

ECONOMIC ANALYSIS

1. Sri Lanka has a large unmet demand for financing for small and medium-sized enterprises (SMEs). The project's credit line will address this issue. An expected economic rate of return cannot be calculated because the SME subprojects to be supported have not been identified. However, the economic benefits that will accrue to the participating financial institutions (PFIs) and SMEs can be identified through the project's outputs.

A. Enterprise Gap of Small and Medium-Sized Enterprises

2. **Credit gap.** The credit gap for SMEs (including micro and cottage) is estimated to be at least SLRs321 billion (\$2.3 billion) (Table 1).

Table 1: Estimated Credit Demand for Small and Medium-Sized Enterprises

Segment ^a	Number of Enterprises	Underserved or Unserved (%)	Underserved or Unserved	Average Loan Size (SLRs million)	SME Credit Gap (SLRs million)
Micro	935,736	22	205,862	1.0	205,862
Small	71,126	50	35,563	2.5	88,908
Medium-sized	10,405	50	5,202	5.0	26,010
Total	1,017,267		246,627		320,780

SMEs = small and medium-sized enterprises.

^a Includes microenterprises. The SME data does not include SMEs in the agriculture sector.

Sources: International Finance Corporation. 2016. *IFC Enterprise Finance Gap Survey*. Washington, DC; Government of Sri Lanka, Department of Census and Statistics. 2015. *Key Indicators of Industry Trade and Services Sector Economic Census 2013/14*. Colombo.

3. The estimated credit gap is based on the following assumptions:
- (i) The definition of SMEs is the same as that adopted for the census in fiscal year 2014 (ended 20 December 2014), which is less inclusive than the new national SME definition (Table 2).
 - (ii) The census estimated the number of total enterprises in Sri Lanka at 1.0 million in 2013. Of these, about 92% are assumed to be micro, 7% small, and 1% medium-sized companies.
 - (iii) The International Finance Corporation's Enterprise Finance Gap Survey in 2014 found that among Sri Lanka's SMEs, 47% do not need to borrow, 40% are unserved, 10% are underserved, and 4%¹ are served—i.e., about half of SMEs have unmet funding demands.²
 - (iv) The survey does not break down the unmet credit demands of microenterprises. However, it does indicate that 22% of respondents named access to finance as a major barrier; this percentage can serve as a conservative proxy.
 - (v) The potential lending volume for each segment is calculated by multiplying the number of enterprises by the average loan size. Exact data on loan sizes is not available but is estimated based on (a) loan data of PFIs, which indicates that the average size of loans to SMEs led by women (more likely to be micro) is around SLRs1.0 million; (b) Credit Information Bureau data that the size of the average SME lease from nonbank financial institutions (more likely to serve smaller SMEs) is around SLRs2.5 million, and (c) Credit Information Bureau data

¹ Percentages do not equal 100% because of rounding.

² International Finance Corporation. *SME Finance Forum*. <https://www.smefinanceforum.org/data-sites/ifc-enterprise-finance-gap> (accessed 16 October 2017).

that the size of the average SME loan from licensed banks (more likely to serve larger SMEs) is SLRs5.0 million.

Table 2: Definitions of Small and Medium-Sized Enterprises

Item	Number of Employees	Annual Turnover
New national definition (to be used for proposed facility)	Manufacturing: less than 300 Services: less than 200	Less than SLRs750 million
Census definition (credit gap analysis)	Industry and construction: less than 200 Trade: less than 35 Services: less than 75	Not applicable

Source: Government of Sri Lanka, Department of Census and Statistics. 2015. *Key Indicators of Industry Trade and Services Sector Economic Census 2013/2014*. Colombo.

4. The assumptions are conservative and likely underestimate the actual credit gap because they (i) do not include the agriculture sector, (ii) adopt a narrower definition of SMEs than the new national definition, and (iii) assume that the unmet demand for microenterprises is lower than for SMEs, whereas the opposite is likely true.

5. **Targeted segments.** Credit demand from SMEs led by women is estimated at SLRs63.1 billion and from unserved SMEs (a proxy for SMEs that have not previously borrowed from a licensed bank) at SLRs115.7 billion (Table 3). Given this demand and the successful track record of PFIs, the proposed onlending requirements that 20% of the number of loans must be to SMEs led by women and 20% of the number of loans must be to new SMEs are feasible.

Table 3: Estimated Credit Gap for Targeted Small and Medium-Sized Enterprises

Item	Underserved or Unserved	Women-Led Enterprises		SMEs Unserved by Banks		Average Loan Size (SLRs million)	Credit Gap of Women-Led SMEs (SLRs million)	Credit Gap of New SMEs to Banks (SLRs million)
		Share	Number	Share	Number			
Micro	205,862	26.3%	54,142	80%	164,690	1.0	54,142	164,690
Small	35,563	8.3%	2,952	80%	28,450	2.5	7,379	71,126
Medium	5,202	6.1%	317	80%	4,162	5.0	1,587	20,808
Total	246,627		57,411		197,302		63,108	256,624

SMEs = small and medium-sized enterprises.

Note: SMEs include microenterprises.

