CATALYZING SMALL AND MEDIUM-SIZED ENTERPRISE VENTURE CAPITAL IN SRI LANKA

Sharini Kulasinghe, Lily Han, Takuya Hoshino, Abhishek Rathi, and Don Lambert

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Lily Han, CFA is an investment principal at D. Capital, United States. Takuya Hoshino is a financial sector specialist at the Asian Development Bank (ADB). Sharini Kulasinghe is a managing director at YSP Advisors, Sri Lanka. Abhishek Rathi is a vice-president at YSP Advisors, Sri Lanka. Don Lambert is a principal finance specialist, South Asia Department at ADB.

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6 ADB Avenue, Mandaluyong City, 1550 Metro Manila, Philippines
Tel +63 2 632 4444; Fax +63 2 636 2444
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EXECUTIVE SUMMARY

Small and medium-sized enterprises (SMEs) are the bedrock of Sri Lanka's economy, accounting for 75% of the total number of enterprises active in the country, providing 45% of employment, and contributing 52% to its gross domestic product (GDP) (Government of Sri Lanka, Ministry of Finance 2015). SMEs are defined as businesses with Rs16 million–Rs750 million in annual turnover. Given their role in the social and economic fabric of the country, SMEs' ability to establish themselves and scale their operations is integral to Sri Lanka achieving equitable economic growth. Consequently, creating an environment conducive for the development and growth of SMEs has been a focus area of successive Sri Lankan governments, and addressing constraints on SMEs' access to appropriate finance is a key part of that effort. Against this backdrop, this paper seeks to evaluate the viability of supporting the SME sector by improving access to equity or risk capital.

The market assessment for this paper points to two distinct types of SMEs: high-growth start-ups and low and moderate-growth established SMEs. Each type of SMEs has very different cultural, operational, and financial profiles. While both categories require equity or risk capital, the nature of their financing needs is quite different. The demand for capital from start-ups is more obvious and well-articulated in the market, as many of them are actively seeking external equity investment. Over the next 5 years, we project that the demand for equity financing by start-ups could reach $200 million.

Established SMEs are also constrained by limited capital bases, as most are self-funded by entrepreneurs and complemented by collateralized loans from commercial banks. We estimate there is a need of $0.5 billion–$1.0 billion in risk capital from established SMEs. Nonetheless, many established SMEs are reluctant to bring on external equity investors due to a fear of losing control of their businesses. The use of more innovative financial instruments that provide risk capital as well as limit the equity dilution of promoters could help address the demand for risk capital by established SMEs. As such, while traditional equity instruments could be deployed to provide risk capital to start-ups, structured equity instruments would be needed to support established SMEs.

The success of an investment strategy based on traditional equity instruments is driven both by the performance of the investee company as well as the ability of the investor to realize value through a sale. Viability of exit is therefore a critical factor in deploying traditional equity instruments. Particularly for SMEs, Sri Lanka's exit environment, although increasingly active, remains in a relatively nascent stage of development compared with more developed markets. Traditional equity instruments are therefore exposed to exit risk. In contrast, structured equity instruments designed with self-liquidating features can mitigate such risks associated with exit.

Based on the preceding evaluation of the market, a fund concept was developed to provide risk capital through revenue-linked self-liquidating instruments, to support the growth of SMEs. This instrument is best suited for firms with established business models and steady operating cash flow whose growth has been constrained by lack of equity. As this instrument will be redeemed exclusively through cash flows generated by the SMEs, it would enable SMEs to access risk capital without diluting their ownership. It would also mitigate exit risk for the fund. Given that this fund provides a funding avenue to address the capital constraints of SMEs and unlock growth, it would likely result in meaningful development outcomes.

In terms of development impact, this fund could promote a range of policy objectives that the Government of Sri Lanka may have, including

(i) creating a larger number of higher-quality skilled jobs that align the talent base with Sri Lanka's increasingly service-oriented economy;

(ii) expanding youth employment opportunities;

(iii) enabling and incentivizing innovation;

(iv) boosting Sri Lanka's export capacity; and

(v) developing the local capital markets through catalyzing follow-on equity investment and foreign investment, and also expanding SME debt capacity.

The objective of this paper is to present the concept for an SME finance fund and a range of structuring options for the Government of Sri Lanka to consider. Specifically, this report includes a market assessment of SMEs and SME finance in Sri Lanka currently, documentation of international precedents, and analysis of fund structuring considerations.

I. SMALL AND MEDIUM-SIZED ENTERPRISES MARKET ASSESSMENT

The objective of the market assessment was to understand the structure of the small and medium-sized enterprise (SME) market, the demand for equity or equity like capital as well as any market nuances that should be considered in structuring any SME finance approach. As such, in-depth interviews were conducted with a variety of stakeholders in Sri Lanka's SME market, as summarized in Table 1.

Table 1: Interviews for Small and Medium-sized Enterprise Market Assessment

Category	Number of Interviews
SME financiers	5
Industry bodies and academics	5
DFIs	1
Venture capital/Private equity funds	3
Government	1
SMEs	15

DFI = development finance institution, SMEs = small and medium-sized enterprises.

Source: York Street Partners.

In addition, we conducted a survey to assess the demand for capital by SMEs to supplement our in-depth interviews and the relatively scarce data on this sector. Groupings of SMEs were selected as respondents for the survey due to the lack of available data on registered firms. The survey respondents were (i) the membership base of the Chamber of Small and Medium Industries and (ii) start-ups who have expressed interest to York Street Partners in raising capital over the last 12 months.

In total, we received responses from more than 90 SMEs (Appendixes 1 and 2); we believe that data from the survey provides a good indication of the nature of demand for equity capital by SMEs.

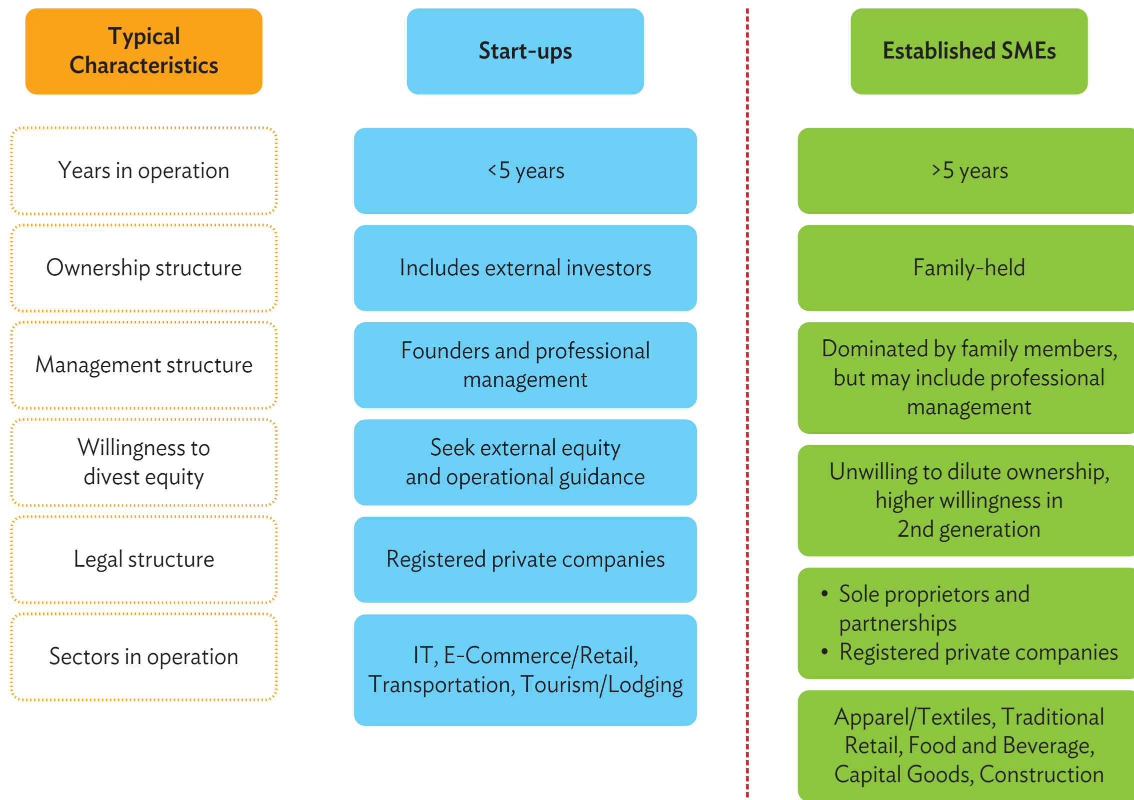
A. Small and Medium-sized Enterprise Market Structure and Demand

There are broadly two different types of SMEs in Sri Lanka, each with distinct operating characteristics, growth trajectories, and capital requirements (Figure 1).

1. Start-ups: An Increasingly Vibrant Ecosystem

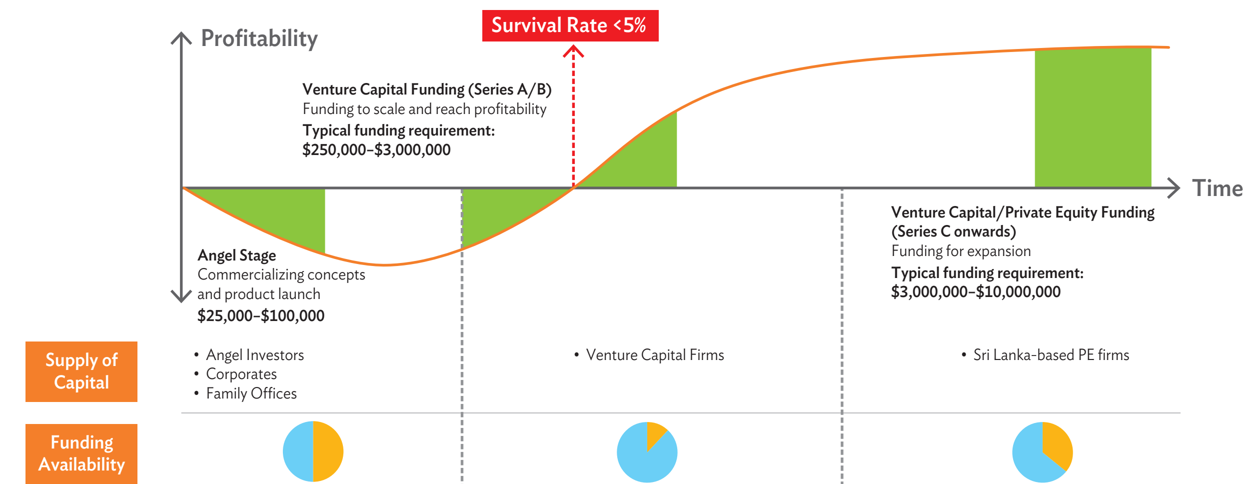
While Sri Lanka has a history of successful information technology start-ups that date from the 1990s (e.g., Virtusa, Millennium IT), the culture of entrepreneurship really began to take off in the last 5 years. Start-ups are an outcome of this increasingly vibrant ecosystem. They are often founded by young entrepreneurs who are trying to build companies and products that disrupt traditional markets. They generally raise angel funding to seed their businesses and therefore have a demonstrated willingness and ability to work with external equity investors. While they promise high returns in the future, they are usually loss making at the point of investment. Consequently, they rarely have access to bank funding (Figure 2).

Figure 1: Types of Small and Medium-sized Enterprises in Sri Lanka



IT = information technology, SMEs = small and medium-sized enterprises.
Source: York Street Partners.

Figure 2: Growth Trajectory of Start-ups



PE = private equity.
Source: York Street Partners.

Start-ups raise **three different types of capital** at specific stages in their evolution:

(i) **Angel funding.** As entrepreneurs launch their business, they require capital to develop their products, test the market, and commercialize their idea. Funding requirements are relatively small and range from $10,000 to $1,000,000. This funding requirement has been filled by a small group of angel investors, whose ability to meet the growing demand for angel funding is limited. Feedback from Sri Lankan angel investors is that entrepreneurs often have excellent ideas but generally lack the business skills to commercialize them. On the other hand, entrepreneurs note that Sri Lankan angel investors have unrealistic growth expectations and heavily dilute promoters early on, reducing their incentive to grow the business. As such, while angel funding is available to Sri Lankan start-ups, the mismatch between the expectations of investors and entrepreneurs, as well as the limited number of angels engaged in the space, suggests there remains a significant gap in financing this segment of the market.

(ii) **Early-stage venture capital.** Start-ups that build viable business models using angel funding require additional capital to reach scale and profitability. Based on interviews with angel investors, we estimate that less than 5% of companies that raise angel funding reach this stage. When they do, there are almost no funding sources in Sri Lanka to support further growth, forcing entrepreneurs to look overseas. However, international and regional venture capital funds have had limited appetite to invest in Sri Lankan companies due to the relatively small size of the domestic market. As such, Sri Lankan entrepreneurs who have developed early stage yet commercially viable businesses do not have access to the early-stage venture capital funding required to scale their businesses and achieve profitability. Demand for capital at this stage ranges from $250,000 to $3,000,000. However, there does appear to be a significant variation in capital demand by sector (Figure 3).

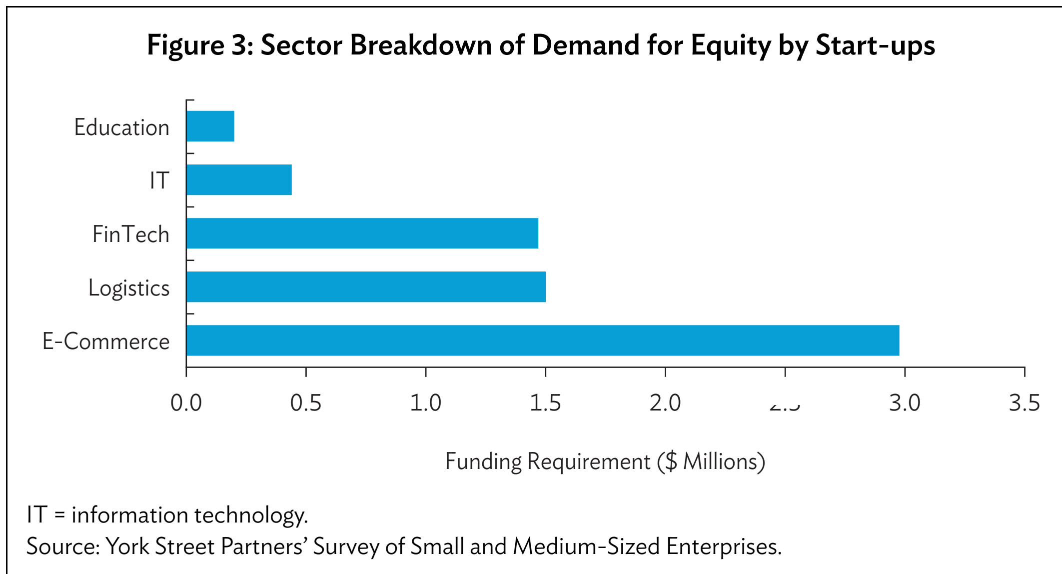


Figure 3: Sector Breakdown of Demand for Equity by Start-ups

IT = information technology.
Source: York Street Partners' Survey of Small and Medium-Sized Enterprises.

