

SRI LANKA

# THE LANDSCAPE FOR IMPACT INVESTING IN SOUTH ASIA

Understanding the current status,  
trends, opportunities, and challenges  
in **BANGLADESH, INDIA, MYANMAR,  
NEPAL, PAKISTAN, and SRI LANKA**



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# ACKNOWLEDGMENTS

This project was funded with UK aid from the UK Government through the Department for International Development's Impact Programme. The Impact Programme aims to catalyse the market for impact investment in sub-Saharan Africa and South Asia. [www.theimpactprogramme.org.uk](http://www.theimpactprogramme.org.uk)

This report was made possible by the generous contributions of time and expert knowledge from many individuals and organizations. The GIIN Advisory Team provided invaluable insights, guidance, and support throughout the preparation of this report. In addition, we would like to thank all individuals that took part in the interviews and surveys in each of the six countries of study. Through these interviews and surveys, we obtained a wealth of experience, understanding, and data on impact investing activities in South Asia. We would also like to acknowledge the country experts who provided critical feedback on our preliminary findings. A full list of the interviewees, survey respondents, and country experts can be found in the Appendices.

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# LIST OF COMMON ACRONYMS

<b>ADB</b>   Asian Development Bank	<b>MDG</b>   Millennium Development Goal
<b>AIF</b>   Alternative Investment Funds	<b>MEB</b>   Myanmar Economic Bank
<b>BoP</b>   Base of the Pyramid	<b>MFI</b>   Microfinance Institution
<b>BRICS</b>   Brazil, Russia, India, China, South Africa	<b>MFTB</b>   Myanmar Foreign Trade Bank
<b>CA</b>   Chartered Accountancy	<b>MNC</b>   Multinational Corporation
<b>CIIE</b>   Centre for Innovation, Incubation and Entrepreneurship	<b>MICB</b>   Myanmar Investment and Commercial Bank
<b>CGTMSE</b>   Credit Guarantee Fund Trust for Micro & Small Enterprises (India)	<b>NABARD</b>   National Bank for Agriculture and Rural Development
<b>CSR</b>   Corporate Social Responsibility	<b>NASE</b>   National Association of Social Enterprises (India)
<b>DFI</b>   Development Finance Institution	<b>NEDA</b>   National Enterprise Development Authority (Sri Lanka)
<b>DFID</b>   Department for International Development	<b>OPIC</b>   Overseas Private Investment Corporation
<b>FIL</b>   Foreign Investment Law	<b>PE</b>   Private Equity
<b>FDI</b>   Foreign Direct Investment	<b>PM</b>   Prime Minister
<b>GAAR</b>   General Anti-Avoidance Rules (India)	<b>PPP</b>   Purchasing Power Parity
<b>GIZ</b>   Gesellschaft für Internationale Zusammenarbeit (German Agency for International Cooperation)	<b>RBI</b>   Reserve Bank of India
<b>HDI</b>   Human Development Index	<b>SEBI</b>   Securities and Exchange Board of India
<b>HNWI</b>   High Net-Worth Individual	<b>SIB</b>   Social Impact Bond
<b>HR</b>   Human Resources	<b>SIDBI</b>   Small Industries Development Bank of India
<b>ICT</b>   Information and Communication Technology	<b>SME</b>   Small or Medium Enterprise
<b>IFC</b>   International Finance Corporation	<b>SMED</b>   Small and Medium Enterprise Development (Sri Lanka)
<b>IFI</b>   International Financial Institution	<b>SVF</b>   Social Venture Fund
<b>IE</b>   Impact Enterprise	<b>VC</b>   Venture Capital
<b>IIC</b>   Impact Investors' Council (India)	<b>WHO</b>   World Health Organization
<b>IMF</b>   International Monetary Fund	
<b>LP</b>   Limited Partner	
<b>LTTE</b>   Liberation Tigers of Tamil Eelam	



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# ABOUT THIS REPORT

The objective of this study is to develop an understanding of the status of the impact investing markets in six countries in South Asia—Bangladesh, India, Myanmar, Nepal, Pakistan, and Sri Lanka. The full report includes an introduction and a chapter for each country. This research is intended to serve as a critical input to future investments and engagement to build and grow these markets. The key themes explored include the current status and trends in terms of the types of active investors, capital deployment, opportunities for and challenges to investing, the demand for impact capital, challenges to accessing capital and opportunities for enterprise growth, and the vibrancy and scale of the supportive ecosystem for the industry.

## Introduction

In recent years, impact investing has become prominent on the global stage as an approach to deploying capital with social/environmental goals as well as financial return objectives. Deployed in both developing and developed markets, impact investments are made across a range of sectors and asset classes.

South Asia is home to more than 1.6 billion people and has experienced dramatic economic growth over the last decade. However, this rapid growth, while changing some economies dramatically, has been uneven between and within countries; about a quarter of the region's population continues to live on less than USD 1.25 per day<sup>1</sup> and large population segments lack access to quality social services, finance, energy, and infrastructure as well as to affordable consumer products. The opportunity for impact through the deployment of capital into organizations and enterprises that increase incomes, create jobs, and provide access to essential services is significant, and the status of the impact investing industries in these countries is worthy of attention.

## Who is an impact investor?

Impact investments are “investments made in companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return.”<sup>2</sup>

The three key characteristics of an impact investor are as follows:

- Expectation of a financial return that can range from the return of capital to risk-adjusted market returns and that can be derived from investments in a range of asset classes.

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<sup>1</sup> Weighted average calculated with the latest country data (2010–2012) from World Bank Development Indicators; Myanmar figures are not included in the weighted average.

<sup>2</sup> For more details, refer to the GIIN website, [www.thegiin.org](http://www.thegiin.org).

- Intent to generate a positive social and/or environmental impact through investments. For example, investors may seek to use investments to increase access to basic services or invest in solutions aimed at mitigating the negative effects of climate change.
- Commitment of the investor to measure the social/environmental performance of underlying investments.

This report focuses significantly on the impact investing landscape in each of the six countries covered. Various terms may be used to refer to the impact investing landscape, including “impact capital” and “impact funds,” depending on the context. For the sake of fluency, the modifier “impact” will be dropped when the context is clear.

While the central goal of this study is to map the current landscape of impact investing activity, there is also significant investment activity on the periphery of impact investing that will be interesting to learn about. In particular, we consider the following two types of investment activity:

- a. Investments in businesses at the businesses serving BoP populations by investors who have may not have explicit impact intention
- b. Investments where there is some intention to have social and/or environmental impact, but this impact is assumed to occur as a by-product and is not measured in any meaningful way

Such investment activity is also important for an analysis conducted to gain a better understanding of the broader opportunity landscape for impact investing going forward. When a section in the report focuses particularly on the investment activity in this peripheral region, we will explicitly refer to these as “impact-related” investments, thereby clearly differentiating them from “impact investing.” (Please note that we are using these labels purely for the ease of reference and do not intend the names to imply any subjective judgment on the nature of an investor’s investment activity or approach.)

## COUNTRY CONTEXT

### Overview

**Sri Lanka, a country that has recently emerged from a 26-year-long civil war, is now showing signs of strong recovery and positive economy-wide growth.** Since the end of the civil war in 2009, the country has experienced dramatic GDP growth and is forecasted to grow at nearly 8.5% annually through 2016.<sup>3</sup>

