ADB

Completion Report

Project Number: 49426-001
Technical Assistance Number: 9102
September 2019

Sri Lanka: Mobilizing Finance for Sri Lanka

Asian Development Bank

TA Number, Country, and Name: TA 9102-SRI: Mobilizing Finance for Sri Lanka			Amount Approved: $500,000 Revised Amount: Not applicable	
Executing Agencies: Ministry of Plantation Industries and Department of Development Finance		Source of Funding: Financial Sector Development Partnership Special Fund	Amount Undisbursed: $76,405.90	Amount Utilized: $423,594.10
TA Approval Date: 22 Apr 2016	TA Signing Date: 31 May 2016	Fielding of First Consultant: 12 Oct 2016	TA Completion Date Original: 31 Mar 2017 Account Closing Date Original: 31 Mar 2017	Actual: 30 Sep 2018 Actual: 18 Oct 2018

Description

The TA was provided to support the modernization of the plantation sector via the issuance of "tea bonds" that would fund capital expenditures for plantations' tea and rubber production and improve access of Sri Lanka issuers to international markets. The TA also intended to formulate a plan to establish a venture capital fund (VCF) for small and medium-sized enterprises (SMEs). In order to sustain economic growth which had slowed down to an average of 4.5% during 2013–2015[1] from over 8% during 2010–2012, the country needed to increase productivity and the global competitiveness of its export-oriented industries, ideally, through a vibrant capital market. However, Sri Lanka's capital market was still in a developmental stage and lacked depth to provide needed funds. The TA aimed to mobilize domestic and international private investment for two of Sri Lanka's drivers for inclusive growth – plantations (tea and rubber) and SMEs, through innovative financial solutions.

Expected Impact, Outcome, and Outputs

The TA's impact was increased foreign investment and investment by individuals. The TA's outcome was strengthened ability of Regional Plantation Companies' (RPCs)[2] and SMEs to access private investment from capital markets. The TA's outputs were: (i) a study on the feasibility of tea bonds completed, (ii) due diligence for the operationalization of an SME VCF to increase SMEs' access to equity capital undertaken; and (iii) knowledge building activities undertaken.

Delivery of Inputs and Conduct of Activities

The executing agency (EA) for the feasibility study on tea bonds was the Ministry of Plantation Industries (MPI), while that for the due diligence for the SME VCF was the Ministry of Finance's Department of Development Finance (DDF). The TA was administered by ADB.

In September 2016, the TA completion date was extended by 6 months, as the government prioritized work for the SME VCF. In March 2017, the report on SME VCF was submitted to the SME steering committee and was disclosed on ADB's website. The tea bond study was delayed as no clear guidance was received from MPI. Initial consultations also revealed that while the legal framework for bonds was present, it was not so for true sales of securitized assets[3]. When RPCs gained a better understanding on how the structure would work, and that they would in effect guarantee other RPCs, they lost interest being unwilling to take each other's credit risk. ADB and the government then refocused the study to identifying the challenges of various stakeholders in the value chain and quantifying the financing gap for the tea sector as a whole. In September 2017, a minor change in implementation arrangement was processed to extend the TA completion date and to replace MPI with DDF as the EA for the tea bond component. MPI had limited capacity to drive the project and its performance is rated as *less than satisfactory*. DDF had a good track record administering ADB projects and understood the sector's financing challenges and its performance is rated *as satisfactory.*

An international consulting firm (in association with a local firm) was selected through a competitive process and engaged in October 2016 for 18 person-months. The firm completed reports on (i) the SME VCF including a fiscal impact analysis and (ii) tea sector development. It also conducted workshops to disseminate their findings to sector stakeholders. For the VCF study, the consultants conducted interviews and sent out surveys and received responses from over 90 SMEs. For the tea study, the team worked with stakeholders, collected data from public sources, and went on missions covering eight regions in the country. A total of four variations were undertaken: (i) to extend completion date from 30 July 2017 to 31 July 2018, (ii) to include tea smallholders (TSHs) in the scope of the tea study as requested by the government, and for a second extension of completion date to 31 August 2019, (iii) to change the

[1] Department of Census and Statistics, National Accounts estimates: http://www.statistics.gov.lk/national_accounts/dcsna r2/production.php.

[2] RPCs are mostly privately managed tea companies with lands provided under a 50-year lease from the government.