(iii) **Late stage venture capital and private equity.** Start-ups that eventually reach scale and profitability sometimes seek expansion capital to grow their businesses. While few companies have reached this stage in the last 5 years, there are several historical precedents, including Millennium IT and Virtusa. There are currently two private equity funds focused on Sri Lanka, which provide capital to businesses reaching this stage of their development.

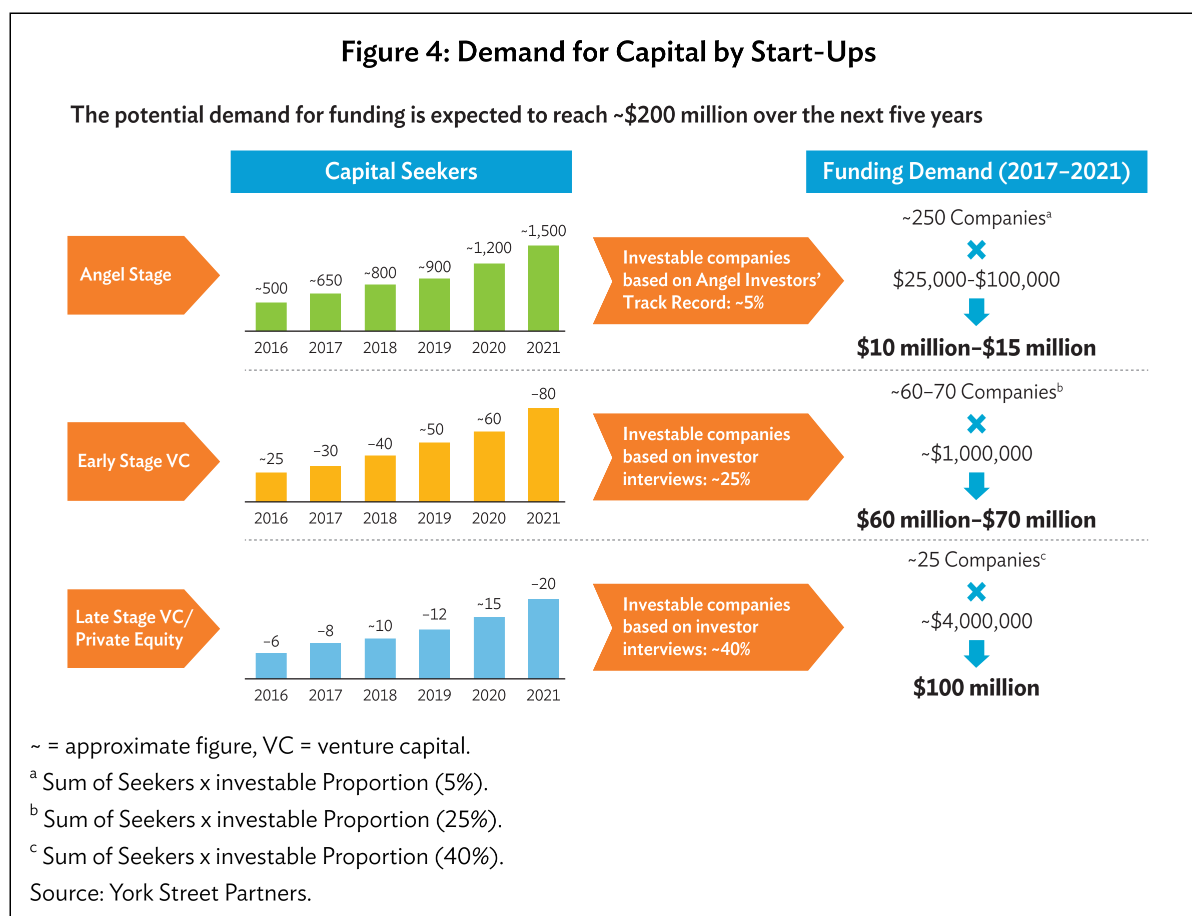
The potential demand for capital by start-ups is expected to reach $200 million over the next 5 years (Figure 4):

(i) **Angel funding.** Unique applications for angel funding are estimated to be in the range of 500 in 2016, based on the applications received by the larger business plan competitions, and assuming 50% overlap. Conservatively, we expect this to grow at a compound annual growth rate of 25% over the next 5 years, far lower than the 50% compound annual growth rate over the last 4 years. Based on the historic track record of business plan competitions for start-ups, 5% of the applications received are assumed to be fundable. As such, 250 companies are likely to become candidates for angel funding, with capital requirements of $25,000–$100,000. Therefore, the demand for angel funding is estimated to be $10 million–$15 million over the next 5 years.

(ii) **Early-stage venture capital.** Approximately 25% of companies that have received angel funding in Sri Lanka have sought to raise venture capital funding, which is conservatively assumed to remain constant over the next 5 years, although additional nonfinancial support to start-ups could increase their success rate and therefore the need for follow-on early-stage capital. With start-ups seeking $1 million in funding on average, demand for early-stage venture capital is estimated to reach $60 million–$70 million over the next 5 years.

(iii) **Late stage venture capital and private equity.** Approximately 40% of the companies that receive early-stage venture capital are estimated to require an average of $4 million additional funding. This information is based on investor interviews; the market remains relatively untested in Sri Lanka.

Figure 4: Demand for Capital by Start-Ups



~ = approximate figure, VC = venture capital.

[a] Sum of Seekers x investable Proportion (5%).

[b] Sum of Seekers x investable Proportion (25%).

[c] Sum of Seekers x investable Proportion (40%).

Source: York Street Partners.

In summary, several characteristics are observed around the finance market for start-up SMEs in Sri Lanka:

(i) **Clear demand.** Sri Lankan start-ups have a clear need and demand for external investment due to their limited track record, low asset base, and constrained access to bank financing.

(ii) **Lack of supply.** Entrepreneurs have few funding options, particularly for early-stage venture capital.

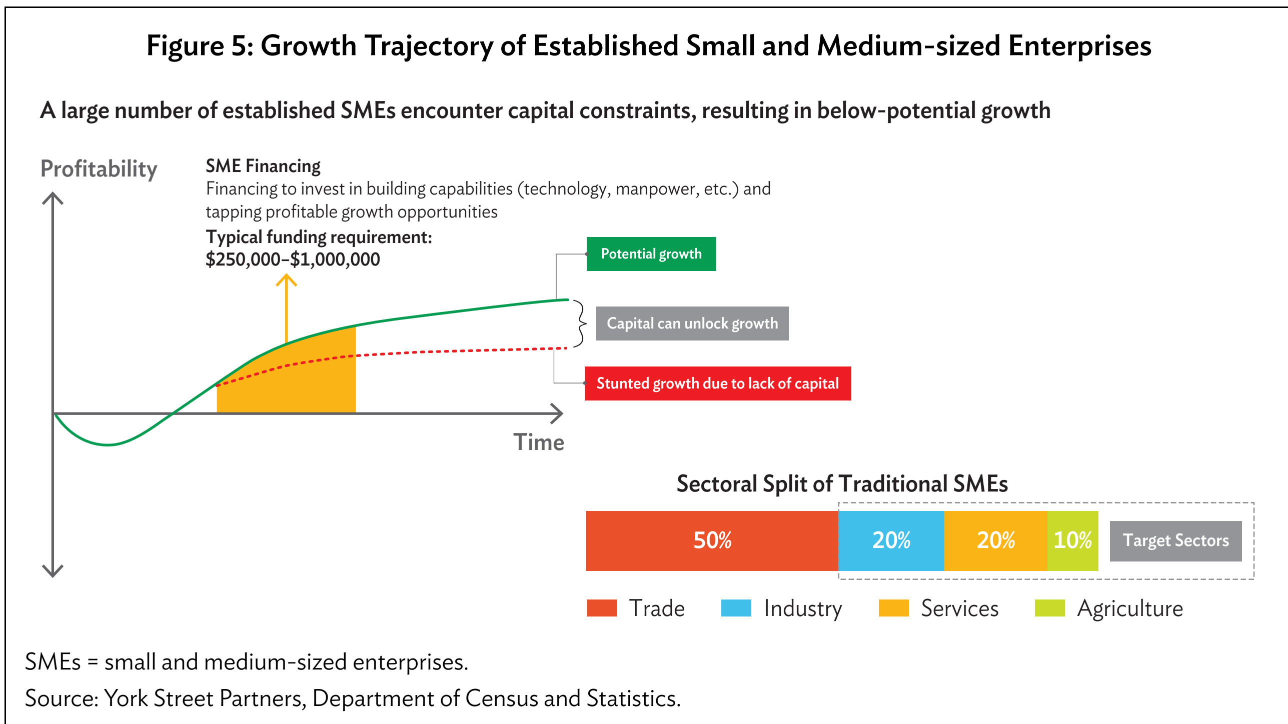
(iii) **Willingness to work with external equity providers.** Start-ups have a more modern business outlook and therefore are receptive to external equity.

(iv) **Nascent market.** Sri Lanka's start-up ecosystem has become increasingly vibrant with the potential for significant growth and could unleash a dynamic culture of entrepreneurship among Sri Lanka's youth; nonetheless, it is only a few years old and is still relatively small.

2. Established Small and Medium-sized Enterprises: Unlocking Growth

In contrast to start-up SMEs that remain relatively small in number, established SMEs constitute the majority of Sri Lanka's SME sector. They are typically long-standing enterprises that have built stable business models in relatively traditional markets. They are mostly managed by their owners or founding families, who are hesitant to give up control and often, operate quite conservatively. Furthermore, many established SMEs remain unregistered businesses that operate as sole proprietorships. With banks still largely engaging in collateral-based lending, many SMEs lack funding for expansion, including capital expenditure upgrades, professionalization of management, expanding into export markets, and talent upskilling. Consequently, their growth has been constrained. Providing the appropriate type of capital therefore has the potential to unlock significant growth (Figures 5 and 6).

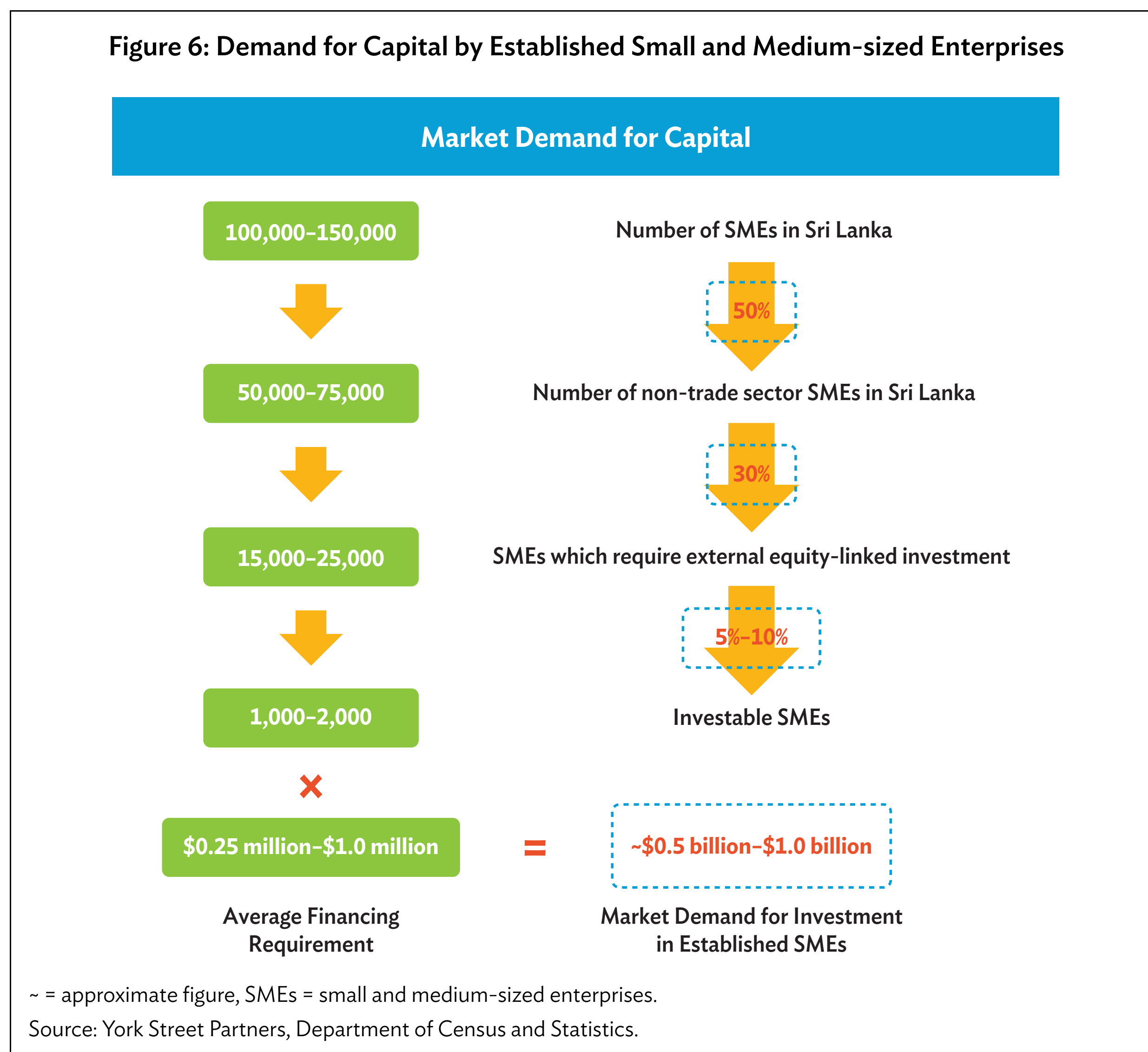
Figure 5: Growth Trajectory of Established Small and Medium-sized Enterprises



SMEs = small and medium-sized enterprises.

Source: York Street Partners, Department of Census and Statistics.

Figure 6: Demand for Capital by Established Small and Medium-sized Enterprises



~ = approximate figure, SMEs = small and medium-sized enterprises.

Source: York Street Partners, Department of Census and Statistics.

The potential **demand for capital by established SMEs** is estimated to reach $0.5 billion–$1 billion. Total lending to SMEs in Sri Lanka, which currently stands at $3.5 billion, is primarily provided by banks. Based on data provided by banks on estimated market share, average loan sizes, and number of borrowers with multiple loans, the number of established SMEs in the country is estimated to be in the range of 100,000–150,000. This was triangulated by statistics from the Department of Census and Statistics in 2013 that estimated 80,000 SMEs in Sri Lanka, but that used a narrower definition of companies with less than 35 employees in trade, 75 employees in services, and 200 employees in manufacturing.