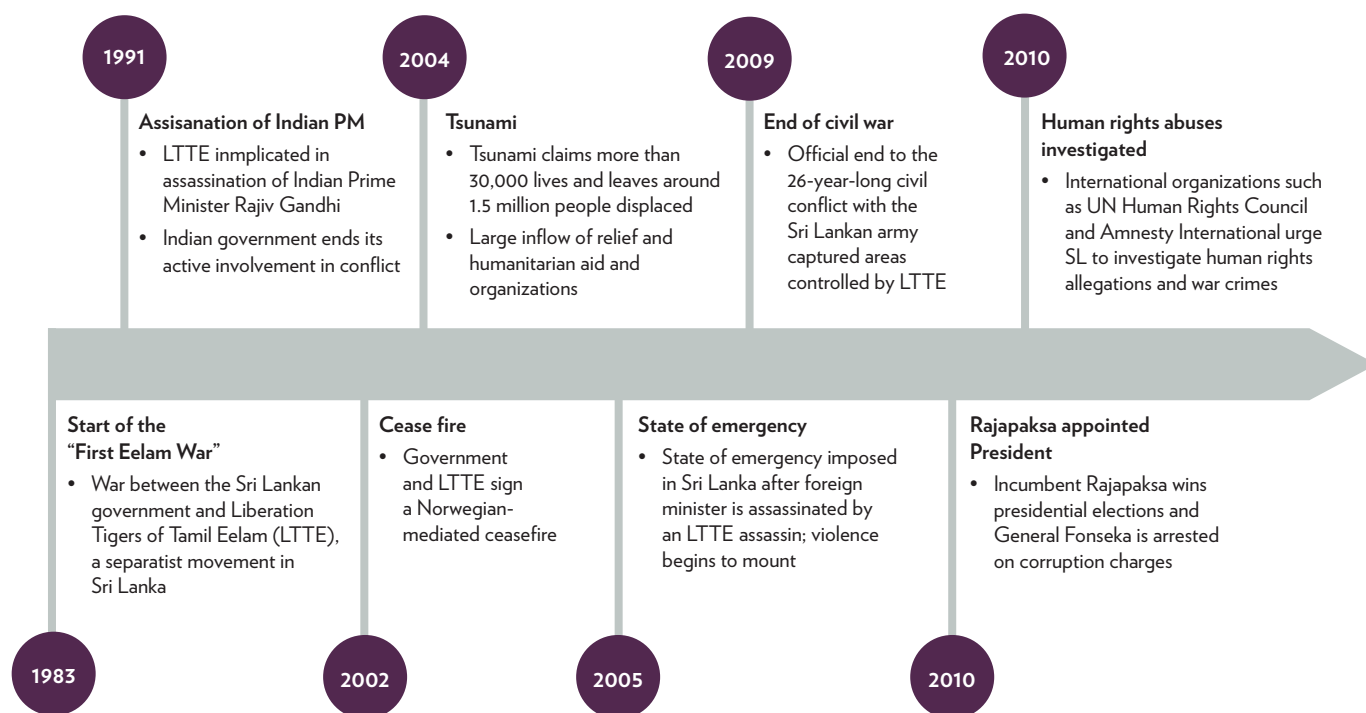
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<sup>3</sup> *International Monetary Fund estimates.*



Throughout the period of the civil war, in addition to widespread political instability and insecurity, Sri Lanka suffered from several natural disasters, including a devastating tsunami in 2004. As a result, there was a heavy inflow of international aid into the country. More recently, however, allegations of human rights violations by the government have made many of these aid organizations wary of engaging in Sri Lanka. Some have, in fact, begun withdrawing from the country, and there has been a continued push from the international community for investigations into these allegations.

**FIGURE 1: TIMELINE OF KEY EVENTS IN SRI LANKA'S POLITICAL HISTORY**



Source: BBC, 2013. Sri Lanka Profile

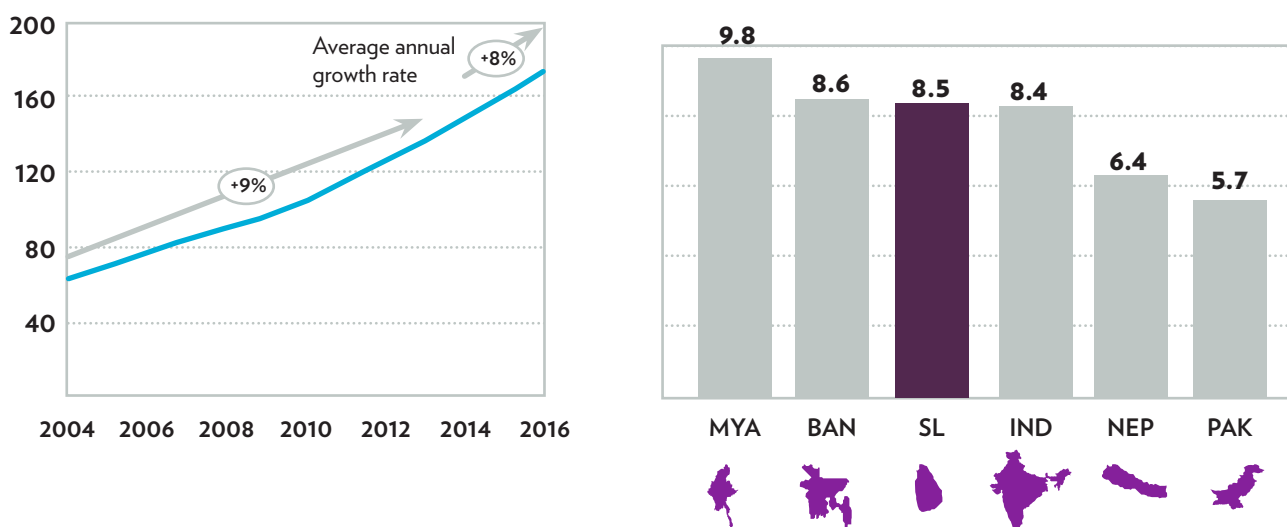
**The implications of these changes for investors are mixed.** The improved political climate and engagement by government are promising, but the scrutiny of the international community presents reputational risk and, as such, many potential investors are wary. Still, strong macroeconomic fundamentals, including rapid current and forecasted GDP growth, are positive indicators.



## GDP growth and drivers of foreign direct investment (FDI)

**Sri Lanka is predicted to be one of the fastest growing economies in Asia.** Sri Lanka's GDP in 2013 was 136 billion (PPP, current international \$) following nearly a decade of average annual growth of 9%. At a forecasted GDP growth rate of 8.5% from 2014 to 2016, Sri Lanka is poised to be the third fastest growing economy in the region, behind Myanmar and Bangladesh but ahead of India.

FIGURE 2: GDP GROWTH OVER TIME (PPP, CURRENT INTERNATIONAL DOLLAR BILLIONS) AND 2014–2016 FORECASTED GROWTH RATE AS COMPARED TO REGION (%)

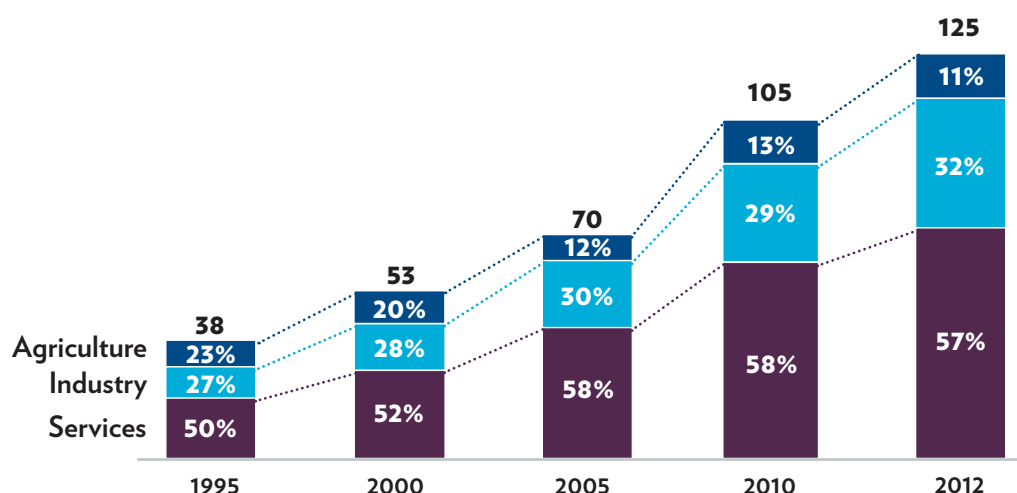


Sources: International Monetary Fund estimates; Dalberg analysis

### Service sector growth has been the strongest contributor to this economic performance.

In 2013, industry contributed to 32% of GDP (strongly driven by the textile and garments, and food and beverage sectors) while services such as tourism, transport, telecommunications, and financial services contributed to 57% of the GDP. Tourism in particular showed strong growth—tourism income rose from USD 362 million in 2005 to USD 1.04 billion in 2013, and is expected to double again in the next five years. Interestingly, while agriculture only contributes a small share of GDP, approximately 32% of the population is employed in the sector, and Sri Lankans still view their country as heavily agricultural, with even formal sector workers retaining ownership of agricultural land that they return to during harvest season to help harvest the yield.

