



Technical Assistance Consultant's Report

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Sri Lanka: Mobilizing Finance for Sri Lanka (Financed by the Financial Sector Development Partnership Special Fund)

Prepared by
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Colombo, Sri Lanka

For Ministry of Finance's Department of Development Finance

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Asian Development Bank

The ADB logo consists of the letters 'ADB' in a white, serif font, centered within a dark blue square.

TA-9102: MOBILIZING FINANCE FOR SRI LANKA
Catalyzing SME Venture Capital

Seminar Notes

23 February 2017



YORK STREET
P A R T N E R S

in association with

D.Capital

Introduction

York Street Partners (Sri Lanka), in association with D. Capital Partners (United Kingdom), have been engaged by the Asian Development Bank (ADB) to consult on developing a concept for an SME focused venture capital fund. As part of this engagement, York Street Partners and D Capital Partners developed a report that included a market assessment of SMEs and SME finance in Sri Lanka, documentation of international precedents, and a proposed design for an SME venture capital fund.

On 23 February 2017, a seminar was held at the Hilton, Colombo, to solicit feedback from various stakeholders on the proposed fund concept. The seminar was well attended with ~75 participants including government representatives, banks, non-banking financial institutions, development finance institutions, fund managers, investors, and representatives from various local chambers representing Sri Lankan businesses.

Seminar Notes

Welcome remarks were delivered by Sri Widowati, the Country Director of ADB in Sri Lanka, who noted ADB's continued and growing support of the Sri Lankan government as it embarks on a program of growth and fiscal consolidation. Mr. S R Attygalle, Deputy Secretary, Ministry of Finance delivered the opening remarks, highlighting the importance of SMEs to Sri Lanka's economic fabric.

Session 1: The rationale for SME venture capital in Sri Lanka

Don Lambert, Senior Finance Specialist, South Asia Department

- The SME sector provides economic growth, employment and regional development
- Venture capital is not just provision of equity, it also involves knowledge transfer from investor to entrepreneur
- Access to finance is an issue throughout developing economies, but is particularly a problem in Sri Lanka.
- Certain attributes make this market unattractive for equity investments – the small market size and lack of exit options are key factors. Accordingly, there isn't significant supply of venture capital in the country
- Our market survey shows that a small section of equity demand is derived from fast-growing young firms, whose owners are willing to cede some control. The larger portion of equity requirement can be attributed to established firms, whose owners however, aren't necessarily willing to give away ownership

Session 2: International precedents in SME venture capital financing

Lily Han, Investment Principal, D. Capital Partners

- Looking at the international experience to date, there are several potential roles for government to play in SME financing:
 - Direct funding/ownership and investment decision-making: less common and governments have increasingly evolved away from this model, because it requires them to be directly involved in day-to-day investment management and decision-making
 - Indirect or hybrid public/private funding models: whereby public sector invests with or through private sector. Usually, public sector provides funds, but invests through private sector professional fund managers and delegates all operational and investment decisions to fund manager/independent directors. This model is much more common.
 - Eco-system building measures: Most governments have complemented their direct and indirect investment strategies with extensive policies stimulating

entrepreneurship, such as improving the economic, political, social, legal, and tax environments facing existing and potential entrepreneurs; reducing doing business “red tape”; etc.

- In addition, several decades of SME financing initiatives—in more developed as well as emerging economies—have given rise to some specific SME financing models that have shown a successful track record in supporting more established SMEs using specific quasi-equity instruments and structures. Their approach also provides useful benchmarks and inspiration for developing the Sri Lankan SME finance market.

Session 3: International experience investing with hybrid instruments

Hubertus van der Vaart, CEO and Co-Founder, Small Enterprise Assistance Fund (SEAF)

Matthew Cumming, Regional Investment Manager, East Africa, Business Partners International (BP)