SME banks estimate that 50% of their SME portfolio is in trading, which is unlikely to be the target market for an SME venture capital fund; as such, SMEs have limited need for equity or quasi-equity capital and are likely to be microenterprises. As such, the target market for this fund is estimated to be 50,000–75,000 SMEs.

Using a combination of estimates from SME financiers as well as data from our market assessment, we estimate that 30% of these SMEs have a need for equity. However, many SMEs have limited appetite to dilute ownership by bringing on external partners. Furthermore, based on our interviews, many do not have scalable operations. As such, we have conservatively estimated that 5%–10% of companies with need for funding would be able and willing to accept investment. This equates to projections of $0.5 billion–$1 billion worth of demand for capital and absorptive capacity by established SMEs over the next 5 years.

In summary, several characteristics are observed around the finance market for established SMEs in Sri Lanka:

(i) **Unwillingness to dilute limits demand for equity, despite the need.** Although many SMEs lack the equity capital to invest in expansion, they have been unwilling to seek external partners due to fear of giving up control; *as such, investing in SMEs will require the use of creative instruments that provide equity capital, capture upside, but limit promoter dilution*.

(ii) **Limited supply.** There are almost no providers of venture capital to SMEs: the only two private equity funds in Sri Lanka are focused on mature and high-growth companies, with professional management in place, which is a very small segment of the overall SME market. Furthermore, their target investment size is in the range of $2 million–$7 million, far larger than the investment requirements of most SMEs.

(iii) **Small and medium-sized enterprises would benefit from technical assistance.** SMEs generally benefit from support in (a) improving management capacity and (b) developing regionally or globally competitive expertise and access to those broader markets.

B. Navigating Exit: Mergers and Acquisition, Private Equity, and Initial Public Offerings in Sri Lanka

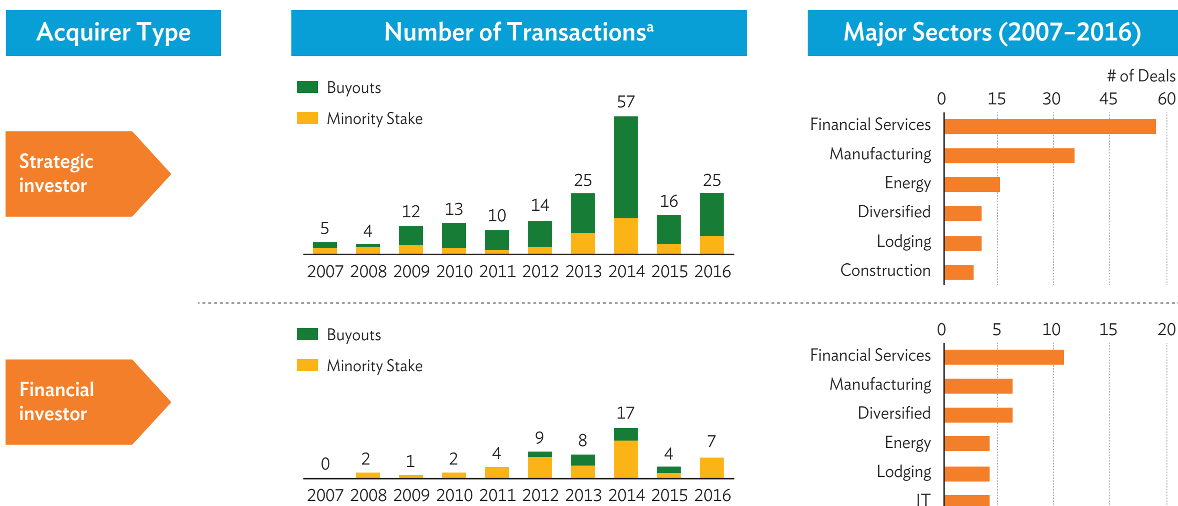
Typically, equity investors exit their investments through trade sales (through the sale of their stake to strategic investors), secondary sales (stake sale to other private equity players), or through initial public offerings (IPO) on a stock exchange. The feasibility of these exit options is based on the depth of the local private equity and mergers and acquisition (M&A) environment.

1. Mergers and Acquisition Environment in Sri Lanka

Comprehensive data on transactions is relatively hard to compile in Sri Lanka as many transactions, particularly for minority stake sales and SMEs, often go unreported. As such, the data set we have compiled is not comprehensive and is likely to be significantly understated. Nonetheless, it provides a good starting point to understand directional trends in the M&A environment.

M&A activity in Sri Lanka has been on a consistently upward trend: it has been dominated by strategic investors in in the country, who accounted for over 90% of all controlling-stake transactions in the last decade and 55% of all non-control transactions in the data set we compiled (Figure 7). The high participation of strategic investors has been partly driven by the lack of private equity focused on Sri Lanka, which has begun to change (see section on Private Equity in Sri Lanka).

Figure 7: Transaction Activity in Sri Lanka



IT = information technology.

[a] Figures for 2016 are until November 2016, data for number of controlling and minority stake sales is not comprehensive.

Sources: York Street Partners, Bloomberg Database.

2. Trade Sales to Strategic Investors

Control transactions in Sri Lanka, where strategic investors acquire majority or full ownership of a company, have generally been relatively few over the last decade (less than $10 million, spread across the financial services, manufacturing, energy, and leisure sectors) with just a handful of deals over $50 million (primarily in the financial services and telecom sectors). The average buyout deal size has been around $15 million. A government-mandated push for consolidation in the financial services sector resulted in a spike of activity in 2014.

The buyout market has been dominated by strategic buyers (apart from the occasional private equity buyout such as TPG's acquisition of Union Bank), particularly since strategic investors typically prefer controlling stakes. Foreign players have also been reasonably active, with 30% of buyout deals in the last decade having a cross-border angle.

The increase in such transactions over the last decade suggests that while overall volumes remain low, there has been a gradual increase in the acquisition appetite by strategic investors accompanied by a similar shift in the mind-set of Sri Lankan promoters toward selling out. Our market analysis suggests that this shift is particularly evident among second generation-run established SMEs and entrepreneurs running high-growth companies.

In terms of minority stake sales, where investors acquire only a minority stake in a company, strategic buyers have been particularly active. As opposed to financial buyers, strategic buyers have accounted for more than half of aggregate non-controlling transaction volume during the last decade. The median size for minority stakes within the data set compiled for this study is $7 million—likely a materially overstated figure given the large number of smaller-sized transactions with unreported deal values.

Initial indications suggest increasing activity in transactions involving minority stakes, with 15 taking place in 2016, making it one of the most active years on record (aside from the spike in 2014).

3. Secondary Sales to Financial Investors

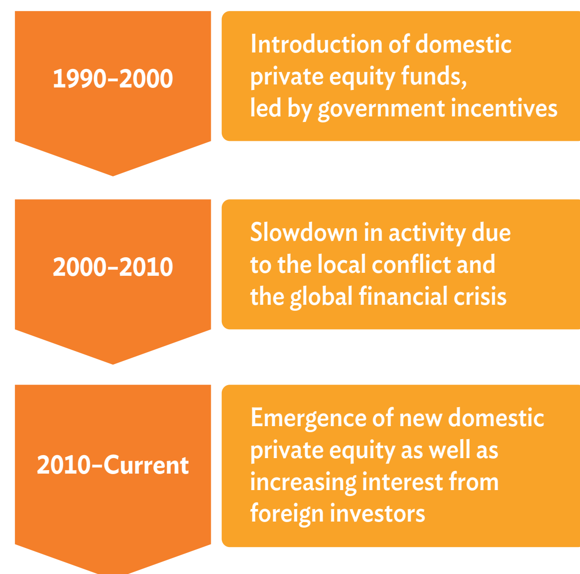
After a period of relative inactivity, Sri Lanka's private equity sector has witnessed growth in the last 4–5 years. Domestic private equity firms in the country were first launched in the early 1990s through a government-initiated push, mainly in the form of tax incentives. This led to the establishment of seven private equity funds by 1992, which collectively invested $20 million in 100 companies by the end of the decade.[1]

The subpar performance of these funds (a follow-up study by the United States Agency for International Development in 2000 categorized only 1 investment as a "success" and 60 as likely to be "lost"), the expiry of tax incentives, and the escalation of conflict then saw a marked decrease in activity, with no new domestic-focused funds launched until 2012. While 3–4 fund managers tried to raise funds right after the end of the conflict, they failed to generate sufficient limited partner interest.

With transaction sizes generally inadequate to generate sufficient foreign investor interest and a dearth of local institutional financial investors, private equity activity slowed down considerably over 2000–2010.

However, this has begun to change over the last few years. Two local private equity funds, Ironwood Capital and The Emerald Sri Lanka Fund, were launched in 2014 with $80 million in aggregate capital and an increasing number of prominent international investors (e.g., TPG) have made investments in the last 5 years. Additionally, several regional private equity funds have evaluated deals in Sri Lanka in recent years, with aggregate private equity deal volume of 20–30 investments since 2010. As such, private equity is increasingly likely to be a potential exit route for venture capital investors going forward (Figure 8).

Figure 8: Private Equity Timeline in Sri Lanka—Brief Timeline



Source: York Street Partners.

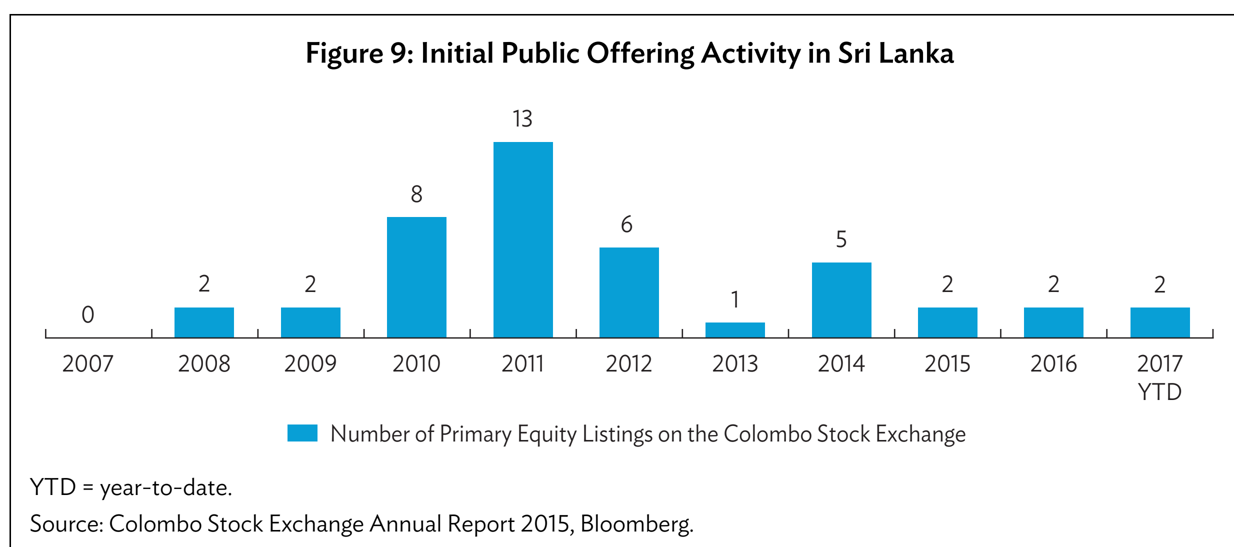
[1] Bouri, Amit, et al., "The Landscape for Impact Investing in South Asia – Sri Lanka", GIIN-Dalberg.

4. Initial Public Offering Market in Sri Lanka

Sri Lankan public equity markets are relatively nascent, with some of the largest companies on the island still privately held. This is primarily due to the general impression of the lack of any material advantages to listing, the requirement of publishing financials publicly, and the unwillingness to dilute equity. This, in turn, results in a moderately liquid market with few participants, with daily average aggregate market turnover at just $6.1 million during the first three quarters of 2017 across 295 listed firms on the Colombo Stock Exchange.

The equity IPO market has been largely dormant in Sri Lanka recently, with only six IPOs between the beginning of 2015 through June 2017. There was a brief spike in 2010–2011, when markets rose by over 100% across a period of 14 months, and 21 IPOs were initiated in those 2 years. Since then, lock-in period directives issued in 2011 as well as market underperformance have decreased investor appetite to pursue IPOs as an exit option (Figure 9).

Figure 9: Initial Public Offering Activity in Sri Lanka



YTD = year-to-date.

Source: Colombo Stock Exchange Annual Report 2015, Bloomberg.

5. The Outlook for Venture Capital Exits

Strategic investors have been the most active acquirers of businesses in the country over the last 10 years. The low participation of financial buyers has been driven by the very limited presence of Sri Lanka-focused private equity funds. However, recently, this has begun to change, with two Sri Lanka-focused private equity funds being established in the last 2 years, and regional and global private equity funds becoming increasingly active. As such, financial buyers are likely to play a more active role in M&A activity in the future. Based on the current environment, IPOs remain the least likely exit route for venture capital investments as their viability as an exit route is closely linked to the performance of the stock market.

Trade Sale

(i) **Control transactions.** There has been relatively steady activity in control transactions. While this has been dominated by local strategic players, international buyers have also been active. Attractive, scalable firms that have synergies with strategic investors could be prime acquisition targets. Local entrepreneurs are gradually becoming more open to sale of control.

However, as many remain reluctant to buyouts, successfully executing this exit route will require alignment early in the deal cycle.

(ii) **Minority stake sales.** The significant number of minority stake sales over the past decade, and particularly the recent increase in deal activity suggests that there is increasing interest in these types of transactions.

Sale to Private Equity

(i) There has only been a single notable private equity secondary sale in the last decade (Actis sold its stake in Asiri Hospitals to TPG in 2015). The dearth of local private equity players and limited interest from foreign funds made this an unlikely exit option in the past.

(ii) However, the emergence of local private equity firms (primarily focused on midsize investments) and increasing interest from regional funds (which typically have a larger size mandate) makes this a more likely exit option going forward, particularly for SME investors.

Initial Public Offerings

(i) IPO activity in the country has been directly correlated to the performance of the markets and therefore, the viability of an IPO as an exit route will be based on timing.

(ii) While there are a few examples of private equity firms which invested in companies prior to IPO, their exits have been staggered over duration after listing due to lock-in rules on institutional investors.

II. INTERNATIONAL PRECEDENTS IN SMALL AND MEDIUM-SIZED ENTERPRISES AND SMALL AND MEDIUM-SIZED ENTERPRISE VENTURE FINANCING

There is a diverse array of international precedents for both government-backed initiatives in venture capital and SME finance as well as specific SME finance approaches that have been proven effective in emerging economies. These precedents would provide useful insights for the Sri Lankan context. In this section, we discuss case studies and lessons learned from both types of precedents.

A. Government-Backed Small and Medium-sized Enterprise Financing Precedents

Governments around the world have often played an instrumental and effective role in supporting SME growth, both through direct capital provision and other ecosystem-building efforts.