Sources: International Finance Corporation. 2016. *IFC Enterprise Finance Gap Survey*. Washington, DC; Government of Sri Lanka, Department of Census and Statistics. 2015. *Key Indicators of Industry Trade and Services Sector Economic Census 2013/14*. Colombo.

6. **Outside of Colombo District.** Although no regional data is available on the credit gap, it is expected to be concentrated outside of Colombo District, areas that the proposed SME credit line is targeting. First, household poverty is lower in Colombo than in other parts of the country. Wealthier households are more likely to manage businesses that can access bank financing. Second, Colombo District has a bank branch for every 3,028 inhabitants. Other areas have much lower branch penetration. Third, an estimated 70% of economic activity occurs outside of Colombo District. Thus, a reduced branch network supports most economic activity, suggesting that many of the underserved or unserved SMEs are located in these areas (Table 4).

7. Commercial banks are the best-positioned intermediaries to bridge this credit gap. Most SME financing is provided by commercial banks in the form of loans. The total of outstanding SME loans and advances of commercial banks is estimated at \$7.0 billion, out of which more

than 50% is estimated to be provided to SMEs outside of Colombo.³ In 2012–2014, nonbank financial institutions disbursed only 4.5% of the total Sri Lanka rupee-denominated small-sized loans (SLRs50 million or less) and 26.6% of the total Sri Lanka rupee-denominated small-sized leases (SLRs50 million or less). This data indicates that commercial banks are the main players in SME lending.

Table 4: Access to Finance and Credit Demand in and outside of Colombo

Item	Poverty Head Count Index	Population/Branch	GDP Total
	(%) FY2013	(no. of people) 2016	(SLRs billion) 2015
Western Province	2.0	4,800	4,611
Colombo District	1.4	3,028	...
Gampaha	2.1	7,483	...
Kalutara	3.1	7,784	...
Outside of Colombo	7.4	6,686	...
Outside of Western Province	8.6	6,502	6,572
Total	6.7	5,883	11,183

... = not available, GDP = gross domestic product.

Source: Central Bank of Sri Lanka. 2017. *Economic and Social Statistics of Sri Lanka 2017*. Colombo.

B. Economic Impact

8. The economic analysis of individual subprojects under the proposed SME credit line cannot be done in advance because of their small size (maximum subloan is SLRs50 million, equivalent to \$333,000) and because details of the subprojects, such as sector, size, and tenor, are not available in advance. However, the PFIs have agreed in the project agreement to assess the economic and financial viability of the subprojects. Moreover, the project's outputs allow for some general conclusions about the positive economic benefits that will accrue to PFIs, SMEs, and the targeted clusters.

9. **Economic impact on lenders.** The PFIs will economically benefit from the facility because (i) it allows them to borrow for up to 10 years at a fixed interest rate, which decreases the interest rate risk of longer-tenor loans; and (ii) through the facility, PFIs can expand their outreach to underserved SMEs—these new clients will diversify PFIs' loan assets and improve their net interest margins.

10. **Economic impact on borrowers.** SMEs have little access to long tenors and fixed interest rates because banks have little access to long tenors and fixed interest rates. The proposed SME line of credit will make such financing available to PFIs, which will in turn help SMEs to undertake capital investments that have longer payback periods. In addition, the onlending requirements of the credit line—(i) at least 20% of the number of subloans must go to unbanked SMEs, (ii) at least 20% of the number of subloans must go to SMEs led by women, and (iii) at least 70% of the value of subloans must go to targeted SMEs (either outside of Colombo, unbanked, female-led, or asset-backed working capital)—will have direct poverty reduction impacts, especially outside of Colombo District.

11. With 5 years as the estimated duration of an SME loan, banks can reuse the funds twice on average during the 10-year borrowing period. Therefore, ADB's \$175 million is expected to

³ Financial information from five licensed commercial banks, as of the end of June 2015, indicates that about 53% of total outstanding SME loans are outside of Colombo.

catalyze \$538 million of SME subprojects,⁴ which will generate 4,231 subprojects,⁵ and create new employment for an estimated 21,155 people.⁶

12. The onlending requirement that at least 70% must be lent to SME subprojects outside of Colombo District will directly contribute to poverty reduction by accelerating regional economic growth. Poverty affects 6.7% of households outside of Colombo and only 1.4% in Colombo (Table 4).

⁴ In the original project, subproject duration was estimated at 3.3 years. Based on 12-months of project data, subproject tenor has averaged 5.2 years. $(\$175 \text{ million ADB funding} + 94.2 \text{ million estimated average SME equity contribution}) \times (10 \text{ years}) / (5\text{-year estimated average loan duration}) = \538.4 million .

⁵ Based on 12 months of project data, the average SME subloan size was SLRs12.4 million (equivalent to \$82,720). $(\$175 \text{ million ADB funding} \times 2 / \$82,720) = 4,231$.

⁶ Based on 12 months of project data, the average number of employees of a SME borrower was 25, and the average total project cost to annual turnover was around 20%. Assuming the average asset turnover ratio of SMEs is 1 and the number of employees will increase in proportion to asset size, each subproject increases employment 20%. $25 \text{ employees} \times 20\% \times 4,231 \text{ subprojects} = 21,155 \text{ employees}$.