Ariunaa Batbold, Managing Director, Asia, Schulze Global Investments

- Hubertus van der Vaart
 - SEAF has roughly \$700 million in committed capital—has made ~420 investments and exited ~260
 - Invests in growth capital in early-stage and SMEs with ~60 % of investments in Asia
 - Funded primarily by DFIs, but also ~20% by public money (in the form of pension funds, associations, etc.)
 - Experience shows funds invested in SMEs result in employment growth and increase tax revenues for the government significantly
 - Framework for taxation is a major concern
 - Triple taxation (investee, fund, LP levels) makes capital allocation less efficient
 - Other taxes – VAT etc. are prohibitive to overall funding environment development
- Matthew Cumming
 - BP was established in 1981 with equal government and private funding share
 - Has over 2,000 active investees, deploys ~\$100 million per year in between 350-750 investments
 - Overall, has invested over \$1.5 billion since inception
 - Clear market need caused by: debt requiring collateral which SMEs do not have, high cost of investment appraisal for small firms, limited upside potential
 - Investees usually need more than money as they may be good in core functional areas, but need support in soft skills including management expertise, resourcing, business development, marketing, etc.
 - Fundamentally, the instruments used are quasi-equity, risk-based funding. They are designed to be cash-flow sensitive and are priced fairly, but competitively
 - Highly flexible in instrument choice, which is evaluated on a case by case basis. Instruments range from pure equity to pure debt and combinations in between
 - Royalty based instruments are effective upside capturing mechanisms but require greater post-investment monitoring
 - Ideally structured to ensure a buffer to company’s cash flows – less expensive than debt early on, but more expensive than debt later on
 - TA program focuses on marketing, financial management, production efficiencies and occupational health and safety. Funded by interest free facility to entrepreneurs

- 8% default rate in Kenyan fund for those who participated in TA vs. 22% in those who did not
- Ariunaa Batbold
 - Pioneered private equity investments in Mongolia
 - Non-financial support and building a relationship/trust with investees is very important. It is therefore critical to have a fund manager with high EQ
 - Typically help investees in introducing global best practices
 - Nans Cashmere, an investee company achieved ISO and ESG certification, became IFRS compliant and received funding from other DFIs including the ADB. In addition Schulze Global took Nans Cashmere to several global fashion shows

Panel Discussion and Q&A

On screening of investments

- Business Partners uses an internal resource database to screen for opportunities
 - Specified set of parameters, and experts in different sectors/functions for evaluation of investments
- Relatively small market for Schulze – know who to target, do not invite applications
- SEAF – benchmark target operating performance to global KPIs, look for companies which underperform, so have areas to improve and add value
- Need to know the market, avoid industries where it is economically viable for a large player to come in and potentially wipe an SME out easily
- Usually easier to evaluate the operating performance of an SME due to the relatively simple nature of smaller businesses
- Important to find entrepreneurs who are willing to listen. Not necessary that they are already sophisticated, but must be willing to learn.

On adding non-monetary value after investing

- Additional non-monetary input provides clear advantages
 - SMEs are usually good at core functions (actual product), but underestimate the need of strong ancillary functions (marketing/business development/financial management) and either hire ill-equipped individuals for these or can't afford skilled individuals for these functions
 - Most important among all non-monetary input is helping an SME get to a standard level of financial controls
 - Need CFOs who understand overall financial environment, rather than just book-keepers
 - Another area where SMEs need support is strategy/operations and business development/marketing
 - Provide management consultant support to review operational efficiency
 - Help in sourcing of capital goods and technology upgradation
 - Important to understand the investee's industry and provide genuine expert input – easy to lose trust if misguided advice backfires
- TA funding is usually grant funding through government/DFIs

On facilitating exit

- For pure equity instruments, needs to be a conversation right from the start and throughout investment duration. Keep continually finding/engaging with potential buyers
- Building a relationship with the investee is significantly important – sticks/legal clauses are not necessarily enforceable

- Add clauses which motivate the promoter to find an exit for you (eg. accelerated dividend payout etc.). Agree on projections early on for enforcing contracts, most entrepreneurs are fairly optimistic in forecasting. Try to keep taking money off the table, relationships can turn sour at any stage. Enforcing contracts with a hostile investee is difficult and a mediation board may be one potential solution.
- Use self-liquidating mechanisms
- IPOs are dependent on prevailing interest rates – easier to IPO in countries with very low interest rates

On funding

- Need to clearly communicate and be transparent with all LPs
- Balance needs of investors, between DFIs (who have social targets) and private investors (who have economic targets)

On government involvement in overall ecosystem

- Need to make investing in SMEs attractive
- Remove triple taxation issues (company level, fund level, investor level)
 - As an example, funds are not taxed in Colombia, and this has led to significant growth in the local PE industry in the last decade
- Provide SMEs which are part of larger holding companies tax benefits to facilitate local strategic interest and exit environment