Government's investment involvement ranges from direct, controlling involvement in all investment aspects, to very light or indirect participation via private sector investment managers. We therefore segment the precedents into two categories (even though several governments have pursued a strategy that combines several aspects of both):

(i) Direct funding and/or ownership and investment decision-making (less common)

(ii) Hybrid funding with private investment managers and/or investors (most common)

1. Direct Funding and/or Ownership and Investment Decision-Making Case Studies

On one end of the participation spectrum, governments have made attempts to directly fund SMEs and build their capacity to realize investment value. In the People's Republic of China (PRC), there have been several government initiatives to invest directly in high-tech start-up firms via state-owned venture capital funds, as well as efforts to establish a venture capital and SME finance ecosystem from both policy and regulation perspectives. Since the establishment of the first venture capital company (China VC Company for New Technologies) in 1985, governments at all levels in the PRC have invested directly in start-up high-tech firms. After the Asian financial crisis of 1997–1998, the government realized that SMEs were more resilient to economic downturns than larger firms. It also came to believe that direct investment was not the most efficient way of supporting the growth of SMEs and high-tech young firms, and began to play a more indirect and supportive role by investing in private venture capital funds. However, the removal of direct public intervention had some downsides. Once the government gave up direct investment in SMEs, the natural pursuit of economic profit by private fund managers had the investment target tilt toward later-stage investments.[2]

In Africa, Kenya led the space with the establishment of the Industrial and Commercial Development Corporation (ICDC) back in 1954. ICDC is a state-owned, self-financing development finance institution dedicated to providing medium- and long-term financial solutions to entrepreneurs and young businesses to promote economic development in Kenya. The Government of Kenya is the sole shareholder, and there is minimal private sector involvement in governance.[3] The fund invests through equity, short- and long-term debt, and guarantees. It has co-invested alongside mainstream private equity and commercial investors on occasion. The institution also offers technical assistance and business development services to its investees. However, investment performance has been reportedly poor, with a high number of write-offs and low transparency.[4]

Singapore represents one of the most successful examples of direct state investment involvement. The Government of Singapore's involvement in funding earlier stage businesses is robust and goes beyond equity financing schemes to include other programs such as cash grants, business incubation schemes, debt financing schemes, and tax incentives to support both early-stage businesses and encourage innovation. Most of these financing schemes operate on co-funding models where the government invests in existing venture capital funds, or co-investment models with the government matching private funding dollar-for-dollar up to a maximum amount. These funds often are managed directly by government agencies or government-linked companies such as the Economic Development Board Investments, Vertex Management, and Economic Development Board Life Science Investment.[5] The funds mostly target businesses in "government strategic areas"—information and communication technology (ICT), biomedical sciences, clean technology, and digital media—and come with integrated business incubation support services.

Nigeria has also had some success with direct state funding and decision-making, albeit at a much smaller scale. In 2011, Nigeria ran a nationwide business plan competition for entrepreneurs to test whether it is possible to distinguish entrepreneurs with potential for growth from their "subsistence entrepreneur" peers. Of the 23,844 applicants, 1,200 winners were selected to receive prizes averaging $50,000 each. Three years later, these 1,200 winners were estimated to have generated more than

[2] Murray et al. (2012).
[3] ICDC Kenya, "About ICDC". http://www.icdc.co.ke/ (accessed 13 March 2017).
[4] Mwaura (2007).
[5] Butler et al. (2006).

7,000 new jobs compared with the control group. It also appears that success was primarily due to capital injection, rather than being a winner of the competition or participating in the business training component.[6]

2. Hybrid Funding Models

Despite these examples of direct state funding initiatives, it is more common for governments to channel SME venture financing by partnering with private investors and/or private sector investment managers. Such programs often use private sector venture capital firms as the commercial conduits through which public support and increased finance is directed. These vehicles are considered hybrid schemes given that they involve an influential participation by the state as a "special" limited partner (LP) or as a public guarantor for a significant proportion of the total funds raised and invested. Critically, after agreeing investment eligibility guidelines, the state delegates full operational autonomy to the general partnership which is mandated, and incentivized, to achieve commercially attractive investment returns for the investors (LPs).[7]

A seminal model is the United States Small Business Administration program "Small Business Investment Companies" (SBICs), created in 1958, in which the US Small Business Administration partners with private investors to capitalize professionally managed investment funds (known as "SBICs") that finance small businesses.[8]

The Government of the United Kingdom also has a history of fostering early stage venture capital going back to the end of the Second World War. Since 1999, it has designed and cofinanced with independent venture capital general partners seven different, hybrid venture capital programs to support the early stages of firm formation and growth. One of these is the enterprise capital fund to provide growing businesses with individual equity financings up to a £2 million ceiling as a British interpretation of the SBIC model.[9]

Australia's experience dates back to 1997, with the creation of the Innovation Investment Fund (IIF) program, started by the Commonwealth Government to provide venture capital to young Australian companies via a series of fund partnerships with Australian investment managers. Elsewhere, Canada has a Labour Sponsored Venture Capital Corporation (LSVCC) and New Zealand runs the New Zealand Venture Investment Fund (NZVIF).

Governments in continental Europe have also played an active role. In France, the government invests annually nearly €200 million in business accelerators and incubators under the "La French Tech" umbrella, designed to support the growth of digital companies. Bpifrance or la BPI, France's public investment bank, is also a key player in the local investment scene, providing more than €1 billion annually in investment funding for a wide range of innovative companies. France also has a system of subsidies, grants, and tax breaks available for early-stage ventures.[10]

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6 Innovations for Poverty Action. 2015. Identifying and Spurring High-Growth Entrepreneurship: Experimental Evidence from a Business Plan Competition. https://www.poverty-action.org/publication/identifying-and-spurring-high-growth-entrepreneurship-experimental-evidence-business.

7 Footnote 2.

8 United States Small Business Administration. SBIC Program. https://www.sba.gov/sbic (accessed 13 March 2017).

9 Footnote 2.

10 Government of France. La French Tech. http://www.gouvernement.fr/en/la-french-tech (accessed 13 March 2017).

In Hungary, the state has taken a multipronged approach when it established the Hungarian Development Bank Plc. (MFB Plc.), a holding company for venture capital fund management companies. The state is 100% owner of this firm. Its subsidiary fund management companies are either stand-alone venture capital funds that are entirely state-owned, are joint ventures with private fund managers, or are engage in opportunistic co-investments with private fund managers.[11]

In the PRC, as previously discussed, the government began adopting a more hybrid approach in the late 1990s, co-investing with private sector investors, in some cases through a fund-of-funds model. These models seek to isolate government influence from the commercial management of the funds and require 3:2 ratio of private to public capital or higher.[12]

With Poland's accession to the European Union (EU) in 2004, the country embarked on a variety of initiatives to support the nascent venture capital industry, leveraging new European structural funds to which they now had access. One program has supported six seed funds, whose investment strategy was often more directed at rescuing vulnerable and ailing small businesses rather than developing exciting high-growth start-ups.[13] Other programs were more directed at high-growth and innovative SMEs, including the national capital funds that operate as a fund-of-funds anchored by a national Polish bank, the Government of Poland, and EU funding.

More recently, Ghana and Nigeria have been pursuing new innovations as far as government support to SME growth is concerned. Ghana used a national reconstruction tax to establish the Ghana venture capital trust fund (VCTF) in 2004. The VCTF's initial mandate was to invest in venture capital funds incorporated in Ghana that make equity and quasi-equity investments to small businesses. However, the fund later expanded its investment mandate to investing in microfinance institutions and other lending entities for on-lending to SMEs. With the first two finance companies, the VCTF was actively involved in developing business plans and setting investment criteria standards for investing in SMEs with social or environmental missions. The inaugural funds provided a reference from which subsequent financial service providers were able to submit proposals in line with VCTF objectives.[14] In 2007, after the National Reconstruction Levy was repealed, the fund widened its investment funds sourcing activities to include private investors, by providing tax incentives for investing in the finance companies. To date, the VCTF has invested in six venture capital funds. The VCTF was also instrumental in creating the Ghana Alternative Market (GAX) in 2013, an alternate listing on the country's stock market specifically for SMEs.[15] This will be useful in providing more exit routes for VCTF's investments.[16]

3. Ecosystem Building and Technical Assistance Support

In addition to investing in SMEs and investment funds financing SMEs, governments around the world have also adopted broader intervention platforms aimed at building the entrepreneurial ecosystem for SMEs.

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[11] Kortum and Lerner (2000).
[12] Chu and Fung (2016).
[13] Footnote 2.
[14] Venture Capital Trust Fund. Ghana Venture Capital Trust Fund Operations. http://www.venturecapitalghana.com.gh/operations/ (accessed 13 March 2017).
[15] "Breaking the Binary" World Economic Forum Policy Guide to Scaling Social Innovation. 2013. http://reports.weforum.org/social-innovation-2013/06-the-venture-capital-trust-fund-ghana/.
[16] Footnote 14.

Facing the challenges that constrain the PRC's ability to fully realize its potential in developing its innovative industries, the government also started to focus on strengthening the entrepreneurial ecosystem to provide a conducive and supportive environment for the growth of the venture capital industry. Since 2006, several laws and other legislative refinements have been enacted to reform the structure, funding, management, and exit mechanisms of the PRC's venture capital industry.[17]

Efforts such as these aimed at strengthening the broader entrepreneurial ecosystem are borne from a growing recognition that capital alone may not be sufficient to build a sustainable SME funding market in the long run. Even in the most developed venture capital markets such as the United States and the United Kingdom, governments have complemented their hybrid and direct 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.

4. Key Implications for Role of Government in Small and Medium-sized Enterprise Financing

There is a general consensus that these funding models need to undergo more rigorous academic evaluations of their performance and results in order to determine more precisely their relative effectiveness. But experiential evidence and the continued growth of these various schemes indicate that they do fill a clear gap in the market, and there is a useful role for government to play in filling that gap.

Besides the benefit of crowding in more capital, other incentives that enhance returns and reduce risk for private sector participation further down the line are key aspects to ensure that the SME financing mechanisms will sustain beyond the government's involvement and without continued reliance on government participation.

These characteristics are especially evident within the more commonly used hybrid public–private investment schemes. The most relevant key incentive parameters are as follows:

(i) **Returns enhancement.** One common return enhancement mechanism is yield limitation for public funds by capping the returns due to publicly funded tranche of a hybrid vehicle. This serves to decrease the overall cost of capital of the fund and increase the expected rate of return for private investors, hence helping to "crowd in" capital from private investors. In Hungary, for instance, the MVF PLC has capped its return to the weighted average of EU base rates. This capping of government yields increases the private LPs' profit when the internal rate of return (IRR) of the fund exceeds the interest rate on the debt. Additionally, public and private funds within hybrid structures can also be treated differentially in terms of timing: either (a) through differential timing of the investment "draw downs" of public and private investor funds (the public commitment to the fund is drawn down first, followed by the private funding and/or (b) the public investor can also take a lower priority in receiving returns and payback of investment by prioritizing the timing of cash flows for private investors. These terms serve to shorten the duration of private investment and boost their IRRs relative to those of the publicly funded tranche.

[17] Footnote 2.

(ii) **Risk reduction and/or downside protection.** The public investor can either provide a guarantee on downside (losses) to private investors or absorb the first loss in the fund up to a certain level. For instance, the Government of Hungary absorbs the initial losses to a fund, up to 5% of the highest subscribed capital of a hybrid fund. This serves to guarantee some minimum return of capital for risk-averse private investors, with the hope that the actual realized defaults will be lower than the perceived risk, demonstrating the attractiveness of the market going forward for investors.

(iii) **Tax subsidies.** Tax subsidies, credits, or deductions for private investors have been common and successful tools for drawing in private investment into hybrid or non-hybrid funds, widely used in the United States and Europe.

(iv) **Fund operating cost subsidies and/or manager capacity-building.** The government contributes funds to cover the design fees and fund management fees over the first few years of the fund, in effect lowering the cost to private investors from management fees, as done by a hybrid venture capital fund in Croatia. Governments have also helped to build fund manager capacity to develop a larger pool of people in venture capital market with the right skills and expertise in early-stage investment. In New Zealand, for instance, the government supported capability building with funded internships for both new and existing venture capital fund managers to expand the domestic skill base.

(v) **Buyout options.** In this case, private investors are given the option to buy the share of the government at (or until) a specific point of time at predetermined price (typically nominal price + interest). The effects on the IRR of private LP are similar to the yield limitation structure, and it further (a) gives both the public and the private LP an opportunity to demonstrate success earlier and more visibly than in the capped return alternative and (b) in the case of success, government gets a quick exit from the fund and can reinvest the money instead of waiting for the returns on fund termination. In New Zealand, the NZVIF's venture capital fund was designed with a "buyout" clause.[18] Under this arrangement, private investors have the option to exercise the buy-out in the first 5 years of the fund life, at a price which returns NZVIF its capital invested plus a rate of return on that capital equal to the yield on the 5-year government bond rate.

At the same time, these various government-incentivized structures do come with several key risks:

(i) **Incentivizing undue risk-taking by fund manager and/or private investors.** When public funds are available in a hybrid structure to absorb the lion's share of the risk while leaving the upside to be captured by private funders, this may incentivize the fund manager and/or private investor to take undue risk in order to maximize their returns, knowing someone else will cushion against losses.

(ii) **Crowding out private sector investors.** Government-backed funds may be able to offer terms that are so subsidized that it discourages private sector investors and fund managers from competing effectively for the same investment opportunities. This effect was observed in the Canadian Labour Sponsored Venture Capital Corporation (LSVCC) program which granted major tax break to LSVCCs and resulted in the high growth of the LSVCCs while the private venture capital industry actually witnessed a small decline.[19]

(iii) **Imposing "hand-out" expectations.** If a government actor plays a large and persistent role in providing subsidized capital on concessionary terms to the market, market actors

[18] Cumming and Johan (2012).
[19] McCullough (2016).

including investors, fund managers, and investees may set their expectations as such and be unwilling to engage on more sustainable commercial terms.

(iv) **Leverage risk.** When government serves to provide debt funding that leverages the capital structure of a hybrid fund with the intention to boost returns for equity funders, this also means that poor fund performance can increase the total losses to private investors.

(v) **Mismatch with investee needs.** If hybrid funds are structured to incentivize the fund manager to treat government funding in a certain way, the fund manager may make decisions that are not in the best interests of the portfolio and investees. For instance, if the fund manager has a buyout option, they may be more focused on raising enough cash to buy out the government's ownership in the fund, imposing exit time frames that are suboptimal for the investee's needs.

B. International Precedents for Financing Established Small and Medium-sized Enterprises

While conventional venture capital funding models have had success in financing high-growth start-ups around the world, they are far less suited to provide financing for the more mainstream established SMEs. Given the important role more established SMEs play as job engines and drivers of economic growth, it is therefore important to highlight investment models and instruments that have been deployed to finance the mainstream SME segment.

