. The PCR rated the project effective in achieving the expected outcome. As regards the envisaged outcome on incremental output, no precise available data could establish that the target of $170 million incremental output of regional SMEs outside Colombo, Gampaha, and Kalutara was achieved. Data was also not available to confirm that the target for annual average incremental output amounting to 2% of 2005 SME sector output was realized. Based on the government’s industry census, the PCR pointed out that aggregate value of outputs of Sri Lanka’s business establishments with fewer than 25 employees increased from SLRs93 billion in 2006 to SLRs137 billion in 2009. The PCR reported that during 2006–2009, the total value of SMEs’ output in Sri Lanka grew by 47%. However, the share of regional SMEs outside the Western Province to this growth in aggregate value was not presented. It is therefore difficult to conclude that the envisaged outcome on incremental output of regional SMEs was realized.

13. The target for employment generation was not reached. By mid-2011, the project envisaged jobs to increase by 50,000 in the regional SMEs. By mid-2012, only 15,892 job opportunities were generated or only 31% of target. While employment fell short of target, this validation shares the PCR’s view that the innovative SME clusters had a leveraging effect to generate further jobs, and the PCBs’ lending capacity to SMEs that was improved under the project helped increase SME outputs and jobs outside the Western Province.

14. All expected outputs were realized except for the credit facility, which was not fully utilized by PCBs. The amount disbursed by the four PCBs was $40.3 million or 81% of the ADB loan, in 966 subloans. The failure to achieve full disbursement can be attributed to the slow subloan disbursement during the first half of implementation (para. 7). Key outputs that were realized were the increase in PCBs’ ratio of SME credit to total credit to more than 4% for regions outside the Western Province, PCBs’ promotion of 13 SME clusters in 6 sectors, training of PCBs’ staff in SME finance, and PCBs’ lending to bankable regional SMEs and SME clusters established by lead firms.

15. This validation rates the project less than effective, which differs from the PCR’s effective rating. The less than effective rating is on account of the lack of precise data to show that the targets were achieved for incremental output of regional SMEs, the shortfall in employment generation, and the PCBs’ partial utilization of the credit facility.

C. Efficiency of Resource Use in Achieving Outcome and Outputs

16. The PCR rated the project efficient. The project promoted SME sector expansion and employment generation as 16 jobs per loan was generated at an average cost per job of $2,000, which was considered efficient. The PCBs efficiently managed the quality of their loan portfolios to SMEs with an average of 3.2% nonperforming loans during implementation. The project was able to successfully promote 13 SME clusters, exceeding the target of 3–5 clusters, indicating efficiency in strengthening the bankability of regional SMEs. While disbursements of subloans were slow during the first half of implementation, it nonetheless gained momentum during the second half. Overall, this validation rates the project efficient.

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D. Preliminary Assessment of Sustainability

17. The PCR rated the project likely sustainable. The project enhanced the operational capacity of PCBs in SME lending, and PCBs have been increasing their SME portfolios. Average nonperforming ratio remained at 3.2%, indicating that most SME subprojects were viable. The SME clusters promoted under the project established strong backward and forward linkages that are likely to be sustainable, fostering bankability of SMEs. With the government’s continued support for promoting SMEs, the outcomes realized by the project are likely sustainable. This validation rates the project likely to be sustainable.

E. Impact

18. The PCR did not rate the project's impact. Nonetheless, the project evidently contributed to creating an environment more conducive to SME lending. The project’s financing of 966 SME subprojects generated about 16,000 jobs that created new job opportunities outside the Western Province. Total value of SME output in Sri Lanka grew by 47% during 2006–2009. The project impact was to be demonstrated by the private sector’s growing contribution to GDP and an increase in the SMEs’ share of private sector operation. At completion, however, the PCR could not report progress in the two metrics. Even with the continued growth of PCBs’ SME portfolios since project completion, given the shortfall in outcome (employment generation) and the absence of other outcome and key impact progress data, this validation rates project impact moderate.

III. OTHER PERFORMANCE ASSESSMENTS

A. Performance of the Borrower and Executing Agency

19. The PCR assessed the performance of the MOFP as executing agency satisfactory. The PSC and project implementation units were established as envisaged at appraisal. The PSC prepared the required project reports based on the PCBs' progress reports. The PCBs complied with the anti-money laundering framework, corporate governance standards, disbursement criteria, and submission requirement of accounts and financial audit reports. Despite the poor security environment in the provinces, subloan disbursements were slow during the first half of implementation. Overall, this validation rates the performance of the MOFP satisfactory.

B. Performance of the Asian Development Bank

20. The PCR assessed ADB’s performance generally satisfactory. ADB closely supervised and monitored the project with four review missions and one project completion review mission. ADB was responsive to the requests of the MOFP and PCBs, particularly on increasing the number of sectors eligible for financing and lowering the cost of funds from a 6-month average weighted deposit rate (AWDR) to a 1-month AWDR. ADB was consistent with its policy on market-based financial intermediation. However, replenishment was not on time, which slowed PCBs’ subloan disbursements during the first half of implementation. Loan closing was extended three times partly because of ADB’s slow disbursement. This factor impeded project success. ADB should have exerted more effort to expedite replenishment. Furthermore, difficulties in monitoring project progress should have been rectified during project implementation since data for the proposed indicators were not available (paras. 12 and 26). Overall, this validation rates ADB’s performance less than satisfactory.
C. Others

21. No resettlement issues were encountered during implementation. The project had no adverse impact on the environment.

IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

A. Overall Assessment and Ratings

22. The project addressed economic disparity outside the Western Province by developing the SME sector in those regions. The project design for addressing the SMEs’ lack of access to financing was relevant (see table). The project generated less than the number of jobs targeted, nonetheless the project created employment opportunities for underdeveloped provinces. Total output value of SMEs in Sri Lanka grew during project implementation. The PCBs became more skilled and equipped in SME lending operations, and growth in their SME portfolios have continued after project completion. The innovative approach of promoting SME clusters established forward and backward linkages that built the creditworthiness of regional SMEs. SMEs outside the Western Province developed quickly through increased output and jobs. Overall, the validation rates the project successful, same as the PCR.