FIGURE 3: CONTRIBUTION TO GDP BY SECTOR (PPP, CURRENT INTERNATIONAL DOLLAR BILLIONS)<sup>4</sup>



Source: World Development Indicators, The World Bank

**Alongside this robust growth, the Sri Lankan government has developed a strong provision of basic services for the public.** Public expenditures on education, housing, healthcare, and other services more than doubled from 2005 to 2012 and accounted for 22% of government revenue as of 2012. Expenditures on public services are expected to increase further, improving both access and quality. While there is increasing private interest in serving the high-end market segments, the widespread and good-quality public provision of basic education and healthcare for lower- and middle-income segments makes these sectors less attractive to the private sector (although some regional variation and inequity are still visible).

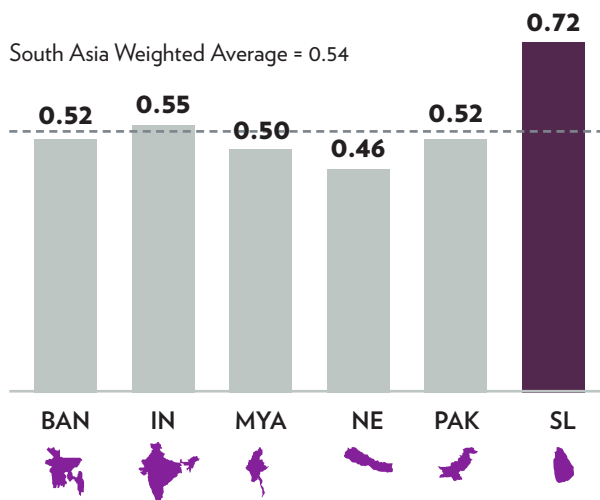
**Widespread public sector provision has also resulted in Sri Lanka's Human Development Index (HDI) score of 0.72, which is much higher than the South Asia weighted average (0.54) and all regional comparators.** Life expectancy at birth is now 75.1, higher than the world average of 70.1. Ninety-three percent of the population has access to improved drinking water, compared to 89% for the world average.

<sup>4</sup> Services, Industry, and Agriculture are used as defined by ISIC Rev 3. Services include wholesale and retail trade (including hotels and restaurants), transport, and government, financial, professional, and personal services such as education, healthcare, and real estate services. Industry includes mining, manufacturing, construction, electricity, water, and gas. Agriculture includes cultivation of crops, livestock production, forestry, hunting, fishing, and other associated activities.

FIGURE 4: HUMAN DEVELOPMENT INDEX FOR SOUTH ASIA

### HUMAN DEVELOPMENT INDEX (SCALE OF 0 TO 1, 1 BEING THE HIGHEST)

South Asia Weighted Average = 0.54



#### HEALTHCARE

- Life expectancy at birth is now 75.1, higher than world average of 70.1, and within the high development index category (>73.4)
- Infant mortality rate is 8 per 1000 live births and 99% of births are attended by a healthcare worker

#### EDUCATION

- Sri Lanka's expected years of schooling for a student starting school is 12.7 and mean years of schooling for adults is 9.3; these figures are both more than South Asia and World averages, and within the medium human development index category
- Literacy rates among men and women are 97.7% and 98.6% respectively

#### WATER AND SANITATION

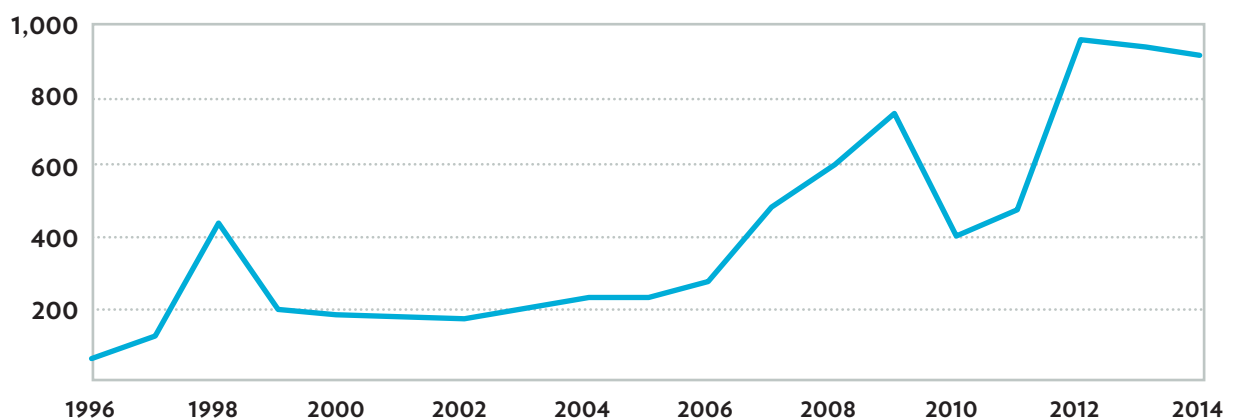
- 93% of the population have access to improved drinking water sources and 91% of the population have access to improved sanitation, both of which are higher than the world averages of 89% and 63%, respectively

Sources: UNDP, 2013 Human Development Index; UNICEF 2013 Sri Lanka Statistics

### Investors have generally responded positively to the stability and growth in Sri Lanka.

FDI inflows have been volatile but increasing since the mid-2000s, rising to USD 1.2 billion in 2013. Key constraints to increased investor confidence and smoother, stronger FDI inflows include concerns over growth being fueled primarily by government infrastructure spending, concerns over limited action to address allegations of human rights violations, and allegations by some investors of corruption and inconsistent application of investment policies.<sup>5</sup>

FIGURE 5: FDI INFLOWS TO SRI LANKA OVER TIME (CURRENT USD MILLIONS)



Source: World Development Indicators, The World Bank

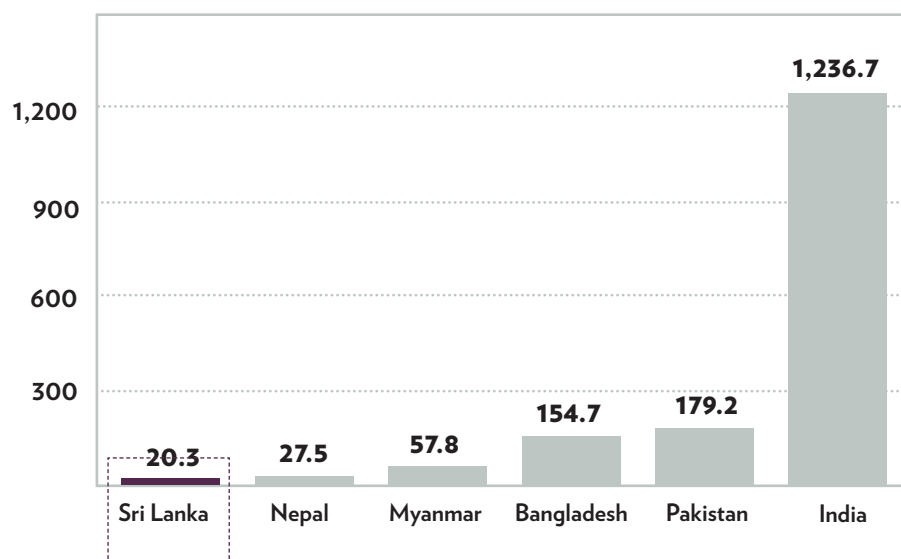
5 News reports: Ranga Sirlal, "Sri Lanka targets \$2 Bln in FDI again for 2014." Reuters, May 29, 2014.

## Key constraints in Sri Lanka

Despite a relatively high HDI score, a large majority of Sri Lanka's population still lives below USD 4 per day (70% in 2011), and a quarter lives below USD 2 per day.<sup>6</sup> Income inequality is high, although it varies significantly by region. The Gini coefficient<sup>7</sup> for Sri Lanka is 0.36 (compared with the South Asia average of 0.33), and it is estimated that the richest 20% earn 45% of the income while the poorest 20% earn only 7%. Eighty-five percent of Sri Lanka's population lives in rural areas, and this statistic has remained fairly constant since 2009.<sup>8</sup>

One other key factor deterring investors from investing in Sri Lanka is the small size of the population and the domestic market. With a population of just over 20 million, Sri Lanka is the smallest of all countries in South Asia. This small domestic market means opportunities for local scale are limited. Although Sri Lanka does enjoy geographic proximity to India and its large market, the advanced nature of many Indian industries means that Sri Lankan businesses struggle to compete there.