Several decades of SME financing initiatives—in more developed as well as emerging economies—have provided a number of interesting SME financing models that specifically target the more mainstream established SMEs.

1. Three Case Studies of Small and Medium-sized Enterprise Finance Funds

Business Partners Limited[20]

Business Partners Limited (BPL) is a fund management company that supports SME growth by providing financing, specialist sectoral knowledge, and advisory services to viable SMEs in sub-Saharan Africa. The firm invests through blended debt and equity offerings for SMEs. BPL itself is not a fund but a permanent financial institution and incorporated as a company structure. This gives BPL a long-term balance sheet that allows it to revolve in and out of investees over time, exiting based on the appropriate horizon for the investment rather than based on a predefined fund term. Since its creation, the firm has also launched several country funds that are structured more as traditional limited-life funds.

In terms of funding, BPL deploys equity instruments, like most traditional venture capital and private equity firms, but blends it with a range of other quasi-equity and debt instruments. These specifically include

(i) quasi-equity instruments such as royalty-based financing where investment repayments are determined as a percentage of revenue, and

(ii) debt instruments such as fully secured, partially secured, or unsecured loans.

[20] All BPL information sourced from public BPL marketing material and https://www.businesspartners.co.za/en-za.

BPL assesses each investee for its risk profile and financing needs and invests through a combination of instruments. As opposed to pure equity investments, these blended finance approaches can enable a partial exit during the investment term by way of debt redemption and royalty payments.

The firm deploys a technical assistance facility and entrepreneur mentorship program that are both essential to ensuring the sustainability of the portfolio. To support its portfolio of nearly almost 2,000 active investments, BPL has developed a database of hundreds of industry experts willing to share their insights with struggling entrepreneurs. The firm has developed an online platform to match entrepreneurs with mentors quickly and easily.

GroFin[21]

Likewise, GroFin is a development financier/impact fund manager specializing in financing and supporting what they term small and growing businesses (SGBs) across Africa and the Middle East. GroFin mainly provides the following investment instruments:

(i) flexible, partially unsecured loans, and
(ii) equity in only about 5% of their transactions, and usually in the form of redeemable equity.

GroFin uses standard pricing mechanisms, term sheets, contracts and standard investment processes that are similar across country offices, while allowing for more flexibility on a limited number of parameters, such as grace periods and repayment profile. This enables the firm to process a high volume of smaller transactions, an important feature of success in reaching many enterprises.

GroFin also deploys local in-house investment professionals to provide tailored business support to increase each business's chance of success. Since its establishment in 2004, GroFin has grown and now manages 10 funds and programs on behalf of more than 30 international development finance institutions, development organizations, foundations, large companies, and private funders with raised funding of more than $500 million. The firm has successfully exited two funds, and one is fully invested and is being harvested (the $170 million GroFin Africa Fund). The remaining funds are in active growth phase and consist of four unlimited-life funds and three limited-life (10-year) funds. The firm targets to invest between $100,000 and $1.5 million of patient risk finance (3–8 year term) in SGBs. Since its inception, the firm has completed over 800 transactions and has raised 10 funds from 32 investors or funders.

Small Enterprise Assistance Funds[22]

Small Enterprise Assistance Funds (SEAF) is a global fund management group, headquartered in Washington, DC and Amsterdam. SEAF, which started operations in 1989, invests growth capital in early stage and SMEs in emerging and frontier markets.

SEAF investment funds employ a full range of financial instruments with a diverse and flexible set of features designed for each opportunity and context. These include equity, quasi-equity, and structured debt.

Each fund is typically accompanied by an active technical assistance component with both internal experts as well as external consultant network, which allows targeted post-investment business development assistance to increase sales and improve operational efficiency.

[21] All GroFin information sourced from public GroFin marketing material and http://www.grofin.com/.
[22] All SEAF information sourced from public SEAF marketing material and http://seaf.com.

2. Key Takeaways for Financing Established Small and Medium-sized Enterprises

The most important common feature across these successful SME financing models is the use of blended and flexible investment instruments rather than traditional equity. A summary of these instruments is provided in Table 2.

Table 2: Summary of Instruments Utilized by International Small and Medium-sized Enterprise Finance Case Studies

Instrument	Description	Business Partners	GroFin	SEAF
Term loan	Financing on a fully collateralized basis	Yes	Yes	Yes
Equity	Direct equity financing	Yes	Yes	Yes
Mezzanine	Debt with equity-like features			Yes
Term loan with royalty	Blended funding structure which combines a partially secured term loan with periodic revenue-based payments that are determined as a percentage of revenue	Yes		
Term loan with shareholding	A combination of a partially secured term loan and minority equity investment	Yes		
Term loan with royalty and shareholding	Combination of an equity and a loan investment with a royalty stream (% of revenue)	Yes		
Property finance with shareholding	Premises financing	Yes		
Property finance with equity participation	Premises financing	Yes		
Property finance with royalty	Premises financing	Yes		

SEAF = Small Enterprise Assistance Funds.

Source: D Capital.

These instruments

(i) provide more flexibility and reduce the need for collateral, a key obstacle for mainstream SMEs in accessing bank lending, both globally and in Sri Lanka;

(ii) offer a strong alignment between the SME owner and fund manager and/or investor. At the same time, they do not put an unnecessary strain on the company's growth given that the flexible repayment schedule accommodates potential fluctuations in the company's performance;

(iii) are less difficult to negotiate than equity and permit the SME owner to maintain ownership control, something that is often the hardest to agree upon with equity financing; and

(iv) allow for a self-liquidating exit.

C. Implications from International Precedents for Sri Lanka

In conclusion, the international precedents cited above provide key lessons and insights relevant for the Sri Lankan context:

(i) **There is an appropriate role for government to play in direct capital provision.** Evidence shows that governments around the world have often played an instrumental and effective role in supporting SME growth, both through direct capital provision and other ecosystem-building efforts.

(ii) **Private sector involvement is paramount.** Government tends to be more effective when it isolates its role to that of resource provider and delegates commercial investment decisions to that of qualified private sector managers. Along with that must come transparent and rational governance, in which government may have oversight as an anchor or sole funder, but limited or no operational interference. The government's overall strategy, policy approach, and fund structuring should also include the input of private sector players in the venture capital industry.

(iii) **Government involvement should be structured carefully to avoid distortionary risks.** A key rationale for government provision of capital is to catalyze private sector activity through a range of returns-enhancing and risk-mitigating mechanisms. At the same time, the very provision of such incentives poses real risks if poorly designed. These risks include undue risk-taking at the expense of the public funds, the risk of crowding out otherwise active private sector actors, creating expectations of below-market terms, creating a false sense of security for private co-investors, and creating a mismatch with actual investee needs.

(iv) **Blended debt and quasi-equity instruments can be more effective for supporting established SMEs than pure equity alone.** In contrast with equity and conventional venture capital-style investing for newer start-ups, investment strategies that blend equity, quasi-equity, and debt instruments in combination packages tailored to the needs of each investee have proven particularly successful in supporting established SMEs. The benefit of this blended financing approach is that it can provide the appropriate growth capital needed by SMEs that have exhausted their access to internal funding, friends and family, or secured bank financing, while at the same time overcoming the common SME aversion to accepting external dilutive equity capital with structures that are self-liquidating and allow for partial or full exit of the investor over time. Additionally, this financing approach is characterized by highly standardized term sheets and investment processes to reduce the costs of investing in many smaller deals. This improves the economics for the fund manager and enables them to reach a high volume of SMEs.

III. FUND DESIGN CONSIDERATIONS

Sound fund structuring is based on a clear understanding of the investment targets' stage, absorptive capacity for investment, receptivity to investment, growth potential with investment, and investment environment.

There is currently a clearer need and demand for outside investment among Sri Lankan start-ups, due to their limited track record, asset base, and consequently constrained access to bank financing. Furthermore, the more modern business outlook of this demographic of entrepreneurs makes them

more receptive to bringing on external shareholders. Nonetheless, as most start-ups are seeking to disrupt traditional industries with new and innovative business models, they face a relatively high attrition rate.

In contrast, the market assessment indicates that established SMEs demonstrate less demand for external equity, particularly if they are conservative family-owned businesses that do not want to dilute control. However, at the same time, many of them require risk capital to support their continued growth. In fact, there are numerous examples of established SMEs that (i) have the potential to take their business to the next level with regards to scale or quality, (ii) have exhausted secured bank lending as a source of expansion capital, and (iii) also exhibit more openness to outside investment under the leadership of second or third generation family members and professional management teams.

The investment environment and available exit strategies are also important considerations in fund design. The market analysis indicates that Sri Lanka's exit environment is becoming increasingly active, but remains nascent compared with regional peers. As such, a successful investment strategy that has the potential to scale and create significant development impact should incorporate instruments and strategies that mitigate exit risk.

Given the distinctive profiles, financing needs of SMEs and investment environment, the work of fund structuring centers around selecting a financial instrument or basket of instruments and accompanying terms that are best suited to meet the needs of investee firms, while also accounting for the appetite of the investors.

As SME finance is still in its early stages in Sri Lanka, this fund concept has been designed to be implemented first as a pilot, with the ability to expand and grow the program based on its initial success.

A. Fund Design Parameters

1. Investment Targets

The fund would aim to support SMEs that have built stable business models. While the majority of the investees would likely be the established SMEs, start-ups that are cash flow positive may also be potential targets. These firms are typically long-standing enterprises that have built stable business models in relatively traditional markets that are core to the country's economy. Most firms are likely to be closely held by their owners and/or founding families. Those that are held by first-generation owners especially, tend to be hesitant to give up control and often operate quite conservatively. Many can be characterized as so-called "lifestyle" businesses where a family's primary motivation is to sustain their lifestyles with steady income rather than major ambitions for growth and sale. Further, many SMEs are unregistered businesses that operate as sole proprietorships. With banks still largely engaging in collateral based lending, many of these SMEs lack funding for expansion. Consequently, their growth has been constrained.

Despite these general constraints, a smaller subset of these SMEs has nevertheless grown through adapting to their changing market environment, taking strategic risks, and professionalizing management—often under transitional leadership of second or third generation family members who are importing new perspectives and management styles from their education and work experiences elsewhere. This cohort of SMEs has the potential to grow from lifestyle businesses to midsize corporations and beyond.

2. Investment Instruments

Funding may be used for a variety of expansion goals not appropriate for collateralized bank debt, such as capital expenditures upgrades, professionalization of management, expanding into export markets, or talent upskilling. Investment sizes may range from $500,000 to more than $3 million. The market assessment indicated that, while there is a demand for non-debt capital by established SMEs, their unwillingness to divest equity and the low exit potential have limited the demand for and ability to deploy traditional equity instruments. Nevertheless, a range of quasi-equity and debt-like instruments that are proven SME finance tools in other emerging market contexts are also structured to address these challenges in SME financing. These instruments span the debt-equity spectrum, illustrating the diversity of structures and terms available to SME investors.

At one end of the spectrum, there are instruments that are characterized by predominantly debt-like features with fixed and regular payment obligations, no ownership stake in the company, and defined time for repayment. However, as distinguished from pure senior, collateralized debt, such instruments may have lower or no collateral requirements and may be more junior in repayment priority. As such, they carry a higher risk profile for the investors and therefore a higher required return. Such instruments include the following:

(i) Subordinated or mezzanine debt: debt that the investees service after their obligations to a senior lender have been met.

(ii) Cash flow-based lending: debt that is backed by the firm's expected cash flows rather than hard assets, although payment obligations are still fixed.

Moving down the spectrum toward more equity-like features are instruments that incorporate more linkage and exposure to performance. Rather than fixed, regular payment obligations regardless of firm performance, the payments may be partially or completely tied to factors such as revenue or profit in each period. This again changes the risk profile for the investor and the accompanying cost to the investee. The time to repayment may also be more variable, given that full repayment is now dependent on the firm's financial performance. At the same time, these instruments retain debt-like features: they do not require ownership stake in the company, do not share in the losses of the company, and are so-called "self-liquidating" in that the investor automatically exits upon full repayment. Such instruments include the following:

(i) **Royalty-based lending or participating loans.** The investor receives a base interest but is also entitled to additional royalties, which are payments as a percentage of a performance factor, usually revenue or EBITDA.

Moving still further down the spectrum toward equity, instruments begin to take on increasingly equity-like features of sharing both upside and downside performance risk, as well as potential ownership and voting rights. Such instruments include the following:

(i) **Silent participations.** An investor (so-called silent partner) provides capital in return for a participation in the profits of the company, and assumes losses up to their invested capital amount but assumes no liability to creditors unlike true equity owners.

(ii) **Profit-participation rights.** Purely contractual participations in a company where the investor participates as well in profits as in losses of the company but is not a shareholder and has no voting or other shareholder rights.

(iii) **Convertible debt.** Debt with a maturity date, fixed repayment terms, and an option to convert the debt into another financial instrument such as equity. This instrument gives the investor the ability to benefit from equity upside if the company performs well, while protecting downside losses.

(iv) **Warrants.** Instruments issued in conjunction with debt, giving the investor the right to acquire equity in the same company. This instrument is similar to convertible debt, but can be "detached" from the original loan instrument as a separate "sweetener" to attract investment and reduce loan pricing.

(v) **Preference shares.** Shares that have preference over ordinary shares, including priority in receipt of dividends and upon liquidation, often with a fixed annual dividend.

Each of these instruments can then be further tailored by adapting a variety of accompanying terms and covenants such as repayment schedule, default conditions, etc. Additionally, these instruments are often deployed in combination with one another to produce the exact risk-return profile suitable for the investor while ensuring affordability for the investee.

One of the most commonly deployed instruments by funds specifically focused on SMEs in emerging markets is royalty- or revenue-linked lending. This instrument is an unsecured loan with fixed interest and principal repayments, but where the unsecured risk component is compensated by a fee based on a percentage of revenue. The instrument is subordinate to senior secured debt. The royalty is typically calculated as a percentage of the monetary value of turnover. The instrument can be structured to be either cumulative or non-cumulative: a non-cumulative structure would effectively have the investor taking risk alongside the investee to receive their percentage of whatever actual revenues the investee realizes in each period; a cumulative structure would have the investee obligated to make payments according to the higher of actual vs. some pre-negotiated budgeted minimum payment per period and is payable over a specified period, irrespective of whether the entrepreneur pays off the disbursed capital amount ahead of schedule. The latter is more protective of investors' downside, while the former is more equity-like and aligned with the entrepreneur's risk exposure.

This type of instrument can be further tailored by varying the proportion between the fixed return (interest payments) and variable return (royalty fee) components. A higher proportion of the return coming from the fixed return component will make the instrument more debt-like, while a higher proportion of the return coming from the variable return component will make the instrument more equity-like. A higher debt-like component of the instrument with fixed payments will be more protective for the investor's downside but imposes a higher debt service requirement on the investee. At the same time, setting the revenue-based fee too high could be extractive of the investee's topline and prevent them from continuing to invest in their future growth.