[3] Securitized assets in this case would be the pooled receivables of RPCs where bond payments would come from. If an RPC is unable to generate enough receivables, the bond trustee would draw from the other RPCs' excess receivables to pay the bond before releasing any of the receivables to the RPCs.

consulting firm's name as recorded in their corporate documentation, and (iv) for a third extension of completion date to 20 September 2018. The consulting firm was rated as *highly satisfactory.* They carefully planned and executed data gathering, incorporated international best practices into their solutions, was responsive to the changing priorities of the EA, and submitted comprehensive and high quality reports within the delivery timeline.

ADB's performance was *satisfactory*, given that ADB had continuous, proactive coordination with MPI and DDF, and was highly responsive to the requirements and changing priorities of the government.

Evaluation of Outputs and Achievement of Outcome

Under Output 1, the study identified challenges for the long-term sustainability and quantified the financial gap in the tea sector. Aside from the shortage of labor in the sector, the study also identified a lack of investments in replanting that has resulted to declining yields due to aging tea bushes. The study suggested that this cycle can be arrested through a widespread shift to mechanized plucking and increased replanting activities that will enhance the viability of investments in the sector. To achieve long-term sustainability, the study proposed funding for infilling, establishment of nurseries, factory modernization, climate change-related investments, and strategic diversification by RPCs. Financing is proposed through an ADB loan that would flow through banks, for final disbursements to end customers—both smaller TSHs and larger borrowers, with attractive terms to borrowers while keeping risks acceptable to banks. In order to balance the differing interests of stakeholders, components should include: debt to provide structured capital to tea sector participants, partnerships with government agencies to ensure effective implementation of the debt and TA, and the establishment of an oversight body and a cash risk reserve to mitigate credit risks in providing long terms loans to smaller borrowers. A TA was also recommended to support utilization and minimize execution risk. The TA will support upskilling of labor, market awareness activities on mechanization, capacity development of tea societies to conduct credit assessment, financial literacy training, and development of financial institutions' capacity to lend to the agribusiness.

Under Output 2, due diligence was completed for the operationalization of an SME VCF. The fund was envisaged to provide capital for SMEs given its substantial contribution to Sri Lanka's equitable economic growth.[4] The SMEs were categorized into: (i) high-growth start-ups and (ii) low/moderate-growth established SMEs. The former mostly comprise young entrepreneurs, with a clear demand for external investment given their low asset base but receptive to external equity having a more modern business outlook. The more established SMEs have typically stable business models in mostly traditional markets but need funding for expansion including professionalization of management, to delve into export markets or upskilling of talent. However, they were mostly unregistered businesses operating as sole proprietorship, hence were not favored by banks being still largely engaged in collateral-based lending. Owners were mainly founding families who were reluctant to accept external capital with accompanying ceding of control. The study proposed funding of their risk capital through revenue-linked self-liquidating instruments, hence with a viable exit strategy, lowering investor's risk profile that simultaneously retains ownership hence is acceptable to more established SMEs. This proposal could be piloted with approximately $10 million and linked to an ADB project, which can directly be invested in the fund together with private investors that will reduce government's risk exposure, accelerate private sector adoption of the model, enable knowledge sharing of private sector investment expertise, and potentially catalyze additional funding beyond government's financing. A fiscal impact analysis was also submitted to the Government of Sri Lanka that established that the fiscal adjustments required to honor sovereign obligations to ADB for such a project would not be consequential to the country's fiscal sustainability.

Under Output 3, two dissemination seminars were held: (i) Catalyzing SME Venture Capital on 23 February 2017 in Colombo with 75 participants from the government, banking sector, and Chambers of Commerce and Industries and (ii) Developing a Financing Strategy for the Tea Sector on 4 September 2018 in Colombo with an estimated 100 attendees from the banking community and the tea sector. The VCF seminar was well received and concluded that the VCF would be needed to provide risk capital to SMEs but would need professional management to be viable. A pilot was considered but was not implemented due to other government priorities. There was also active participation during the tea sector seminar revealing high interest for tea sector development for future ADB support.

In view of the substantial follow-on activities that resulted under this TA, it is assessed to have delivered its key outputs, taking into account the complexities and scale of both the SME and tea sector.

Overall Assessment and Rating

The TA is rated as *efficient.* Overall TA utilization was 85%, mainly because training costs were prudently managed at only 43% utilization, and contingency untouched. The TA was extended twice, mainly due to shift in government priorities, in timing of the VCF study and in the focus of the tea study from to an overall financing strategy rather than bond issuance.

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[4] In 2015, Sri Lanka's small and medium sized enterprises (SME) sector accounted for 30% of the its GDP and contributed 35% of the country's employment playing an important role in reducing poverty.