Session 4: Proposed structure of an SME venture capital fund in Sri Lanka

Sharini Kulasinghe, Vice President, York Street Partners

- SMEs have limited access to risk capital, which has constrained their growth. This has been driven by both demand and supply side factors, including:
 - SMEs are generally unwilling to dilute ownership and want to limit operational influence by investors. Further, they often lack the management and technical skills.
 - Potential investors are often hesitant to invest in SMEs due to the perception of high risk in the sector as well as a lack of exit options
- A fund that provides risk capital through a hybrid instrument designed to address these concerns could be effective in supporting the growth of Sri Lankan SMEs. Proposed design features include:
 - Downside protection through partial repayment of capital
 - Fixed 5 year term
 - Below market interest rate
 - Periodic payment of a percentage of revenue
 - Tailored technical assistance
- Legally, this instrument would be structured with part of the capital being invested through unsecured debt, and the remaining part through non-voting, redeemable, preferred shares

Panel Discussion and Q&A

Anura Warnakulasooriya, Managing Director, Midaya Ceramics

Niluka Amarasinghe, Senior Manager – SME Business Development, HNB

Mohideen Carder, Chairman, Sri Lanka Chamber of Small and Medium Size Industries

On the need for the instrument

- SMEs are clearly underserved and have capital requirements
- Virtually all formal SME funding currently in Sri Lanka is debt – no suppliers of equity capital.

- Debt requires rigid repayments and is not suited for all types of capital needs
- The availability of equity capital will support banks as they need an equity base for lending to SMEs
- Concept could target specific needs – such as companies which require technology upgradation to scale up
- The fund could work with chambers to identify potential investees
- There is demand for 5x the size of the pilot fund proposed

On fund size

- Participants suggested that demand for this type of fund could be at least 5 times the proposed fund size of \$10 million

SME Concerns

- Any funding mechanism should be reasonably easy to access, with simple processes. It should also be widely and transparently accessible to all qualifying SMEs
- Would prefer minimal operational interference, but welcome guidance
 - TA would be helpful, especially in equipping SMEs with the capability to export
 - Second generation is more willing to have input than older entrepreneurs
- Cash flows of the instrument should be closely aligned with investees cash flows

Fund Management

- Important to develop relationship with entrepreneurs rather than rely on reports and board representation
- While some participants felt that it was important to take a board role, others, particularly SMEs felt that this would make investment unattractive. One solution was to design the technical assistance program in a way that carefully monitors and supports SMEs growth
- The fund should have access to the credit information bureau (CRIB) to verify information provided by the SME
- Fund manager should be able to deploy Sri Lankan networks to be able to support investees
- Requires specific KPI targets

On fund governance and government involvement

- There were clear concerns about limiting the role of the government in the investment evaluation process
- If a government agency is the primary funder of this concept, developing a governance structure that upholds minority rights and provides a significant role for independent directors will be critical in ensuring the credibility of this pilot
- Seminar participants suggested that the pilot could potentially be funded completely through private sector involvement, given the size of the proposed fund

Seminar Schedule

Time	Event	Speakers
8.30-9.00 AM	Arrival of delegates	
9.00-9.05 AM	Welcome	Sri Widowati, ADB
9.05-9.15 AM	Opening Remarks	Mr. S R Attygalle, Deputy Secretary, Ministry of Finance
9.15-9.30 AM	Session 1: The rationale for SME venture capital in Sri Lanka	Don Lambert, ADB
9.30-9.45 AM	Session 2: International precedents in SME venture financing	Lily Han, D. Capital
9.45-10.25 AM	Session 3: International investing experience with hybrid instruments	<ul style="list-style-type: none"> • Hubertus van der Vaart, Small Enterprise Assistance Fund, Washington DC • Matthew Cumming, Business Partners • Ariunaa Batbold, Managing Director, Asia, Schulze Global Investments
10.25-11.05 AM	Q&A on morning sessions	Moderator: Takuya Hoshino, ADB Panellists: Don Lambert, ADB; Lily Han, D. Capital; Hubertus van der Vaart, Small Enterprise Assistance Fund; Matthew Cumming, Business Partners; Ariunaa Batbold, Schulze Global Investments
11.05-11.20 AM	Tea and Coffee Break	
11.20-11.40 AM	Session 4: Proposed structure of an SME venture capital fund in Sri Lanka	Sharini Kulasinghe, York Street Partners
11.40 AM-12.15 PM	Panel discussion and Q&A with SMEs and SME financiers <i>Discussion on proposed fund structure and instruments</i>	Panellists: Anura Warnakulasooriya, Midaya Ceramics; Niluka Amarasinghe, HNB; Mohideen Carder, SLCSMI
12.15-12.25 PM	Closing Remarks	Mr. Atapattu, Director General, Department of Development Finance, Ministry of Finance
12.25-1.30 PM	Lunch	