



Technical Assistance Consultant's Report

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Sri Lanka: Small and Medium-Sized Enterprises Line of Credit Project (Financed by the Japan Fund for Poverty Reduction)

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Asian Development Bank



Performance Report October 2016

TA 9080 – SRI: Small and Medium-Sized
Enterprises Line of Credit Project

Preface

The SME Line of Credit is an initiative by the Ministry of Finance and the Asian Development Bank (ADB) where ADB will provide USD 100 million through innovative bank auctions with the aim of channeling more funds to Sri Lankan firms that struggle to access the finance they need to grow. The ADB funds will be lent to participating financial institutions (PFIs) that will then lend the funds to small and medium-sized enterprises (SMEs). To access the funds, the PFIs have to bid successfully for the funds at eight semiannual auctions across four years.

This innovative auction mechanism was introduced to create a market price for bank borrowings that are targeted for on-lending to the least-well served SMEs, such as new or rural borrowers or those led by women. As PFIs are likely to bid below their normal marginal borrowing costs, they will maintain a financial incentive to disburse the funds. It is expected that the auction mechanism will address previous credit lines' difficulties in incentivizing PFIs to disburse the funds quickly and efficiently to SMEs.

Performance Analysis

The first auction was concluded on the 27th of April 2016 where 9 PFIs participated and one PFI, National Development Bank PLC (NDB), won the whole tranche of USD 12.5 m at an interest rate of 6.01% (Annexure 1).

Performance is tracked against two broad parameters. First, the PFIs need to disburse the funds; the project will have no development impact if the funds remain undisbursed. Second, the funds once disbursed need to be reaching the intended borrowers.

Performance Analysis – Disbursement

On an absolute basis, disbursements have been strong, and almost the entire tranche was on-lent to SMEs in approximately a month's time (Table 1).

Table 1: Disbursement Summary

| Fund Disbursement | |
|-------------------------|--|
| Disbursement Start Date | 27 th July 2016 |
| End of Reporting Period | 29 th August 2016 |
| Total Days | 33 Days |
| Fund Utilization | |
| Total Auctioned Funds | LKR 1,822,000,000 (USD 12,500,000 equivalent) |
| Funds On-Lent to SMEs | LKR 1,744,246,934 (at exchange rate of 145.76) |
| Utilization | 95.73% |

Disbursements are also strong on a relative basis. Compared to ADB's Small and Medium Enterprise Regional Development Project, which ran from 2008-2012, the auction mechanism's financial incentives are driving disbursements at a much faster rate (Table 2).

Table 2: Comparison with Previous SME Credit Lines

| | Small and Medium Enterprise Regional Development Project (2008-2012) | SME Line of Credit (2016-2019) |
|--|--|---------------------------------------|
| Loans disbursed | \$40,371,325 | \$11,966,250 |
| Months | 45.27 Months | 1.10 Months |
| Rate | \$0.89 million per month | \$10.9 million per month ^a |
| ^a Given funds are disbursed only semiannually, this rate is expected to decline to an average of approximately \$2 million per month over the project's lifespan. | | |

Performance Analysis – Development Indicators In designing the credit line, the Ministry of Finance and ADB selected development indicators against which the project would be measured. These indicators focused on borrowers that are often excluded from the banking sector such as first-time borrowers or women-led SMEs.

Presently, the project is exceeding the development indicators. In particular, loans to first-time borrowers and women-led enterprises are well above their targets (Table 3). The one indicator that has performed poorly is working capital loans against which fixed or financial assets have not been pledged. This indicator aims to encourage cash flow lending. The underperformance could reflect the winner of the first auction’s specific credit policies or the banking sector’s general discomfort with cash flow lending. In any case, PFIs in subsequent auctions will only be allowed to extend working capital lines if fixed and financial assets are not pledged.

Table 3: Development Indicators

| Criteria | Target | Actual | Success |
|--|--------|--------|---------|
| The number of sub loans to SMEs borrowing from a commercial or specialized bank for the first time | ≥ 10% | 21.29% | ● |
| The number of sub loans is to SMEs that are led by women | ≥ 5% | 24.52% | ● |
| The amount of sub loans is lent cumulatively to “targeted SMEs” | ≥ 50% | 86.22% | ● |
| SMEs where funds are used for subprojects outside of Colombo District | - | 69.79% | |
| SMEs borrowing for working capital against which fixed or financial assets are not pledged | - | 0.00% | |
| SMEs led by women | - | 20.25% | |
| SMEs which had not previously borrowed from a licensed commercial or specialized bank. | - | 20.49% | |

Additional information on the SMEs assisted under the program is included in Annexure 2.

Impact Stories

Y.L. Achala knew nothing about fish until 15 years ago when she married Rohana, who, at the time, helped manage the largest aquarium in the Government of Sri Lanka's Department of National Zoological Gardens. He was the one who gave her first lessons in fish farming.