The TA is rated as *effective.* The TA supported two knowledge products: introduction of an SME VCF which received positive feedback garnering willingness by both government and private investors to contribute to the fund, and the development of a financing strategy for the tea sector that will be assimilated in a 2020 pipeline project. While ADB did not pursue the establishment of an SME VCF, the study heavily influenced the design of the Women Entrepreneurs Finance Initiative (WeFi) project. The grant drew lessons from the study to address the issues of women-led SME's lack of access to equity and bank financing, which restricted their growth. The grant—effectively an equity contribution—not only helps finance capital requirements but lowered debt equity levels so that women-led SMEs can get bank financing. Similarly, the proposed Second Additional SME Credit Line includes a tea component that is directly based on the study.

Overall, the TA is considered *successful* and has ultimately found intermediate financing to the marginalized groups women-led SMEs and the tea growers*.* The TA is *less than relevant* because of the limitations in its design—outcome targets: tea bond issuance and establishment of an SME VCF were too ambitious and could not have been a result of the stated outputs. Nevertheless, although not as originally planned, the TA's outcome of strengthened ability to access private investment from capital markets was achieved and fully aligned with ADB's focus on catalyzing private investment as reported in the interim country partnership strategy 2015–2016[5] as well as Government of Sri Lanka's thrust on increased foreign investments and investments by individuals.[6] The TA is *effective* as its outcome of strengthened ability to access private investment from capital market by RPCs and SMEs was met. The TA is *efficient* as targets were generally achieved within the budget and with implementation delay due to external factors. The TA is *likely sustainable* as evidenced by the resulting design and structure of the ongoing WeFi project and the inclusion of a tea sector component as endorsed by the Government of Sri Lanka in a 2020 project.[7]

Major Lessons

The TA identified that SMEs were mainly divided into (i) fast growing, more open young firms and (ii) more established firms who are unwilling to cede control. While both have underserved capital requirements, traditional equity instruments could be used for the former and a more innovative financial instrument that would limit equity dilution would be needed by the latter. A VCF, through a pilot project, with independent directors and limited government role in the investment evaluation process to ensure credibility, may be able to provide the much needed capital to support growth in the SME sector. The proposed exit strategy with redemption principally through cash flows generated by SMEs, will not only enable SMEs to retain ownership, but also help manage investors' risks.

The TA also confirmed that the proposed tea sector support aimed at introducing new technology and reaching both smaller TSHs and larger RPC borrowers would need to include various stakeholders to be sustainable. Amongst others, Sri Lankan financial institutions should develop specialized services on banking in the agriculture sector including to cater to smaller borrowers. In addition, organizations in the tea sector including the research institute and societies can play a role by providing information on farming techniques, ensuring availability of high-quality inputs, and by running market education programs.

Recommendations and Follow-Up Actions

ADB is encouraged to continue developing feasibility studies that produce innovative solutions under actual projects to address developmental challenges. As in the case of this TA, it served as preparatory work that had provided valuable inputs into the design and structure of succeeding projects.

ADB should continue discussions with the government to explore the creation of a VCF as a pilot and as a possible component in a future ADB intervention, to create an alternative financing solution for SME sector development. The ongoing Capital Market Development program will catalyze the country's capital market development and increase viability of establishing such a fund in the future. For the tea sector development, a joint project between SAPF and SAER should be explored to strengthen technical aspects of the project with agricultural and financial expertise. Furthermore, better governance in the sector should be encouraged. ADB, the government, and industry stakeholders are encouraged to have constant communication and coordination to ensure that project goals and government priorities throughout project development and implementation are in alignment.

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[5] ADB. 2015. *Interim Country Partnership Strategy: Sri Lanka, 2015–2016*. Manila.

[6] Economic Policy Statement 2015 made by the Hon Prime Minister Ranil Wickremesinghe in Parliament in November 2015.

[7] The proposed SME Credit Line Additional Financing Project scheduled for 2020 commitment includes a component on tea sector development.