FIGURE 6: 2012 TOTAL POPULATION BY COUNTRY (IN MILLIONS)



Source: World Bank Development Indicators, The World Bank

6 World Bank 2011; ECHO 2012.

7 The Gini coefficient represents the income distribution of a nation's residents. This is the most commonly used measure of inequality. The coefficient varies between 0, which reflects complete equality, and 1, which indicates complete inequality. Source: Wikipedia, [http://en.wikipedia.org/wiki/Gini\\_coefficient](http://en.wikipedia.org/wiki/Gini_coefficient).

8 Rural Poverty Portal, *Rural Poverty in Sri Lanka*.

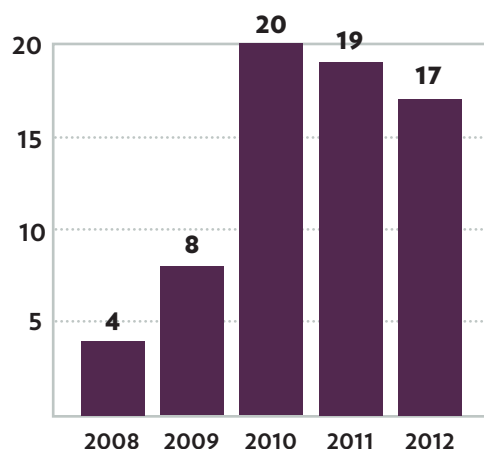
**Sri Lanka's stock market is also relatively small in terms of market capitalization.**

The market saw huge year-on-year growth between 2008 and 2010, but then contracted as investor confidence dropped (Figure 7). In 2011–2012, there were several cases of market manipulation reported in the media—including allegations of price manipulation and insider trading—which have left domestic and foreign investors wary. The markets have been recovering only sluggishly since.

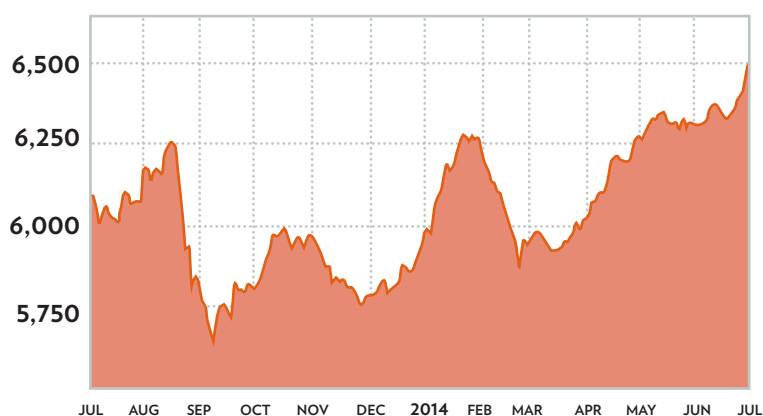
**Furthermore, capital markets are perceived to be extremely volatile, which again acts as a deterrent for investors.** This holds true even for foreign investors for whom public equities would otherwise present an easier, lower-risk asset class with which to enter and gain country exposure.

**FIGURE 7: SRI LANKA TOTAL MARKET CAPITALIZATION (USD BILLIONS) AND COLOMBO ALL SHARE INDEX OVER TIME (USD, JULY 2013–JULY 2014)**

**TOTAL MARKET CAPITALIZATION  
OF LISTED COMPANIES**  
(CURRENT USD BILLIONS)



**PRICE OF SRI LANKA COLOMBO STOCK EXCHANGE:  
ALL SHARE INDEX**  
(USD, JULY 2013 TO JULY 2014)

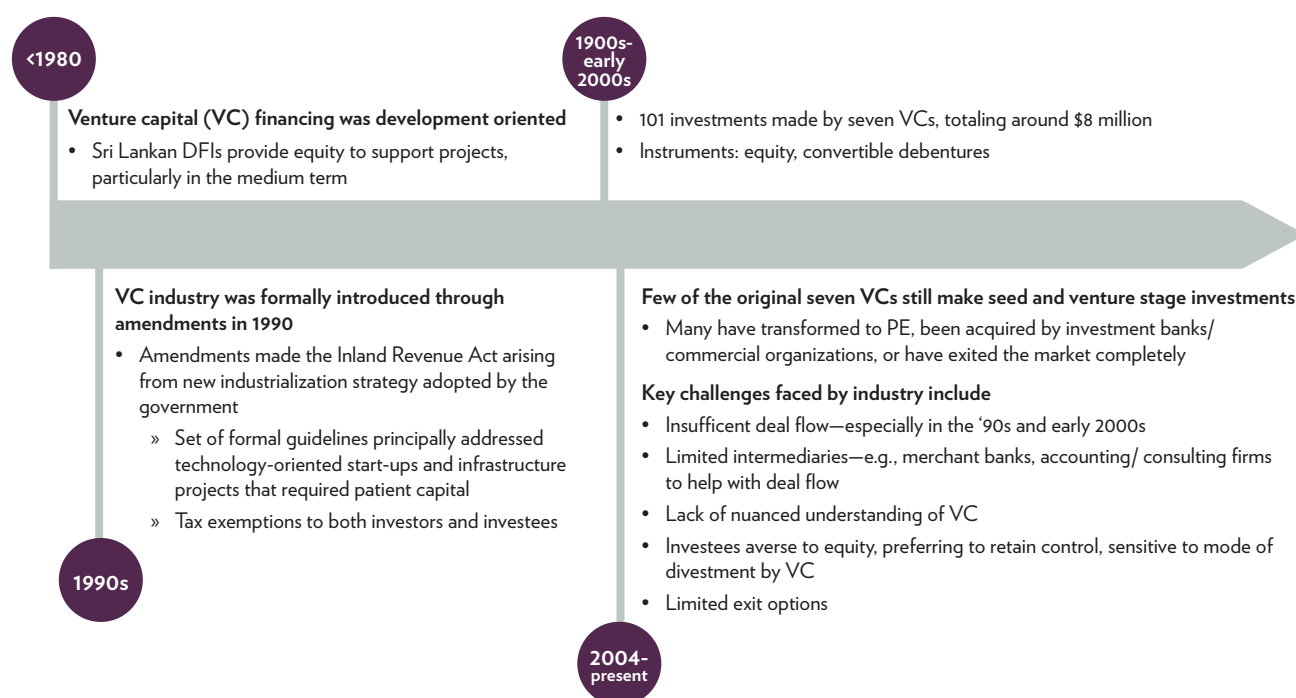


Sources: World Development Indicators, The World Bank; Bloomberg Stock Market and Financial Markets Overview.

Interestingly, Sri Lanka has a fairly long history of institutional venture capital. In the 1990s, the government recognized the need for increased risk capital in the market and encouraged banks to establish venture capital (VC) investment arms.

Through the 1990s and into the early 2000s, 101 investments were made by seven VCs, totaling around USD 8 million. However, few of these seven VCs still exist, and the practice of investing risk capital has never truly become embedded in the economy. The investments made during this period were fairly high risk, and returns were not strong, in part due to the limited experience of fund managers at the time, and in part due to aversion on behalf of strong entrepreneurs to open their ideas and companies to bank-linked VCs out of fear that they would be taken over (see Figure 8 below). Therefore, these early VC funds have either morphed into more conservative private equity (PE) funds, been acquired by investment banks/commercial organizations, or closed down completely. Nonetheless, positive implications have been a greater familiarity with equity instruments and a relatively active (although small) mainstream PE market. However, the negative perceptions created by these unsuccessful efforts have left a sour taste for many domestic investors who remain wary of deploying risk capital.