Now she owns Spring Valley Fish Farm in the western Sri Lanka town of Bandaragama and her mainstay is breeding and exporting ornamental fish. These days, she is focusing on specially- bred varieties of guppy, most of which are sent to Australia and New Zealand where demand is rising. In all, she reckons she exports around 10,000 to 20,000 fish monthly.

Given increasing calls for her fish and for the top-quality service she always seeks to provide, Achala was keen to expand and started to scout locations for a second sales outlet. And thanks to ADB's SME Line of Credit Project, she will soon be able to realize her goal.

"I heard from National Development Bank that there is a financing scheme for small- and medium-sized enterprises from ADB and available through them. The process was quick and I managed to get the funds I needed within a week," she said. With the SLRs3 million loan, she bought the land for the new shop and construction will start in early January 2017.

She is not only happy to be able to expand her business but is also extremely proud that she runs the biggest ornamental fish farm business owned by a woman in the whole country.



"We work hard to provide our customers with the highest quality, most healthy, and most colorful ornamental fish." - Ms. Y. L. Achala, Proprietor, Spring Valley Fish Farm



Sathya started his cushion business from zero and is now looking toward a promising future.

After Sinnaiyah Sathyaseelan, or Sathya as he is known, finished school at the age of 16, he moved from his family home in the inland town of Thalawakele to Colombo to find a job. He found one in a workshop that made seat cushioning for cars and vans and after 6 years, started his own vehicle cushioning business in Wattala just north of Colombo.

Today, he runs the business with his wife, Malar. Things have been going fairly well for almost 14 years although, like many small businesses, uneven cash flow can be a problem and had prevented Sathya and Malar from improving or expanding their business.

Sathya Cushion Works buys the cloth, padding, and other material locally and are lucky to have a three-month credit period to pay. The firm also has to pay rent on its premises and salaries for its seven employees who work year round. For small firms like Sathya and Malar's, customers aren't always swift to pay so juggling the incomings and outgoings just from company profits is tough.

So when Sathya and Malar wanted to do some light renovations to the workshop to make the roof and floor more robust, they were not quite sure how they would manage it despite the business having a monthly average turnover of SLRs2.5 million and profits of around SLKs 500,000.

Sathya and Malar visited a few banks but, as a first time borrower, none were receptive until they were able to access funds made available through the SME Line of Credit Project. "The manager was supportive and the process was swift. So after several years of planning, I finally managed to renovate my workshop and have funds left over that I can use as working capital," said Malar. With less worry day-to-day about whether their customers will pay on time to allow them to pay their own bills, Sathya and Malar can plan a bigger and better future.

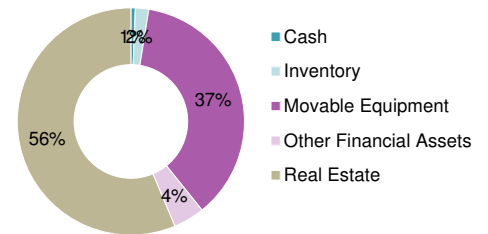
Annexure 1: Summary of First Auction Bidding

| Bank Name | Bid Rate | Bid Amount | Allocated Amount |
|---------------------------|-----------------|-------------------|-------------------------|
| National Development Bank | 6.01 | 12,500,000 | 12,500,000 |
| Sampath Bank | 5.03 | 12,500,000 | 0 |
| Commercial Bank of Ceylon | 5.01 | 5,000,000 | 0 |
| Nation's Trust Bank | 4.90 | 5,000,000 | 0 |
| DFCC | 4.50 | 4,000,000 | 0 |
| Peoples Bank | 4.01 | 3,000,000 | 0 |
| Hatton National Bank | 4.00 | 8,000,000 | 0 |
| Seylan Bank | 3.80 | 3,000,000 | 0 |
| Bank of Ceylon | 2.51 | 3,000,000 | 0 |