DESIGN AND MONITORING FRAMEWORK

Impact the TA is Aligned with
Foreign investment and investment by individuals encouraged (Economic Policy Statement 2015)[a]

Results Chain	Performance Indicators with Targets and Baselines	Status of Achievement	Data Sources and Reporting	Risks
Outcome Ability of RPCs and SMEs to access private investment from capital markets strengthened	a. By 2018, at least \$100 million of the foreign investment portfolio is raised through “tea bonds” (offshore US dollar bonds) (2016 baseline: \$0) b. By 2018, an SME VCF is established by the government (2016 baseline: not applicable)	a. No foreign investment portfolio raised through “tea bonds” b. No SME VCF established	a. Bond prospectus b. Incorporation documents	Tea bond pricing or terms are not competitive with alternative financing. Sri Lanka’s laws make an offshore bond collateralized by future sales legally untenable. The SME VCF is unviable because there are very few SMEs with a business model suitable for venture capital or because there are insufficient divestment options.
Outputs 1. Study on the feasibility of tea bonds completed 2. Due diligence for the operationalization of an SME VCF to increase SMEs’ access to equity capital undertaken	1. By Q4 2016, a report on tea bonds is submitted to the MPI (2016 baseline: not applicable) 2. By Q4 2016, a report on due diligence for the operationalization of an SME VCF is submitted to a steering committee established under the SME credit line (2016 baseline: not applicable)	1. A report on Mobilizing Finance for the Tea Sector was submitted to government in August 2018. The report proposed funding to support mechanization and associated replanting through long-term debt with an attached TA 2. Completed. The March 2017 final report on Catalyzing SME Venture Capital and its fiscal impact analysis have been posted on ADB’s website:	1–3. Consultant’s report	

Results Chain	Performance Indicators with Targets and Baselines	Status of Achievement	Data Sources and Reporting	Risks
		https://www.adb.org/projects/documents/sri-mfsl-catalyzing-sme-venture-capital-tacr https://www.adb.org/projects/documents/sri-49426-001-tacr		
3. Knowledge building activities undertaken	3a. By Q1 2017, a seminar on tea bonds is conducted (2016 baseline: 0) 3b. By Q1 2017, a seminar on an SME VCF is conducted (2016 baseline: 0)	3a. Completed. The Developing a Financing Strategy for the Tea Sector was conducted on 4 September 2018 in Columbo 3b. Completed. The Catalyzing SME Venture Capital seminar was conducted on 23 February 2017 in Colombo https://www.adb.org/projects/documents/sri-49426-001-tacr-0		

Key Activities with Milestones

1. Study on the feasibility of tea bonds completed

1.1 Consult local and domestic stakeholders (including the MOF, MPI, CBSL, SEC, and tea brokers) and provide a draft tea bond feasibility study that analyzes RPC demand (to include RPCs' medium- and long-term capital requirements and financing options), investor demand, revenue pooling, and bond structuring; the contingent liability on the sovereign debt sustainability; and the legal and regulatory environment for offshore bond issuance by Q3 2016 – Interviews

1.2 Provide a final tea bond feasibility study by Q4 2016 – A final report on potential financing solution to modernize and increase productivity of the tea sector was presented to the Ministry of Plantation Industries and Department of Development Finance in July 2018

2. SME VCF for SMEs' access to equity capital developed

2.1 Consult local and domestic stakeholders (including the MOF, CBSL, SEC, SMEs, and financial institutions) and provide a draft SME VCF due diligence report by Q3 2016 that includes a demand analysis, a business plan (to include financial projections), fund ownership, corporate governance, and an analysis of government financial support to an SME VCF on the sovereign debt sustainability

2.2 Provide a final SME VCF due diligence report by Q4 2016

3. Knowledge building activities undertaken

3.1 Prepare materials and provide administrative support for a seminar for RPCs and other sector stakeholders on the proposed tea bonds by Q1 2017

3.2 Prepare materials and provide administrative support for a seminar for SMEs and other sector stakeholders on the proposed SME VCF by Q1 2017

Results Chain	Performance Indicators with Targets and Baselines	Status of Achievement	Data Sources and Reporting	Risks
Inputs				
Financial Sector Development Partnership Special Fund: $500,000				
Note: The government will provide counterpart support in the form of counterpart staff and other in-kind contributions.				
Assumptions for Partner Financing				
Not applicable.				

CBSL = Central Bank of Sri Lanka, MOF = Ministry of Finance, MPI = Ministry of Plantation Industries, NA = not applicable, RPC = regional plantation company, SEC = Securities and Exchange Commission, SMEs = small- and medium-sized enterprises, TA = technical assistance, VCF = venture capital fund.

[a] Government of Sri Lanka, Prime Minister's Office. 2015. *Economic Policy Statement made by Hon Prime Minister, Ranil Wickremesinghe in Parliament on 5th November 2015*. http://www.pmoffice.gov.lk/download/press/D00000000009_EN.pdf

Source: Asian Development Bank.