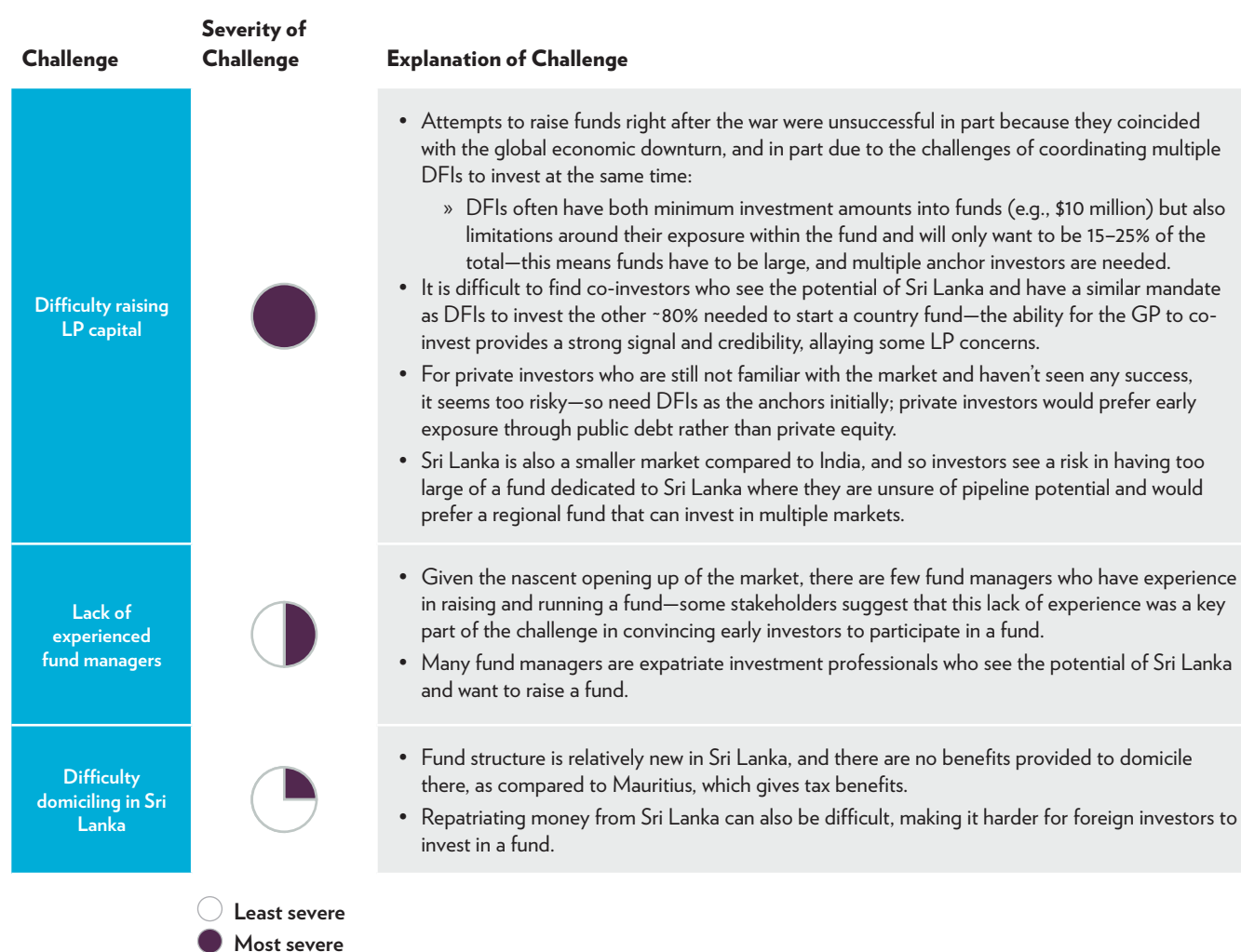
FIGURE 8: PATHWAY FROM EARLY VC TO CURRENT CONSERVATIVE COMMERCIAL PE IN SRI LANKA



Sources: “Venture capital financing—Sri Lankan experience,” Lanka Ventures, 2004; Stakeholder interviews

More recently, there were a handful of attempts by both domestic and regional fund managers to raise a Sri Lanka-focused impact investing fund, but these too were unsuccessful for a range of reasons, as outlined in Figure 9. At least two to three funds have tried to raise capital in the past and have failed. The goal was to raise capital committed solely for Sri Lanka, out of recognition that capital committed for South Asia through regional funds was heavily directed to India. However, given the size and immaturity of the Sri Lankan market at the time (post-war) as well as the internal constraints on DFI as limited partners (LPs), these attempts were unsuccessful. The International Finance Corporation (IFC), for example, had a USD 10 million mandate for investing into a fund, but this expired due to the inability to find co-investors for the fund.

**FIGURE 9: CHALLENGES TO RAISING COUNTRY-SPECIFIC IMPACT INVESTING FUNDS FOR SRI LANKA**



Sources: Stakeholder interviews; Dalberg analysis



# INVESTING IN SRI LANKA: THE SUPPLY SIDE

**There is increasing interest and activity in Sri Lanka, which provides a number of advantages to investors compared to other countries in South Asia.** Compared with its neighbors, Sri Lanka has perhaps the easiest regulatory environment to navigate, which gives investors the required confidence in their ability to invest and exit. Another key feature of the market is the growing maturity of entrepreneurs—primarily in terms of the diaspora/returnees who tend to be active and the domestic business community that has grown businesses over a long time. The small size of Sri Lanka—in terms of both market and geography—is both an advantage and a disadvantage. It is an advantage in that it is easy to identify entrepreneurs and partners as networks are strong and easy to access, and in the ease of getting around the country to rural areas to work with a diversity of enterprises. On the other hand, in such a small market, scale becomes a challenge as the domestic economy is limited and investors sometimes need to find deals that present opportunities to scale offshore.

## The broad impact capital market in Sri Lanka

**USD 386 million has been deployed to date by DFIs and a further USD 100 million has been deployed by other impact investors<sup>9</sup> (see Figures 10, 11 and 13).** At least 12 international finance institutions (IFIs) and development finance institutions (DFIs), 11 funds, and one foundation have active impact investments in Sri Lanka. These investors have a total of 31 current investments. More information on the observed investment preferences for this set of investors can be found in the section “Key trends of impact investing in Sri Lanka.”

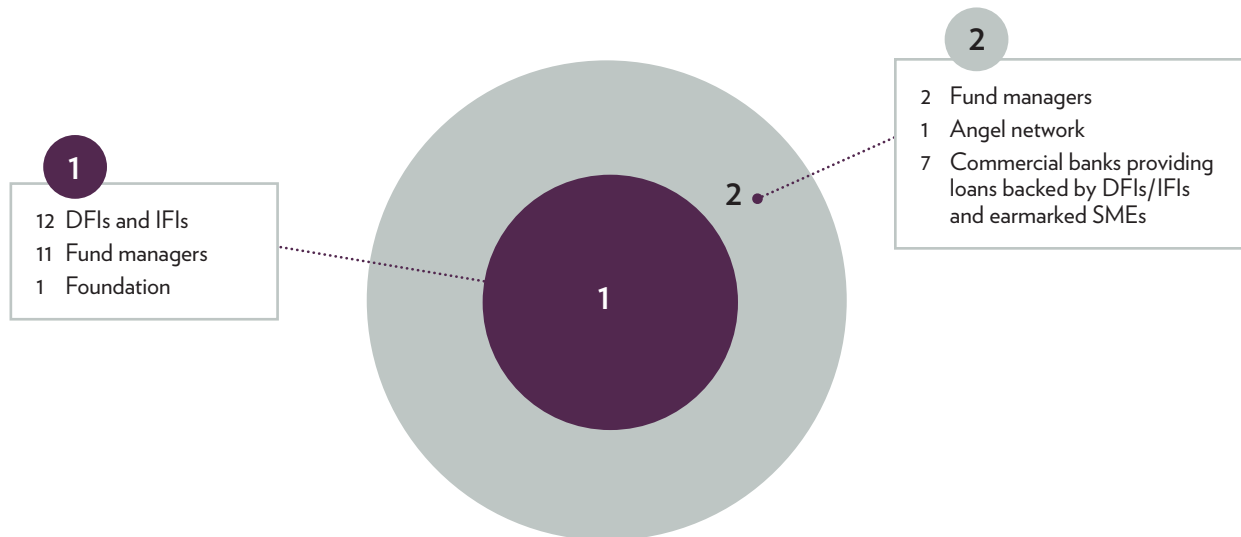
**Overall, despite the large number of actors, the total volume of impact capital deployed is not proportionally large as compared to other regional markets.**

Given the small size of the market, the deal sizes for both funds and DFIs tend to be smaller in Sri Lanka than in other countries in the region. Moreover, while there are a large number of DFIs active in Sri Lanka (as many as are currently active in India), several have engaged only through syndicated loans with other DFIs; therefore, the number of deals made overall is relatively small.