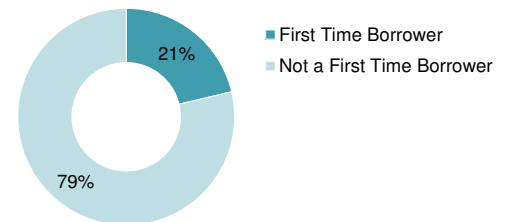
Annexure 2: Summary of SME Lending

| Fund Disbursement | |
|---|---|
| Bank | NDB Bank PLC |
| Total Value of Loans Disbursed (LKR) | 1,789,597,240.00 |
| Utilization of SME Credit Line (LKR) | 1,744,246,934.00 |
| Funds Unutilized (LKR) | 45,350,306.00 |
| Summary of SME Loans | |
| Total Number of Loans Disbursed | 155 |
| Average Upfront fee (LKR) | 426,732 |
| Average Interest Rate | 11% |
| Average Interest Rate vs. Average Weighted Prime Lending Rate (AWPLR) | 0.73% points below 6-month AWPLR as of 2 September 2016 |
| Average Margin over Funding Cost | 5% |
| Average Tenor (Months) | 56 |
| Average Equity Contribution of SMEs to Total Subproject Amount | 47% |
| SMEs' Average Annual Turnover | 204,958,411 |
| SMEs' Average Number of Employees | 30 |
| Rate Analysis | |
| Interest Rate | Percentage of Total Loans |
| 9% - 10% | 4% |
| 10% - 11% | 88% |
| 11% - 12% | 4% |
| 12% - 13% | 3% |
| 13% - 14% | 1% |
| Margin Over Funding Cost | Percentage of Total Loans |
| 3% - 4% | 3% |
| 4% - 5% | 85% |
| 5% - 6% | 8% |
| 6% - 7% | 3% |
| 7% - 8% | 1% |

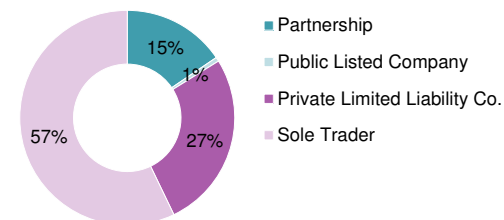
Collateral Type
(Percent of Loans with a Given Collateral)



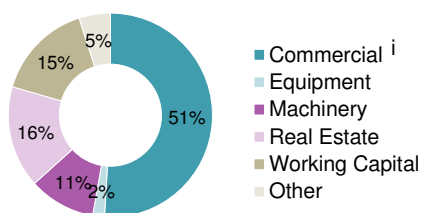
First Time Borrower
(Percent of Disbursements)



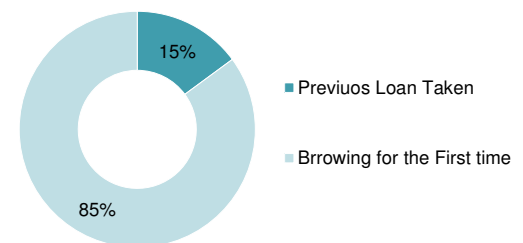
Legal Structure
(Percent of Disbursements)



Primary Purpose of the Loan
(Percent of Disbursements)

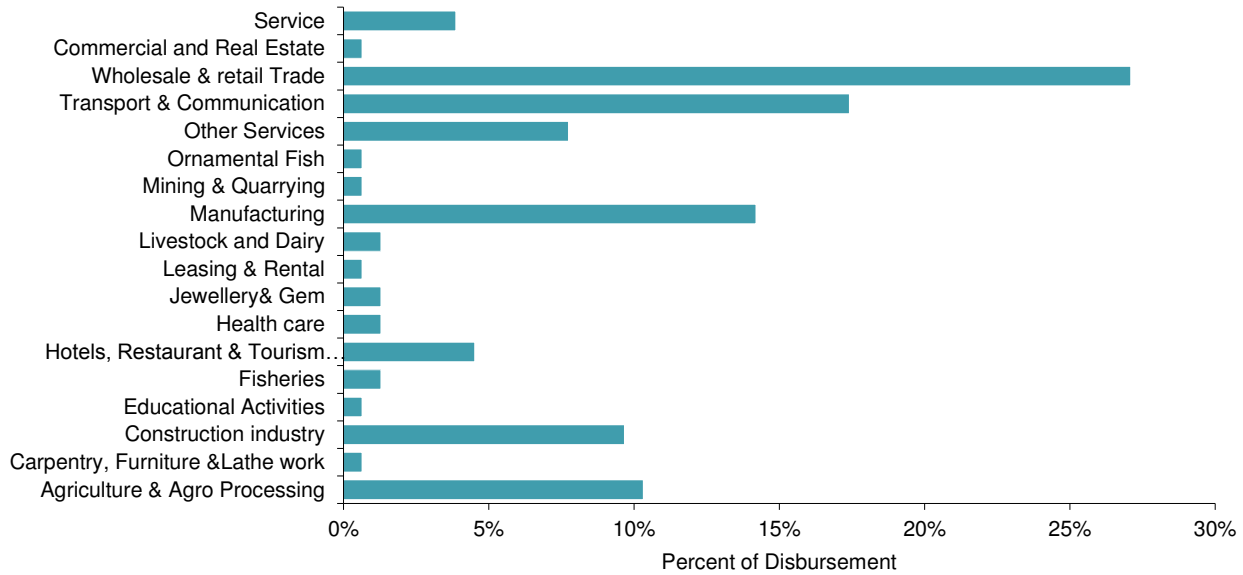


Previous Loan Taken from PFI
(Percent of Disbursements)



i. The 'Commercial' category will be re-classified in subsequent reports, so these distributions will change.

Sector of Activity



District of Borrowers' Project