The debt component is still a critical component of the instrument's utility in SME financing because it provides a degree of downside protection for investments in what are high-risk, but often not high-yield SMEs. If investors become exposed to pure equity-like risk, but with modest return, then the instrument will not be sustainable in the long run and may distort the market instead of promoting its long-term rational development. Indeed, it is precisely this capital gap that the fund seeks to fill established SMEs with high risk profiles but modest growth prospects that have exhausted senior bank debt but are not yet attractive to commercial strategic or financial investors who seek more pure equity risk and return.

Ultimately, it will be a key to preserving some flexibility for the fund manager to adapt the instrument based on market and investee dynamics. This discretion will be important to strike the right balance between not oversubsidizing the investee's risk-taking but also not overburdening them with repayment obligations.

This type of instrument does require companies to have a transparent business model and proper financial and reporting systems. A cash flow-focused financial forecast should be attached to any royalty-based loan term sheet. This forecast ensures alignment of investor and entrepreneur expectations and reduces the potential for accounting irregularities due to associated covenants. Investees must also be committed to transparency and remain open to frequent monitoring, reporting, and auditing in relation to the fund manager as the fund manager's ability to monitor and verify investee performance is critical to the success of this instrument.

This instrument works well in the Sri Lankan context as it provides risk capital, with downside protection, while creating a self-exit mechanism. The benefits of such an instrument are that it effectively addresses some of the barriers to equity investment observed in the Sri Lankan market, including limited owner receptivity to outside equity and limited exit options. At the same time, it allows SMEs to risk capital for expansion purposes.

Implementing this instrument in the Sri Lankan legal context would require the fund to invest in SMEs through a combination of two instruments:

(i) **Unsecured debt.** Capital repaid through periodic defined principal payments + interest income generated through the life of the loan.

(ii) **Redeemable preference shares.** This instrument would be structured to entitle the fund to a percentage of company revenue for a defined period of time. Capital invested through this instrument would be entirely redeemed through the royalty payment. Income generated in excess of the capital invested would be income to the fund.

The allocation of capital between unsecured debt and redeemable preference shares should be at the discretion of the fund manager, within predefined parameters. As discussed, the higher the debt component, the higher the downside protection for the fund.

In the deployment of capital, eligibility criteria for funding may include

(i) demonstrated operational track record, customer base, and revenue streams;

(ii) growth capital needed for capital expenditures or operating expenditures not appropriate for bank financing;

(iii) 5–7-year horizon for realizing potential returns with capital;

(iv) gross IRR of investment instrument targeting more than 20%;

(v) debt to equity ratio of 1:1 or less;

(vi) willingness to take outside capital; and

(vii) openness to transparent financial accounting and frequent monitoring/reporting.

3. Exits

A key benefit of royalty-based loans is their self-liquidating nature. Interest and principal payment on the loan component and royalty payments are made within a finite period, at which point, the investor concludes their involvement in the company. Royalty-based loans set to an average 5-year term allow sufficient time for the company to make use of this expansion capital. Additionally, a 5-year investment term has the benefit of allowing for some recycling of investor capital within a long-lived fund so that their initial funding commitment can reach a greater number of companies than just the first investment cohort.

Nonetheless, reliance on a self-liquidation mechanism is not necessarily sufficient for a successful outcome. Entrepreneurs can be overly optimistic in projecting performance and ability to repay the investor within a certain time period. Hence, investors need to ensure that terms of liquidation are based on realistic expectations.

4. Technical Assistance and Value Addition Strategy

Besides pure provision of capital, investees also often look for other value-adding benefits from their investors. For the investor, providing technical assistance (TA) and nonmonetary forms of support can serve to both augment growth potential as well as mitigate risks such as poor financial management, lack of management know-how, and talent issues.

However, effective TA should be first based on an assessment of the firm's key gaps and the most value-adding and targeted interventions to apply. Then TA should be applied at every stage of investment, from business advice following the assessment of the initial application, assistance with the negotiation process during the due diligence phase, and guidance with growing or turning around a business during the post-investment phase. Specifically, interventions can target a whole package of support including

(i) market research and product development,

(ii) sales and marketing upgrades,

(iii) quality assurance,

(iv) management upskilling and information systems,

(v) staff training and skill development,

(vi) using management consultants to improve operational efficiency, and

(vii) help in sourcing of capital goods and technology improvements.

SME financiers highlight one particularly key nonmonetary input is helping SMEs get to a standard level of financial controls. This can range from appointing a chief financial officer to implementing a range of more robust policies and reporting practices.

The fund should be able to draw from a large bench of expert resources to execute this intensive support. This means dedicating both internal staff as well as contracting professional consultants who have specific expertise required by each portfolio company. Eventually, the fund can build up a database of registered and active experts in the Sri Lankan market to promote skills transfer and grow local networks of reliable in-country mentors.

The requirement for intensive TA means that adequate funding must be provisioned. TA facilities for SME funds across the world range from 5% to as high as 10% of the capital deployed. This can be funded by the following:

(i) **Raising a pool of grant-based technical assistance funding.** A common approach is to raise donor funding, as may be available from a development finance institution such as the Asian Development Bank (ADB), to endow a separate TA facility managed by the fund manager, and provided as an additional component to the investment.

(ii) **Providing technical assistance through interest-free loans.** An alternative or parallel approach can be to provide TA funding to investees not as a grant but as an interest-free loan that must be repaid at the end of the investment term. This can further ensure that resources are only made available based on strict criteria of commercial soundness and financial return, and that the investees take their obligation to use TA funding well as seriously as their obligations on the investment capital.

5. Fund Management and Operations

The fund management process will proceed from deal sourcing and due diligence to intensive post-investment monitoring and value addition. To standardize investment products and streamline due diligence and deal processing, a detailed set of investment policies, procedures, and guidelines should be developed so that once operational, the fund's execution strategy is both clear and efficient.

Deal sourcing and due diligence should be geared toward screening and selection of business owners who have the required skills and compatible expectations to the fund. Potential opportunities should be assessed for

(i) absorptive capacity and ability to service debt and royalty payments;
(ii) value addition potential and projected returns with expansion capital;
(iii) feasibility of 5-year investment period;
(iv) commitment to transparency and openness to frequent monitoring, reporting, and auditing;
(v) sufficiency of level of financial disclosure and reporting;
(vi) management quality; and
(vii) key risks requiring special monitoring.

Selecting the right investees is important, but the real work begins in the post-investment phase. Frequent interactions with the investee will be required for a variety of purposes including diagnostics and strategic action planning for monitoring and support, allocation of specific technical assistance resources, ongoing performance monitoring, and acting on specific triggers to manage risk and course, correct for any issues arising (Figure 10).

A qualified fund management team with expansive local business networks among established SMEs, and relevant investment and business management experience to support their growth during the investment phase, will be critical to the success of the fund.

Figure 10: Fund Management Operations

BOD = Board of Directors, IC = Investment Committee.

Source: York Street Partners.

A pilot project deploying $10 million may be executed by a team of approximately four investment staff. Because pilots are inherently intended to prove the case for larger-scale interventions and impact, pilot operational design should be embedded with plans to facilitate scale-up conditional upon performance. Performance will be based on indicators including

(i) the availability of a pipeline of qualified investees from initial screening,

(ii) the pace of capital deployment to the initial cohort of 25 investees,

(iii) performance of servicing debt and royalty,

(iv) investee overall revenue and profitability growth, and

(v) the efficacy of TA for investee performance.

Because the fund's quasi-equity instruments are designed to deliver cash flows to the fund steadily throughout its life rather than weighted toward latter years, a 12–24-month period after investment should provide sufficient data points on the performance indicators. At that point, if performance proves positive, the government may already consider committing a new tranche of funding to scale up the fund and begin supporting a second investee cohort.

6. Additionality

The proposed investment strategy and structure of the fund is designed specifically to address the most critical challenges of supporting established SMEs, as laid out in more detail in Table 3.

Table 3: Challenges of Supporting Established Small and Medium-Sized Enterprises

SME Financing Challenges	Fund Solution
Exhausted collateralized bank debt • No more collateral to offer to access bank funding. • Senior bank debt not appropriate for certain types of expansion spending where cash flow availability to service costly debt is more uncertain.	• Offer capital that does not require full collateralization. • Offer capital that is matched to the risk profile of what business activities or assets it is being used for.
Owner reluctance for outside interference • Family business owners, particularly first generation, are reluctant to take any capital that would give outsiders rights to interfere in their business.	• Offer predominantly hybrid equity instruments that do not require ownership stake or voting rights as pure equity would.
Limited growth potential • Established SMEs may be set up as lifestyle businesses to serve a limited market with a conservative management approach.	• Deploy technical assistance at every stage of investment to boost management capacity and find ways to optimize business performance.
Limited exit options • Established SMEs are not managed to achieve high growth and sale to third party. • Sri Lankan capital markets still limits broad and deep exit pathways,	• Invest through predominantly self-liquidating hybrid instruments.
High costs of investment • Performance-based lending requires more due diligence than collateral-based lending. • Customizing and negotiating for each small deal is costly; investors are incentivized to focus on larger deals to spread high costs over larger amount.	• Focus on most critical risks to streamline due diligence. • Investment structures can be standardized as can legal documents, with little need for costly customization or negotiation.
Long lockups and low deal volumes • Investor capital may be tied up for long periods in small, illiquid firms. • Ability to recycle capital for new deals is limited.	• Structure self-liquidating instruments with average 5–7 year term can enable some recycling of capital.

SMEs = small and medium-sized enterprises.

Source: York Street Partners.

7. Snapshot: Profile of Pilot Fund

A summary of the terms for a pilot fund is provided below:

Table 4: Profile of Pilot Fund

Objectives	• Grow employment • Improve competitiveness of local SMEs • Support formalization of SME sector • Mitigate exit risk
Investment Strategy	This fund seeks to initiate growth across Sri Lanka's SME sector by providing SMEs with the risk capital they require through products that are specifically tailored to limit the dilution of owners, while also mitigating the nascent exit environment for Sri Lankan private equity investment.
Fund Size	$10 million
Target Internal Rate of Return	5%–10% (Appendix 3)
Fund Life	Investment Period: 2 Years Holding Period: 5 years
Investment instruments	• Unsecured debt • Redeemable preference shares with revenue-linked payments
Exit Strategy	Self-liquidating instrument
Drawdowns	Years 1 and 2: 100%
Distributions	Each year of the fund life
Reinvestment	No
Fund Management Team	Led by a chief investment officer, supported by 5 investment officers
Technical Assistance Size	$1,000,000
Technical Assistance	Tailored technical assistance delivered through direct support through Fund Management Team, who mobilize specific external expertise as required by portfolio companies
Risks and Other Considerations	Low levels of transparency and financial reporting among SMEs may result in lower than expected returns from royalty-based instruments

SMEs = small and medium-sized enterprises.

Source: York Street Partners.

8. Summary

There is a clear demand for risk capital by established SMEs that require equity or equity-like capital to grow, but are constrained by their unwillingness to dilute and by the lack of exit options. Anecdotal evidence from our market assessment suggests that this lack of availability of risk capital to SMEs has constrained their growth. As such, there is a clear role for the Government of Sri Lanka to play in catalyzing the provision of risk capital to SMEs. The pilot fund in Table 4 represents a strategy for the government to support the SME sector.

This fund could add value to the market in a number of different ways and achieve several policy priorities as summarized in Table 5.

Table 5: Fund's Value Addition

Target Market	• Larger established SMEs • Start-ups with positive, stable operating cash flow
Intervention	• Provide risk capital to larger SMEs based on a risk assessment by the fund manager • Risk capital provided through self-liquidating, equity-like instruments
Potential Policy-related Outcomes	• Support the growth and scaling up of high potential SMEs • Grow employment • Specific sector focuses could be selected by the Government of Sri Lanka • Mobilize private capital
Potential Development Outcomes	• Provide an additional incentive to initiate formalization of the sector • Support professionalization of SMEs
Risks	• Low levels of formalization in the SME sector may result in costly implementation

SMEs = small and medium-sized enterprises.

Source: York Street Partners.

B. Legal, Tax, and Regulatory Considerations

In today's capital markets, a "funds" regime has come into being as a specific legal construct to support the deployment of capital managed by professional private sector intermediaries such as fund managers, asset managers, and banks. There are now several jurisdictions that have created legal forms for entities domiciled in their jurisdictions which are specifically designed to accommodate such fund vehicles. In particular, these legal forms (i) provide for the pooling and segregation of funds designated for a defined investment purpose, (ii) facilitate the delegation of fund management discretion to a third-party professional manager, (iii) protect investors from legal liability for investment outcomes, and (iv) maximize tax efficiency.

Sri Lanka currently does not have such a "funds" regime; there is no legal form for limited liability partnerships or investment vehicles in the nature of "funds." The only existing legal framework for a fund structure is the Unit Trust Code of 2011, which explicitly prohibits investments in unlisted securities and is therefore not applicable to a fund providing financing directly to SMEs.

Additionally, the involvement of the government as a key stakeholder has implications on the level of regulatory and public scrutiny the proposed fund's operations are subject to. Given this, the structuring of a fund entity will need to consider both tax efficiency as well as supervision implications.

1. Legal Incorporation Options

We have considered three potential structures through which to operationalize a fund investing in Sri Lankan SMEs:

(i) **Establishing a special statutory body under an Act of Parliament.** This is likely to be both difficult and cumbersome to achieve and would necessarily involve parliamentary involvement at the setup stage. It will also result in significant governmental regulatory oversight on a continuing basis. As such, it may be time consuming to execute and may not make sense if it is a limited-life fund.

(ii) **Establishing the fund as a limited liability company in Sri Lanka, with a finite life enshrined in its Articles of Association.** While this is the only legally viable option for a locally established fund given current law, it has several implications that reduce the efficiency of capital deployment, which we consider in detail below.

(iii) **Establishing the fund as an overseas investment vehicle domiciled outside of Sri Lanka.** Private sector funds operating in Sri Lanka have taken this route, as it allows them to leverage global standards for private equity funds. Singapore has been one such favorable fund domicile.

2. Tax Implications

For these two possible legal structures, the tax implications would be as follows:

(i) **Limited Liability Company in Sri Lanka.** If constituted as an LLC, the fund will be liable to a 28% income tax on profits made on interest income from debt investments and capital gains made on exit on equity investments, as the tax authorities are likely to adjudge these as business/trade profit for an investment company (instead of considering them tax-exempt capital gains). Additionally, dividend income is subject to a withholding tax of 14% (effective 1 April 2017, following the 2016 budget announcements). Investors in the fund will be further subject to applicable levels of income tax based on any profit gained through investments in the fund. This is distinguished from other jurisdictions with fund regimes that exempt investors from or reduce the second layer of taxation on their earnings from fund distributions. This double taxation could result in a net effective taxation on returns of as much as 50%. If the Government of Sri Lanka will be the sole investor in the fund, the impact of this taxation on its investments is unlikely to be a deterrent, as it is the direct recipient of any taxation imposed. However, this double taxation effect will be a significant impediment for attracting any outside private sector investors.