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<sup>9</sup> These figures represent the best effort to scope the total impact investing market in Sri Lanka. However, it is possible that not all impact capital has been captured due to investor confidentiality or other limitations. These figures should be treated as approximate representations of the market.

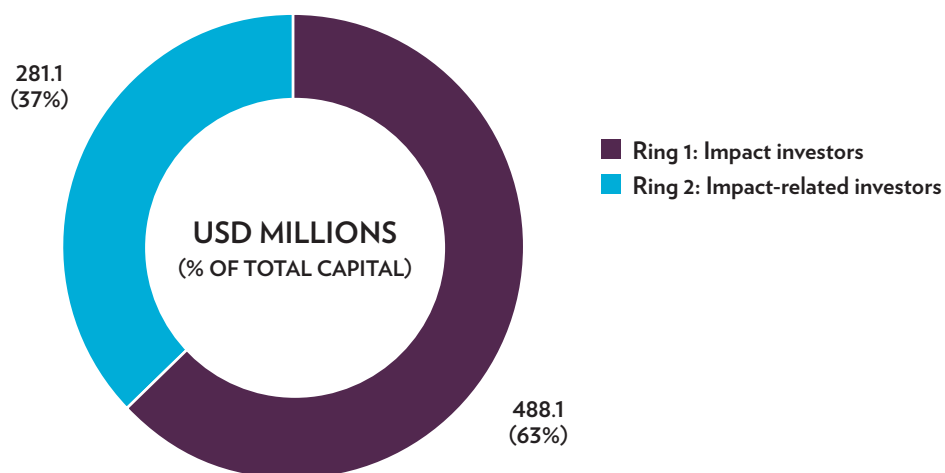
FIGURE 10: NUMBER OF DIRECT IMPACT AND IMPACT-RELATED INVESTORS IN SRI LANKA



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

There are also a set of impact-related investors (Ring 2) with approximately **USD 281 million invested (Figure 11)**. These investors include two fund managers, one angel network, and commercial banks lending to small or medium enterprises (SMEs) with DFI-backed capital. This group currently has 22 known investments, but the number is probably very high due to sizeable capital being used for SME loans by commercial banks. As there is no portfolio information publicly available for these, the exact number of investments made is unknown.<sup>10</sup>

FIGURE 11: TOTAL KNOWN CAPITAL DEPLOYED BY RING



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

<sup>10</sup> See “Defining key terms and concepts” in the introduction chapter of this report for an explanation of the framework used for categorizing investors using a two-ring framework, where the inner ring—Ring 1—represents the impact investing activity and the outer ring—Ring 2—represents the activity related to impact investing but lacking either an explicit impact intention or measurement.

## Active impact and impact-related investors in Sri Lanka

**Sri Lanka has a large number of actors and varied investor types with a mix of both local and international players.** Figure 12 provides specifics on the active impact investors in Sri Lanka, which includes funds managers, DFIs, foundations, family offices, HNWLs, and banks.

**There are significantly more international investors than domestic investors in the impact investment market (as domestic investors tend to be commercially oriented rather than impact focused), but these investors are only deploying a small share of their total capital in Sri Lanka.** Of the 13 funds currently active, one is a domestic fund, two are regional (i.e., focused on South Asia), and ten are international. Traditionally, local funds in Sri Lanka have prioritized financial returns and had little interest in the impact investment market. While we see a large number of international funds deploying impact capital, the small size and uncertainty of the Sri Lankan economy have led these investors to invest only a small share of their portfolios in the country. A few additional funds are currently raising small amounts of domestic capital, although these will likely fall within Ring 2 in our framework.

**DFIs and IFIs are the most active investors by amount of capital deployed, with all 12 DFIs/IFIs making investments directly into enterprises.** DFIs/IFIs are responsible for USD 386 million, or about 79%, of the USD 488 million deployed by impact investors. While the amount of capital is sizeable, the number of companies absorbing this capital is not. To minimize their risks and due to the difficulty in finding large, investable companies, most DFIs/IFIs have invested only in syndicated loan deals with other DFIs/IFIs, implying that the number of enterprises receiving DFI/IFI capital is actually quite small.

**DFIs and IFIs are also engaging indirectly in the impact-related market by channeling capital through commercial banks for SME lending and in small amounts deployed through foreign funds as intermediaries.** As we have seen throughout the region, DFIs and IFIs are heavily backing SME loans through commercial banks (through both loans and guarantees). Overall, 42% of capital deployed by DFIs in Sri Lanka has been invested into financial institutions, with the goal of increasing access to finance.

**Unlike in many of the other countries under study, DFIs are not currently investing in any country-specific funds in Sri Lanka.** However, this is to change in the near future as a new Sri Lanka-specific fund is being set up through a joint venture between a domestic bank and a regional fund manager.<sup>11</sup> As DFIs now understand the market better, they are ready to increase their exposure in the country by investing in local funds.

**Foundations have mostly exited Sri Lanka; hence, we see only one foundation providing impact capital.** Following the end of the civil war, the country faced a

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<sup>11</sup> “Zephyr charts \$50-million Sri Lanka plan,” *Economic Times*, 2014.

humanitarian crisis, and in 2004, the country suffered from a devastating tsunami. These events sparked a wave of philanthropic capital from foundations. Sri Lanka has since recovered and has transitioned to a middle-income country, reducing the perceived need. Accusations against the government of widespread human right violations have further isolated foundations. Thus, we see only one foundation actively deploying impact capital in Sri Lanka today.

**A large number of high net-worth individuals (HNWIs) and family offices are active as investors primarily due to one domestic angel network with more than 70 members, but the amount of capital deployed by these investors is relatively small.** Domestic and diaspora HNWIs and family offices have been engaged in the impact capital market, both as direct investors into enterprises and as contributors to funds. One angel network has about 70 members—including HNWIs and family offices—but despite their large number, the network has deployed less than USD 100,000. Of these members, 10–12 are from the region and the remaining are members of the Sri Lankan diaspora. Domestic HNWIs are likely to increase their engagement in the future, as a number of them have already pledged capital to upcoming domestic funds and are expected to make up a significant share of new domestic funds.

**As in other countries in the region, family and friends are a significant source of seed and venture capital through informal investments that do not have set timelines or contracts.** While the exact amount of capital deployed through family and friends is unknown, it is likely to be the predominant source of capital in these early growth stages.

**The most active institutional investors are commercial banks lending DFI capital to SMEs; one pension fund is scoping the market.** Seven commercial banks are investing on the periphery of the impact investing market by making loans to SMEs with DFI/IFI capital. As discussed above, DFIs and IFIs have provided capital to these banks that has been earmarked solely for SME lending in an effort to catalyze investments to these businesses, leading to economic growth and higher financial inclusion. Beyond banks, one pension fund is looking to back a domestic fund.