Overall Ratings

<table>
<thead>
<tr>
<th>Criteria</th>
<th>PCR</th>
<th>IED Review</th>
<th>Reason for Disagreement and/or Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relevance:</td>
<td>Relevant</td>
<td>Relevant</td>
<td>Lack of precise data to show the achievement of the target for incremental output of regional SMEs; a shortfall in jobs generated; and the credit facility not fully utilized by PCBs (paras. 12–15).</td>
</tr>
<tr>
<td>Effectiveness in Achieving Outcome:</td>
<td>Effective</td>
<td>Less than effective</td>
<td></td>
</tr>
<tr>
<td>Efficiency in Achieving Outcome and Outputs:</td>
<td>Efficient</td>
<td>Efficient</td>
<td></td>
</tr>
<tr>
<td>Preliminary Assessment of Sustainability:</td>
<td>Likely sustainable</td>
<td>Likely to be sustainable</td>
<td></td>
</tr>
<tr>
<td>Overall Assessment:</td>
<td>Successful</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>Borrower and executing agency:</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td></td>
</tr>
<tr>
<td>Performance of ADB:</td>
<td>Satisfactory</td>
<td>Less than satisfactory</td>
<td>Slow disbursement substantially hampered project success (para. 20).</td>
</tr>
<tr>
<td>Impact:</td>
<td>Not rated</td>
<td>Moderate</td>
<td>Lack of data demonstrating achievement of target impacts (shares of SME and private sector outputs); shortfall in and unavailable data on outcomes, suggesting problematic achievement of impact as well (para. 18).</td>
</tr>
<tr>
<td>Quality of PCR:</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>Refer to para. 27.</td>
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</tbody>
</table>

ADB = Asian Development Bank, IED = Independent Evaluation Department, PCB = participating commercial bank, PCR = project completion report, SMEs = small and medium-sized enterprises.

Note: From May 2012, IED views the PCR's rating terminology of "partly" or "less" as equivalent to "less than" and uses this terminology for its own rating categories to improve clarity.
B. Lessons

23. This validation finds the lessons drawn out by the PCR suitable. Adopting a local interest rate anchor—such as the AWDR—was not widely accepted by other development partners, which in many cases adopted fixed interest rates, often lower than prevailing market rates. Therefore, promoting a standard anchor for interest rates is needed to conform development partners’ assistance to the local environment and to avoid market distortions. This validation agrees with the PCR findings that including a capacity development technical assistance in project design would have provided the necessary skills training, and improved the capacity of borrowing SMEs. SMEs generally suffer capacity constraints and lack skills in business development, marketing, planning, human resource management, and other business skills. Institutional support in various business aspects would make SMEs more bankable. This validation supports the PCR findings that timely disbursement is critical especially for financial intermediation loans under the project. Project administration should have given greater attention to efficient and timely disbursement to facilitate implementation.

C. Recommendations for Follow-Up

24. This validation shares the PCR’s recommendations on continued supply of resources for medium- to long-term lending to SMEs funded by development partners; and for support in developing SMEs’ capacity in various business operations to enhance sustainability and growth potential. The PCR’s general recommendations are suitable, especially on (i) having simpler and more flexible administrative procedures, (ii) enhancing resident mission staff capacity on the finance sector, and (iii) improving the withdrawal application process to avoid implementation delays.

V. OTHER CONSIDERATIONS AND FOLLOW-UP

A. Monitoring and Evaluation Design, Implementation, and Utilization

25. The project design called for a systematic project performance management system to be included in the PCBs’ management information. The PCR did not assess the system’s effectiveness in generating the needed information in a timely manner. Nonetheless, the PCR showed key performance indicators, particularly for subloan disbursements, SME credit to total credit ratio, nonperforming loans ratio, and jobs generated by the project.

26. One main issue relating to project monitoring and evaluation is the DMF’s use of outcome and impact data that were either not available or could not be generated from official existing data, as reported in the PCR’s para. 38. This problem should have been discussed and rectified during project implementation. In future, there may be a need to carefully select the performance indicators and secure reliable source of data for performance monitoring when formulating DMFs.

B. Comments on Project Completion Report Quality

27. The quality of the PCR is satisfactory. It is clear, concise, and consistent with ADB’s Project Administration Instructions 6.07A. The status of achieving targets in the DMF was clearly presented in Appendix 1. The presentation on the status of compliance with loan

covenants in Appendix 2 was informative. The analysis was adequate to substantiate the ratings. The lessons drawn from the findings and the recommendations were sound.

C. Data Sources for Validation


D. Recommendation for Independent Evaluation Department Follow-Up

29. All project activities have been completed. A project performance evaluation report could be prepared if this would help support higher-level sector, thematic, or country evaluation.