(ii) **Overseas Investment Vehicle.** If constituted as an OIV, the fund will not be required to file income tax returns in Sri Lanka, thereby providing investors a significant tax advantage compared with a locally established LLC. While its investments will need to be made through a specific "Share Investment Account," it would also not require getting tax clearances to remit any proceeds from exited investments back to the country of domicile. Income in the form of dividends, however, is subject to a 10% withholding tax (14% from 1 April 2017 following the 2016 national budget announcements) regardless of whether these are paid to locals or nonresidents. However, the establishment of an OIV will be accompanied by material fund administration charges and higher overall setup costs.

The fund will derive its returns from interest income from unsecured debt and dividend income from redeemable preference shares. If the fund is structured as an LLC, interest income is likely to be considered taxable operating income, subject to a tax rate of 28%.

However, if it is structured as an OIV, it is currently not subject to withholding tax, although a change to this ruling is currently under consideration. Nonetheless, the tax impact on interest income is relatively low given the partial weightage of the debt component and relatively low interest rates targeted.

Dividend income, regardless of whether the fund is structured as an LLC or an OIV, would be subject to a 10% withholding tax based on the current framework. Given the limited tax benefits and comparatively higher administration and setup costs, an overseas domiciled structure may be less preferable than an LLC setup in Sri Lanka for purposes of this fund.

3. Regulatory Implications of Government of Sri Lanka Ownership

In consideration of the government's role, majority share ownership of the fund by the Government of Sri Lanka is likely to influence the regulatory supervision to which the fund would be subject. Based on the 19th Amendment to Article 154 of the Constitution (passed in May 2015), the Auditor General is required to audit any company registered under the Companies Act No. 7 of 2007 where the Government of Sri Lanka, a public corporation or a local authority holds "50% or more of the shares." Further, there is no distinction drawn between separate classes (ordinary/preference/voting/nonvoting) of shares, negating the use of structured equity categories.

Additionally, the likely rectification of Standing Order 156 of the Parliament would result in a majority government-owned fund coming under the purview of the Committee on Public Enterprises, a widely followed parliamentary subcommittee which assumes extensive powers and could raise questions on operational decisions relating to individual fund investments themselves. Since a fund providing risk-capital is likely to witness a significant number of investment failures, justifying these could be onerous and add to cumbersome levels of operational burden. As such, being subject to audit by the auditor general's department and supervision by the Committee on Public Enterprises could hamper the operations of the fund and disincentivize high-quality fund managers.

C. Incentivizing the Fund Manager

1. Legal Structure Options for the Fund Manager

The global "funds" regime described above typically allows for two separate legal entities—the fund and the fund manager. Since Sri Lanka currently does not have such a "funds" framework, we have considered two options to structure the second function, namely that of the fund manager:

(i) **Separate legal entity formed as a limited liability company.** As a separate legal entity, the fund manager would be contracted by the fund to provide it with investment management services. In this case, the fund would have to pay value-added tax (VAT) and nation building tax (NBT) on the management services provided by the fund manager and the fund is not likely to have output VAT from which it could be deducted, resulting in it being an additional cost. This could get compounded by the fact that the management fees paid by the fund may not be entirely tax deductible.

(ii) **Fund management team directly employed by the fund.** If the fund management team is directly employed by the same legal entity as the fund, there would be no additional VAT or NBT tax liability. Furthermore, employment costs are generally entirely tax deductible.

The global "funds" regime has enabled the separation of the fund and fund manager to enable investors in funds to delegate investment responsibilities to a separate legal entity. Given that Sri Lanka does not have a legal framework for "funds," the separation of fund manager responsibilities into a separate legal entity is unlikely to limit the legal liability of investors for investment outcomes.

Another rationale for the separation of the fund and fund manager has been to allow the fund manager to raise and manage additional follow-on funds from other investors.

Nevertheless, the separation of the fund manager into a different legal entity is unlikely to provide the same benefits as that of global fund regimes. Furthermore, it will impose an additional tax liability on the fund, thereby depressing its financial returns. Employing the fund management team directly within the fund's legal entity is therefore likely to be the most efficient structure. However, engaging as direct employees may make it more difficult to attract institutional fund managers, particularly for a pilot project. As such, a combination of both options could be considered.

2. Incentivizing the Fund Manager

The particular risk-return profile of the proposed fund drives recommendations for short-term and long-term compensation arrangements that sufficiently incentivize the team to continue performing throughout the life of the fund.

Private equity fund managers are typically incentivized through a dual compensation structure—a management fee, generally a percentage of assets under management; and carried interest, a percentage of the returns investors make above a defined hurdle rate. This structure was developed to ensure that the fund manager covered their operating costs through the management fee, while incentivizing them to maximize returns through the carried interest component. This conventional compensation structure can be utilized in a scenario where the fund entity contracts with an external fund management firm to manage the fund, with precise performance metrics and compensation levels and structure to be negotiated with eligible service providers. Fund managers also often contribute a portion of their own capital into the fund alongside that of other investors to further align manager and investor incentives.

If the fund management team is employed internally by the fund entity for tax efficiency purposes as described earlier, it may be advisable to explore employee compensation models where the team is incentivized by market-competitive base compensation plus benefits, as well as annual merit incentive bonuses subject to performance targets established at the beginning of each year. These performance targets could be assessed via a holistic set of key performance indicators (KPIs) that incorporate both financial and development impact goals. Financial KPIs might include number of deals advanced, deal quality metrics, and the use of TA funds. Development impact KPIs might include impact metrics relevant to the government's policy objectives for the fund, such as job creation, skills development, regional investment, and contribution to exports.

D. Sources of Capital

The Government of Sri Lanka, with the support of ADB, is interested in anchoring the proposed fund concept in order to provide direct finance and stimulate private sector investor participation and subsequent capital market development. As such, the following investor participation structures were considered:

(i) **Sole funding provided by the Government of Sri Lanka.** Given the below market returns and significant development impact of establishing an SME finance fund, the government is the most likely investor to provide seed funding. Further, by acting as the sole or majority investor, the government could provide stronger control from a governance perspective, which may be an important objective in putting public capital at risk. To support this capital requirement, the government may draw upon funding from ADB. The projected IRRs of 5%–10%, with an investment horizon of 6–12 years, should provide the government with

sufficient earnings from invested capital to support repay a loan from ADB.[23] However, because the timing of cash distributions from the funds will not be smooth but skewed toward the latter years of the fund's life span when exits are initiated, the government will likely need to find a bridging mechanism through other budgetary resources to service the ADB loan in the interim. That notwithstanding, the expected rate of return compared with the government's cost of capital from the ADB loan should make the government's investor role a financially viable one.

(ii) **Leveraging private sector capital.** Bringing on private sector investors would reduce the government's risk exposure. Further, introducing private capital during the pilot phase would result in faster private sector adoption of the model, enable access to investment expertise of private co-investors, and potentially increasing the size and impact of the fund beyond the governments capital limits. Of course, bringing on co-investors will also necessitate a negotiation over sharing of profit participation and control rights, but the government may prioritize raising enough capital to enable a larger fund size, even to the extent where it is no longer a majority capital contributor. Sri Lankan commercial banks represent one particularly appropriate source of co-investment to tap. In addition, as described in further detail in the legal structuring section, due to Sri Lankan requirements around administration of state entities, there may be benefits for the government to accept minority ownership to facilitate the more efficient operations of the fund.

In addition to investment capital, the proposed fund concepts also require some component of TA funding. This TA funding, ranging from 3% to 10% of the total fund size, can come from one of several sources:

(i) ADB or other donor grant funding (likely to be limited in size to $150,000–$250,000 available for this initiative);

(ii) Government of Sri Lanka grant funding; and

(iii) ADB loan funding with government guarantee, repayable by the fund to ADB.

E. Governance Considerations

The fund's governance structure will need to incorporate a multitude of investor considerations including the proposed investment strategy and investor oversight requirements. It is also directly driven by the fund's chosen legal structure.

As such, the specific governance structure would have to be finalized once the fund's legal incorporation form has been determined. However, a number of key principles should be taken into consideration in setting the fund's governance structure:

(i) **Oversight provided by the Board.** A Board of Directors is a broader governance authority whose function is to supervise the fund manager, but not engage in investment decision-making. Ideally, the Board should be composed of a majority of independent directors and/or directors nominated by minority shareholders. Absent that, key strategic decisions including the appointment or dismissal of the fund manager should require the affirmative vote of the independent directors.

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[23] Financing terms are typically 15-year loan with a 3-year grace period where the government's repayments do not have to begin until the 36th month. The loan comes with a commitment charge of 15 bps on undrawn balances and is typically priced at an interest rate of LIBOR + 50 bps.

(ii) **Delegation of investment decision-making, execution, and operations to independent, qualified professionals.** As observed from international precedents, government investment interventions tend to be more effective when the government isolates its role to that of capital provider and delegates commercial investment decisions to qualified private sector managers. In accordance, transparent and rational governance will facilitate a clear oversight role for government as an anchor or sole funder without involvement in the operations.

(iii) **Separation of fund management and investment decision-making.** Fund management involves business development, investment analysis, execution, and operations. Investment decision-making requires making the final determination on either making or passing on an investment opportunity. Separation of these two functions ensures that there is an external and independent check on the fund manager, who often, by nature of the work involved, develops a close relationship with potential investees. As such, an investment committee should be formed with the authority to review pipeline, review investment recommendations from the fund manager, and approve or veto investment decisions. Members of the investment committee can include both representatives from the fund management team, as well as independent, nongovernment-affiliated members who are investment, finance, or industry experts. The investment committee could be structured in two ways:

(a) **Independent Committee within the Limited Liability Company.** The Articles of Association of the LLC could allow for the establishment of an independent committee to approve the fund manager's investment proposals. While the Board would have the right to appoint the independent members, the committee would operate completely independently of the Board. A precedent for this was established by Fitch Ratings, Sri Lanka, in which the Central Bank of Sri Lanka is a significant shareholder, established an independent panel to approve all ratings issued by Fitch. Fitch Sri Lanka's Articles of Association explicitly states that the panel will be composed of "Fitch Rating Analysts," and will operate independently of the Board.

(b) **Board of Directors of the Fund Manager.** If the fund management is contracted to an external entity, the Board of that entity could function as the investment committee and be required to include independent members.

F. Government Participation

Defining the government's level of contribution and participation in a fund is an important governance consideration. While the Government of Sri Lanka may have a firm majority ownership of the fund, it will be important to strike the right balance between the government's rights as a majority shareholder, adequate rights and protections for minority shareholders, and ensuring the integrity of the investment decision-making process. Private investors may fear conflicts between the government's interests and their interests arising if the government's nonfinancial interests prompt them to take decisions disadvantageous to the financial outcomes of the fund. In this respect, establishing an independent investment committee, and ensuring a majority of independent directors on the Board, will help assure private investors about the government's limited ability to influence operations. Additionally, certain rights can be ingrained into the fund's constitutional documents or shareholder agreements that afford minority investors certain rights and protections, such as matters over which they have veto right.

One particularly important right is that minority shareholders be given director and officer nomination and appointment rights to put in place individuals that will appropriately represent their interests in the governance and management structure. This includes rights to nominate and appoint individuals to the Board of Directors and the investment committee and the right to appoint and dismiss the fund manager (Appendix 4) who should be able to operate independently to make investment decisions and operate the fund. Other protective rights include the right to question the action of officers and directors, the right to receive certain reports and inspect certain records, the right to maintain their percentage ownership of the entity, the right to participate in decision-making about the dissolution of the entity, and the right to participate in decision-making on any amendments to fund constitutional documents or shareholder agreements.

Specific legal structuring to address questions of minority shareholder protections will need to be carefully explored in more detail with legal counsel and the potential private investors that are ultimately engaged.

IV. CONCLUDING RECOMMENDATIONS

To support the growth of the SME sector, the Government of Sri Lanka, particularly the Ministry of Finance, is recommended to consider operationalizing the fund as a pilot project that could be expanded based on its successful performance over time.

The fund would provide risk capital through revenue-linked, self-liquidating instruments, to boost the growth of Sri Lankan SMEs. This instrument is best suited for firms with established business models and/or steady operating cash flow whose growth has been constrained by the lack of equity financing available to them in the country. As this instrument will be redeemed principally through cash flows generated by the SMEs, it would enable SMEs to access risk capital without diluting their ownership. It would also mitigate exit risk for the fund, lowering its risk profile to investors. Through this strategy, the fund would create an avenue to address capital constraints of SMEs, unlocking their future growth potential and result in meaningful development outcomes.

The government is recommended to consider a pilot fund size of $10 million to test the concept before pursuing larger-scale capital commitments. The government can play a catalytic role by directly investing in the fund, alongside private investors. To fund its capital contribution, the government can pursue a loan from ADB for its contribution.

Besides the Government of Sri Lanka’s contribution to the fund, bringing on private sector investors would reduce the government’s risk exposure, accelerate private sector adoption of the model, enable access to investment expertise of private sector co-investors, and potentially increase the size and impact of the fund beyond the government’s capital limits. Sri Lankan commercial banks represent one particularly appropriate source of co-investment to tap into.

As observed from international precedents, government tends to be more effective when it isolates its role to that of capital provider and delegates commercial investment decisions to qualified private sector fund managers. As such, transparent governance will facilitate a clear oversight role for government as an anchor, with limited or no operational interference. A separate expert investment committee should be formed to assume fiduciary responsibility for investment decision-making and provide oversight to the fund manager. The Government of Sri Lanka and other fund investors can exert appropriate governance oversight via positions on a Board of Directors.