**FIGURE 12: IMPACT INVESTORS AND IMPACT-RELATED INVESTORS ACTIVE IN SRI LANKA**

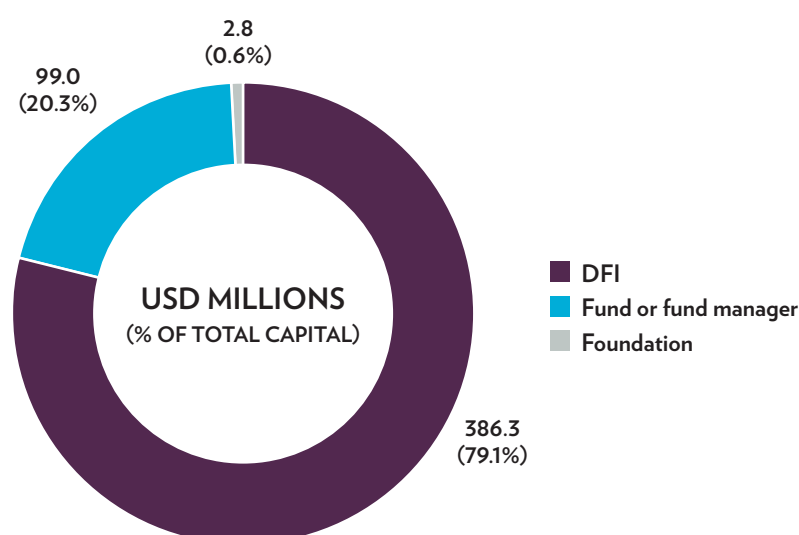
TYPE OF INVESTOR	ESTIMATED NUMBER	DETAILS OF INVESTORS IN SRI LANKA
Fund managers	13	Ten international funds (that have invested only a small share of their capital in Sri Lanka), one domestic fund, and two regional funds are currently making investments, and a few funds are scoping and preparing to launch in Sri Lanka.
DFIs and IFIs	12	All DFIs and IFIs are making direct investments into enterprises in Sri Lanka, and a few are also channeling capital through commercial banks for SME lending and investing small amounts in foreign funds.
Foundations	1	Only one international foundation is making investments in Sri Lanka, as many have exited the country with Sri Lanka being considered a middle-income country and facing concerns about human rights violations during the recently concluded civil war.
HNWIs and family offices	70+	Over 70 HNWIs and family offices are members of a domestic angel network, and several HNWIs have pledged capital to upcoming domestic funds. Family and friends are a predominant informal source of seed and venture stage capital.
Institutional investors	7 banks, 1 pension fund	Seven commercial banks are lending to SMEs with capital provided by DFIs. One pension fund is potentially backing a domestic fund.

## Key trends in impact investing in Sri Lanka

The following section examines trends among impact investors, who collectively have about USD 488 million currently deployed. The activities of impact-related investors will be discussed in the section “*Beyond the impact investing market.*” Looking across the landscape of currently deployed capital in Sri Lanka, we can observe several trends in investment preferences of impact investors by instrument, stage of growth, sector, and deal size.

### INVESTOR MIX

FIGURE 13: IMPACT CAPITAL DEPLOYED BY SOURCE (USD MILLION)



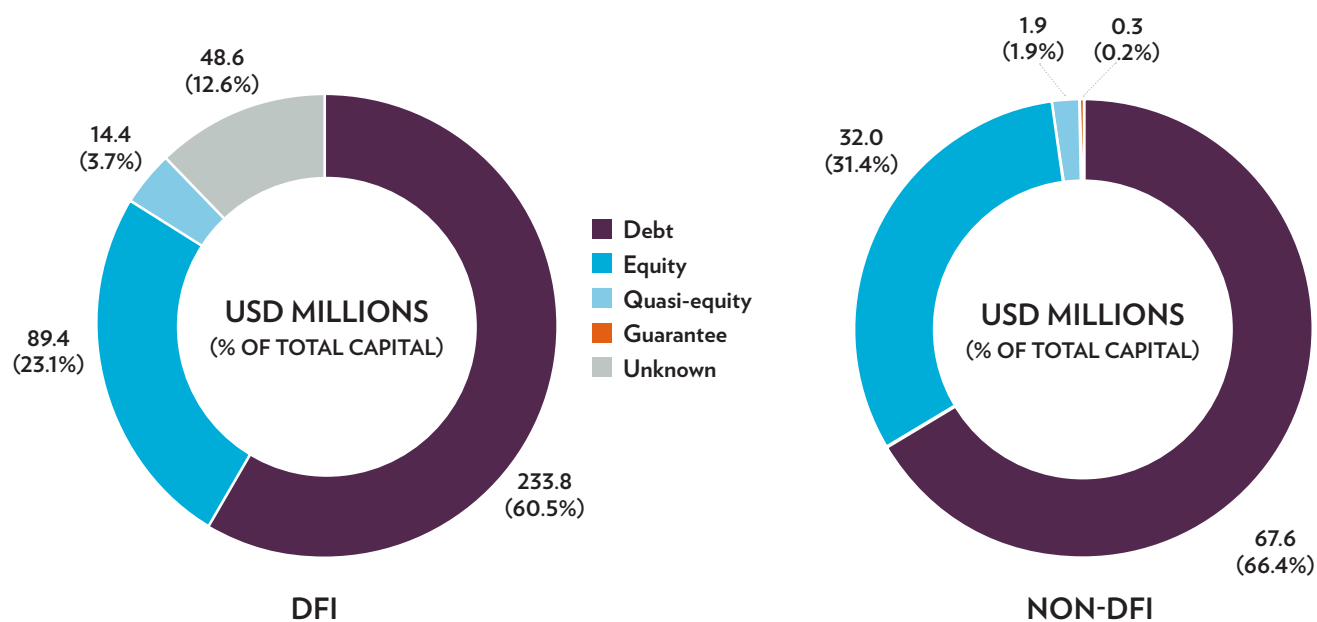
Sources: Stakeholder interviews; Investor websites; Dalberg analysis

**DFIs and IFIs have the most capital currently deployed among impact investors (about 79%), with funds and foundations contributing the remainder.** There are a large number of DFIs and IFIs active in Sri Lanka, but their prevalence in the market can also be explained by the large deal sizes that DFIs and IFIs tend to make relative to other investors. Funds and fund managers are also active, with USD 99 million currently deployed. One foundation makes up the remaining 0.6% of active capital among impact investors, with about USD 2.8 million deployed.

## INSTRUMENT

**Overall, impact investors in Sri Lanka have deployed more capital through debt than other instruments.** Sixty-two percent of direct investments are debt, compared with 25% through equity. This is an interesting trend since equity is not a new concept to Sri Lanka (as described earlier), unlike in the other markets where both investors and enterprises are less comfortable with the instrument. This preference for debt is driven more by enterprise preference for debt than by investor preference, particularly for growth and mature stage companies, and is consistent across investor type—both DFIs and non-DFIs.

FIGURE 14: IMPACT CAPITAL DEPLOYED BY INSTRUMENT (USD MILLION)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

**Investment instrument also partly depends on growth stage.** Seed, venture, and growth stage companies have seen more equity investments from investors. Due to the inherent risk of earlier-stage companies, equity investments allow investors to be more strategically involved. Moreover, investors understand that in early stages, debt can actually constrain enterprise growth. In contrast, DFIs investing in large enterprises tend to invest through debt, driven largely by the capital needs of enterprises.



**Investors are experimenting with new instruments.** Besides debt and equity, which are more familiar instruments in Sri Lanka, impact investors have made some small to mid-sized guarantees to support access to finance for SMEs and non-bank microfinance institutions. Figure 15 provides an overview of investors providing guarantees; the IFC investments outlined in the figure do not qualify as direct investments into enterprises and therefore have not been captured in the totals in the analyses.