By acting upon these recommendations, the government has the opportunity to meet a number of import policy priorities and development impact goals:

(i) creating a larger number of higher-quality skilled jobs that align the country's talent base with Sri Lanka's increasingly service-oriented economy;

(ii) expanding youth employment opportunities;

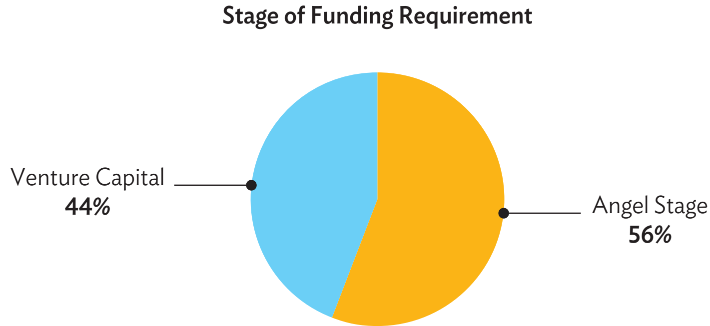
(iii) enabling and incentivizing innovation;

(iv) boosting Sri Lanka's export capacity; and

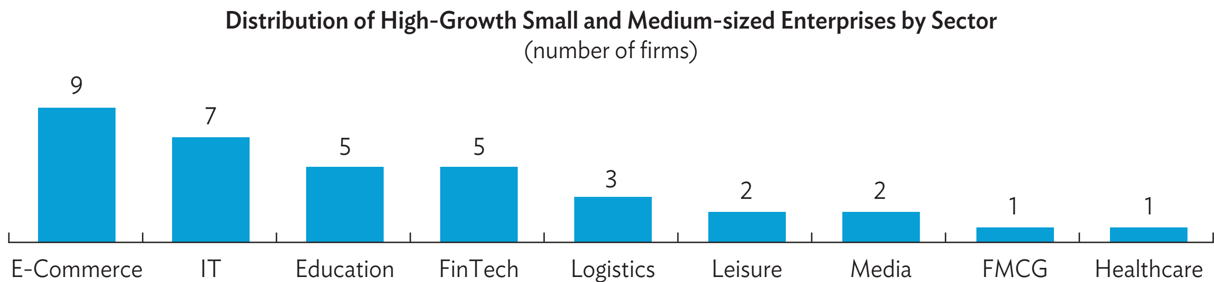
(v) developing the local capital markets through catalyzing follow-on equity investment and foreign investment, and also expanding SME debt capacity.

Appendix 1: Presentation of Survey Data on Start-Ups

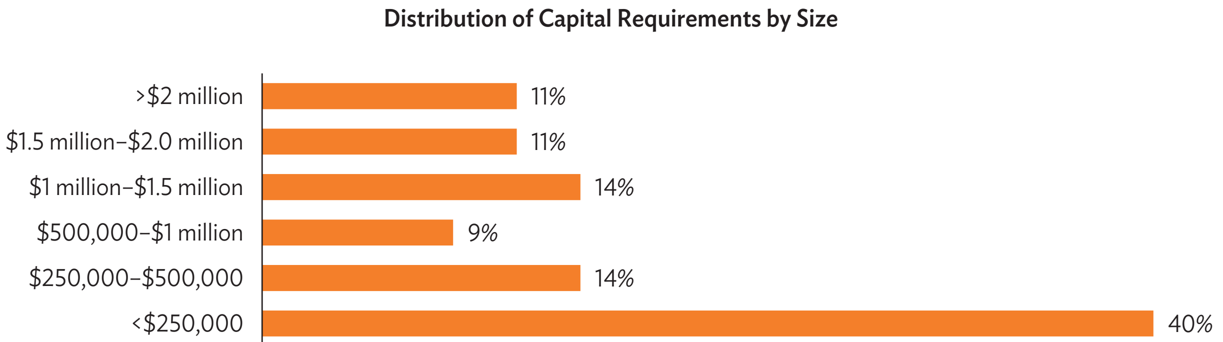
We surveyed 35 start-ups to understand their capital requirements. The data from this survey are presented below.



Note: Of the 35 small and medium-sized enterprises surveyed, 20 were seeking angel funding and 15 were raising early-stage venture capital.
Source: York Street Partners.



Note: E-Commerce and information technology-focused small and medium-sized enterprises dominated the survey.
Source: York Street Partners.

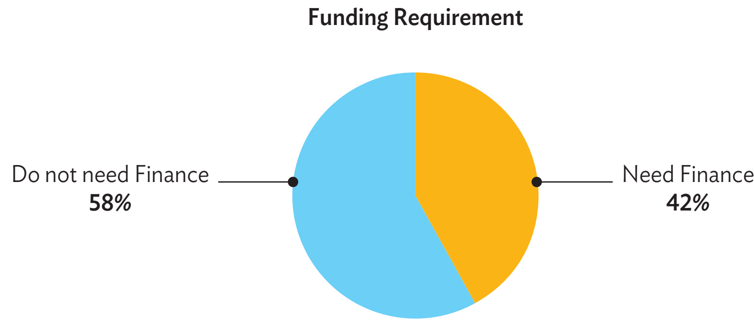


Source: York Street Partners.

Appendix 2: Presentation of Survey Data on Established Small and Medium-Sized Enterprises

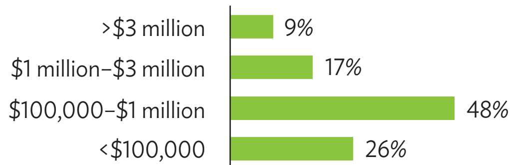
We surveyed 55 established small and medium-sized enterprises to understand their capital requirements. The data from this survey are presented below.

Funding Requirement

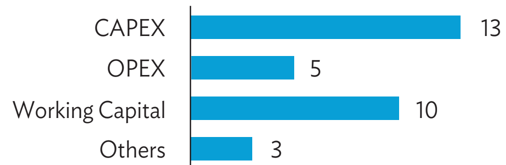


Note: Of the 55 small and medium-sized enterprises surveyed, 23 expressed a need for external funding.
Source: York Street Partners.

Distribution of Capital Requirements by Size

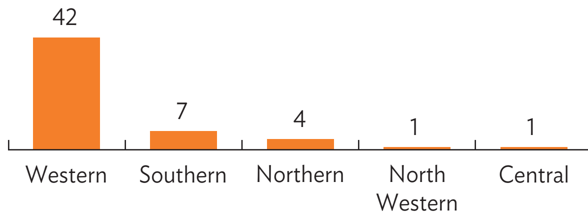


Distribution of Capital Requirements by Function (number of firms)[a]

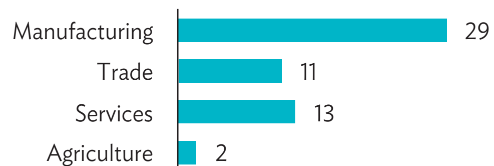


Note: The average funding size required was $1 million.
[a] Certain companies required capital for multiple functions, "others" relates to paying off existing debt.
Source: York Street Partners.

Distribution of Established Small and Medium-sized Enterprises by Province (number of firms)



Distribution of Established Small and Medium-sized Enterprises by Sector (number of firms)



Source: York Street Partners.

Appendix 3: Analyzing Fund Projected Returns

The investment strategy of the fund is to provide risk capital to support the growth of established small and medium-sized enterprises (SMEs) through self-liquidating, royalty-based instruments. This instrument is an unsecured loan, in part repaid through fixed interest and principal components and in part redeemable as a preference share repaid through cash flows based on a percentage of revenue for the duration of the investment.

As such, the primary financial return drivers of the fund are (i) the growth in revenue of portfolio companies and (ii) the cost of administering the portfolio.

Projected Portfolio Performance

The proposed fund pilot project is forecast to execute on its investment mandate according to the following parameters:

Table A3.1: Fund Pilot Project Forecast

Investment Mandate	Forecast
Typical target company revenue	$3,333,333
Average ticket size	$400,000
Total investments (number)	25
Investment life (years)	5

Source: York Street Partners.

The fund manager should have some discretion in structuring the royalty-based instrument, within defined parameters. There are four main variables: (i) the percentage of capital invested as an unsecured loan, (ii) the interest rate applicable on the unsecured loan, (iii) the percentage of revenue paid as a royalty payment, and (iv) the duration of the investment. The following assumptions on the average structure have been made for this evaluation, which result in an instrument return of 24%.

Table A3.2: Average Structure Assumptions

Investment Structure	Assumption
Debt weightage	50%
Interest rate	8%
Duration (years)	5
Redeemable preference share weightage	50%
Capital repayment/dividend (% of revenue)	1.6%

Source: York Street Partners.

A write-off rate of 5% has been assumed, in line with the nonperforming loan ratio of the Licensed Finance Sector in Sri Lanka, resulting in a gross portfolio internal rate of return (IRR) of 14.2%.

Fund Operating Expenses

The two main operating expense categories for managing the fund are as follows:

(i) **Fund management costs.** If the fund manager is an external entity, the fund would pay the manager a management fee and carried interest, a profit-sharing incentive, based on the performance of the investments. The management fee has been set at 2% with the carried interest set at 20% as a base case. Overall, this would result in a net return to investors of 8.3%. However, if the fund management is administered internally, management costs are reduced due to tax efficiency and a base + bonus employee compensation structure, net returns to investors would be 8.9%.

(ii) **Taxes.** Assuming internal management, if the fund is structured as a Sri Lanka domiciled limited liability company (LLC), a tax rate of 28% on interest is assumed and withholding tax of 14% on dividends. The resultant IRR net of taxes consequently reduces to 6.6%. Should the fund be an off-shore entity, there would be no tax on interest payments, but significant fund administration charges, resulting in an IRR net of tax of 5.7%.

Should the pilot phase prove successful and merit scaling into a larger fund with a multi-year investment period, the fund would benefit from being able to recycle capital as well as spread its initial establishment costs over a longer time horizon, thereby increasing its financial returns to investor.

Projected Internal Rate of Return Summary

The fund's projected returns can be examined at several levels (Table A3.3):

(i) **Gross investor internal rate of return.** The returns to investors before management costs and taxes are accounted for, but after portfolio administration costs. In this case, a local Sri Lanka LLC would reduce some of the portfolio administration costs, resulting in a slightly more favorable gross IRR than if the fund were to be domiciled offshore and incur higher administration costs.

(ii) **Net investor internal rate of return, pretax.** Returns to investors after management costs have also been paid, but before taxes. It is assumed that the fund's management costs may be slightly lower if the fund entity engages a team as internal employees with a base + bonus compensation structure rather than contracting a third-party fund management firm with a management fee + carried interest compensation structure.

(iii) **Net investor internal rate of interest, after-tax.** Returns to investors after all costs and taxes have been paid. Taxation will further reduce effective net returns to IRR, with different tax treatment for an offshore vs. onshore fund domicile as described in the earlier commentary on taxation.

Table A3.3: Projected Returns

IRR Level	IRR			
Domiciling Options	**Sri Lanka LLC**		**OIV**	
Gross Investor IRR* (before management costs and taxes, after portfolio administration costs)	12.2%		11.4%	
Fund Management Options	**External**	**Internal**	**External**	**Internal**
Net Investor IRR (after management costs, before taxes)	8.3%	8.9%	7.5%	8.1%
Net Investor IRR (after management costs and taxes	5.4%	6.6%	5.1%	5.7%

IRR = internal rate of return, LLC = limited liability company, OIV = overseas investment vehicle.

* Difference due to portfolio administration cost differences between domiciling the fund in Sri Lanka vs. overseas.

Source: York Street Partners.

Summary Cash Flow (Sri Lankan Limited Liability Company with Internal Management)

In summary, the fund model forecasts the following cash flows for a $10 million fund over a 7-year period (Table A3.4):

Table A3.4: Cash Flow Forecast

In $'000s	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Capital Drawdown	5,333	4,531	–	–	–	–	–
Capital Invested	5,000	4,854	–	–	–	–	–
Of which: Debt	*2,500*	*2,427*	–	–	–	–	–
Of which: Equity	*2,500*	*2,427*	–	–	–	–	–
Dividend and Installment Inflows	683	2,021	2,684	2,757	2,832	2,146	709
Net Portfolio Cash flows	(4,401)	(3,018)	2,477	2,539	2,601	1,967	649
Cash Distributed to Investors	–	–	4,265	2,233	2,199	1,595	549
GP Carried Interest	–	–	–	–	–	–	–
Cumulative Capital Drawdown	5,333	9,864	9,864	9,864	9,864	9,864	9,864
Cumulative Amount Invested	5,000	9,854	9,854	9,854	9,854	9,854	9,854
Cumulative Distribution	–	–	4,265	6,498	8,698	10,292	10,841
Number of Portfolio Companies	13	25	25	25	25	25	13

Source: York Street Partners.

Sensitivity of Returns

Further analysis was conducted to determine the sensitivity of projected fund returns to changes in specific variables in the assumptions used to model fund cash flows and returns, given all other variables are kept constant. The analysis shows that investor returns are particularly sensitive to instrument duration, as revenue-linked dividends get larger over the years and contribute to increasing surplus returns over capital redemption. Likewise, returns are also sensitive to the percentage of revenue collected as dividends—a 10-basis point change in the rate resulting in a 140-basis point change in net returns. Other variables that would impact returns include the interest rate charged on the instrument and the growth rate of companies during the investment duration.

Portfolio Companies' Average Revenue CAGR (%)	Investor Net IRR
13%	6.0%
14%	6.4%
15%	6.8%
16%	7.2%
17%	7.6%
18%	8.0%

Instrument Duration	Investor Net IRR
2 years	−17.7%
3 years	−7.0%
4 years	0.8%
5 years	6.6%
6 years	10.7%
7 years	14.0%

Capital/ Dividend Rate (% of revenue)	Investor Net IRR
1.4%	3.9%
1.5%	5.2%
1.6%	6.6%
1.7%	7.9%
1.8%	9.2%
1.9%	10.5%

Investor Net IRR
% Debt in Instrument Structure

Interest Rate (%)	30%	40%	50%	60%	70%
5%	−1.7%	1.8%	5.0%	8.2%	11.2%
6%	−1.3%	2.2%	5.5%	8.8%	11.9%
7%	−1.0%	2.7%	6.0%	9.4%	12.5%
8%	−0.7%	3.1%	6.6%	10.0%	13.1%
9%	−0.4%	3.5%	7.1%	10.5%	13.7%
10%	0.0%	3.9%	7.5%	11.0%	14.3%
11%	0.3%	4.4%	8.0%	11.6%	14.9%

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The following 14 interviews were conducted in confidentiality, and the names of interviewees are withheld:

Interview with an industry association president, October 2016.

Interview with a director of a healthcare company, October 2016.

Interview with the co-founders of a financial technology company, October 2016.

Interview with the CEO of a financial technology company, October 2016.

Interview with the CEO of a hotel company, October 2016.

Interview with the CEO of a budget hotel company, October 2016.

Interview with the chairperson of a bank, October 2016.

Interview with the senior manager of development credit at a bank, October 2016.

Interview with the manager for SME banking at a bank, October 2016.

Interview with the managing director of a private equity fund, October 2016.

Interview with the managing director of a decorative tools company, October 2016.

Interview with a partner at a private equity fund, October 2016.

Interview with the managing director of an IT company, October 2016.

Catalyzing Small and Medium-sized Enterprise Venture Capital in Sri Lanka

Small and medium-sized enterprises (SMEs) are the bedrock of Sri Lanka's economy. Comprising 75% of all active enterprises, Sri Lanka's SMEs provide 45% of employment and contribute 52% to its gross domestic product. Creating an environment conducive to SME growth is integral to achieving equitable economic growth in Sri Lanka. Against this backdrop, this paper seeks to evaluate the viability of supporting the SME sector by improving access to equity or risk capital. This paper assesses SME demand for equity, reviews international precedents of government support for SME capital, and provides an analysis of fund structuring considerations. It presents recommendations for a government-initiated venture capital fund for SMEs in Sri Lanka.

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