**FIGURE 15: EXAMPLES OF GUARANTEES BEING USED BY IMPACT INVESTORS**

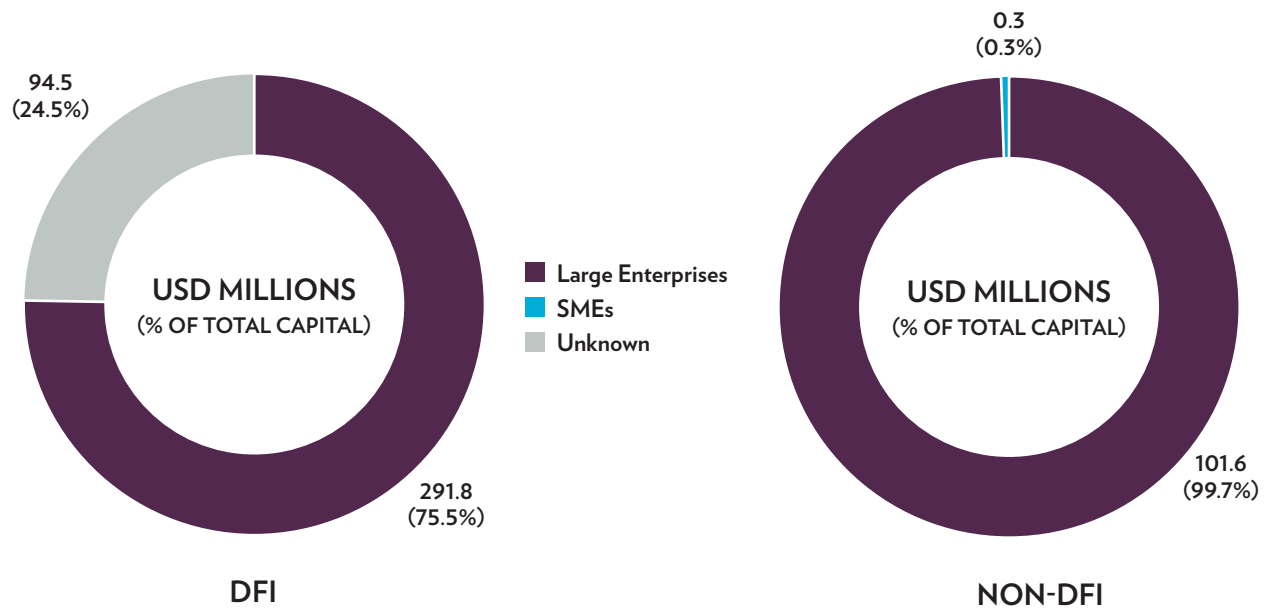
Investor Offering Guarantee	Organization Receiving Guarantee	Amount and Purpose
International Finance Corporation World Bank Group	Commercial Bank	<ul style="list-style-type: none"> <li>• USD 14.87 million</li> <li>• Used to back SME loans provided by the bank</li> </ul>
	NDB Bank	<ul style="list-style-type: none"> <li>• USD 13.11 million</li> <li>• Used to back SME loans provided by the bank</li> </ul>
Helps commercial banks increase their capacity and encourages SME lending. For DFIs, this is a less risky investment that creates a multiplier effect as commercial banks lend money to enterprises.		
Grameen Crédit Agricole Microfinance Corporation	Berendina	<ul style="list-style-type: none"> <li>• USD 0.26 million</li> <li>• Help partially secure a bank loan from domestic bank for 3 years</li> </ul>
Guarantees to Berendina Microfinance have been given to enable the enterprise to access commercial bank loans. The guarantee makes it easier for microfinance companies that lack collateral to access capital.		

Sources: Stakeholder interviews; Investor websites; Dalberg analysis

## SIZE OF INVESTEE COMPANIES

**A majority of impact capital has been invested in large companies.** While it is expected that large companies will absorb the most capital, as deal sizes tend to be larger for these companies, only a very minimal amount of known capital (USD 300,000 or 0.1% of all capital) has flowed to SMEs. This is likely a function of the predominance of DFIs in Sri Lanka and their preference for large ticket sizes, which only relatively large companies can absorb.

FIGURE 16: IMPACT CAPITAL BY SIZE OF INVESTEE COMPANY (USD MILLIONS)

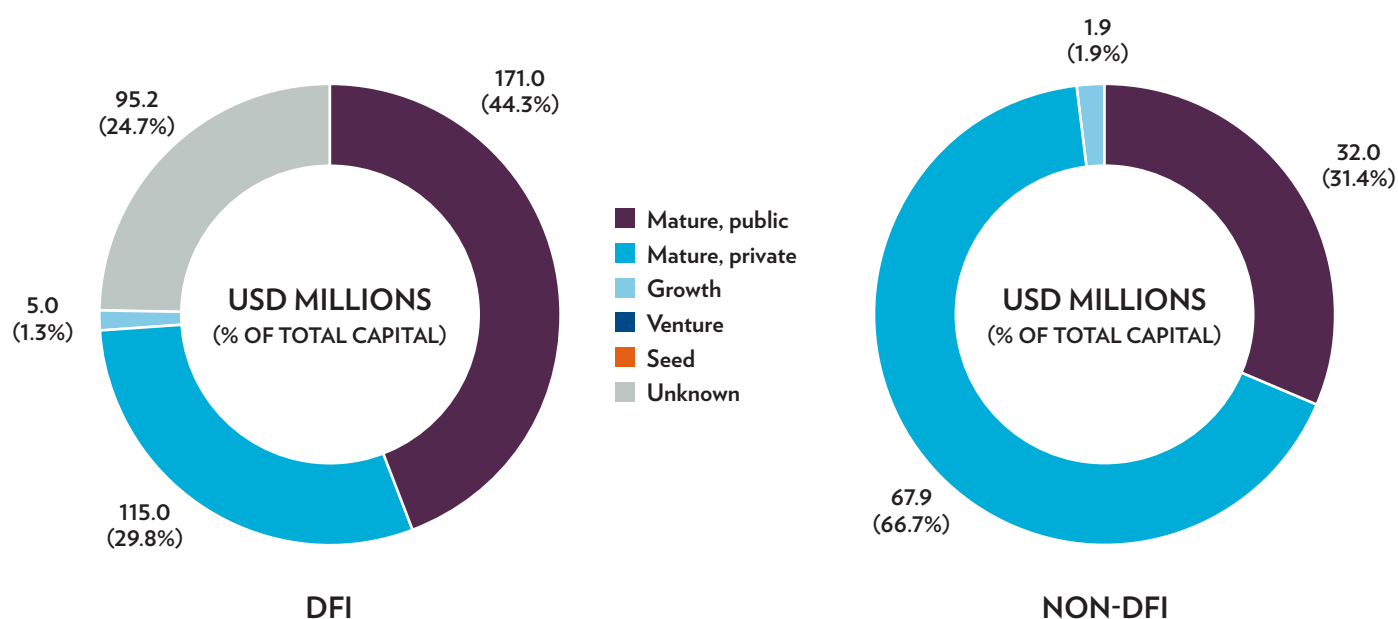


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

## GROWTH STAGE AND DEAL SIZE

As with the other markets under study, there is strong preference for mature companies—both listed and private—among all types of impact investors. DFIs need to make large investments and therefore, target enterprises that can absorb large amounts of capital, leading to a focus on larger and more mature companies. We also see non-DfI investors providing capital to listed and private, mature companies. As a result, 79% of total capital from impact investors has been invested in mature companies.

FIGURE 17: IMPACT CAPITAL DEPLOYED BY GROWTH STAGE

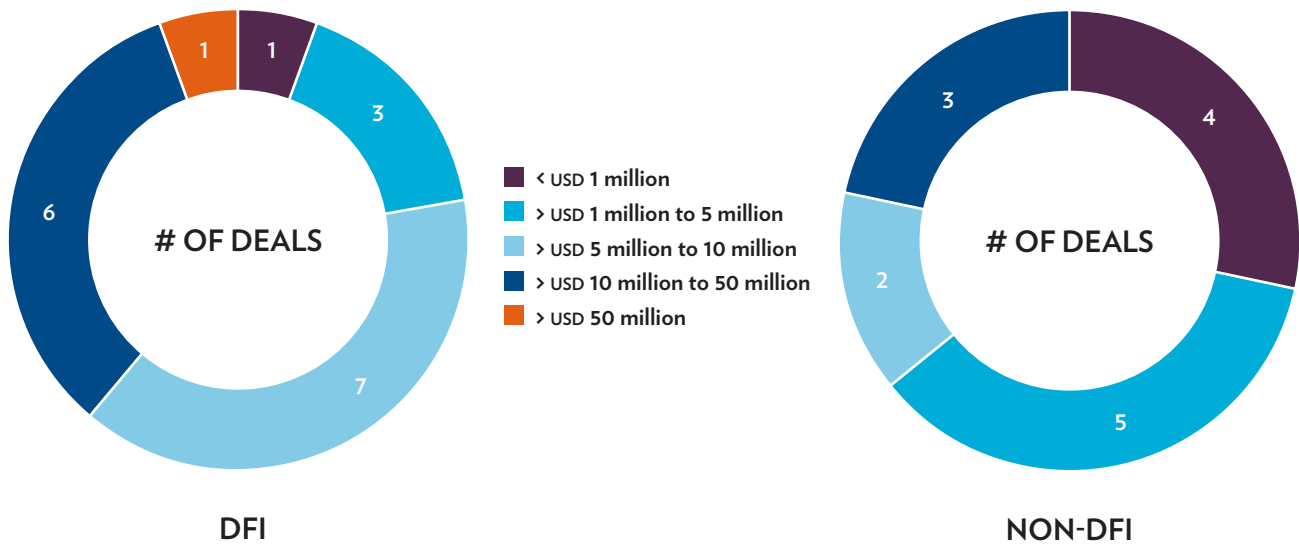


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

While they still represent a small proportion of capital, angel investors, VCs, and bank SME portfolios (to a lesser extent), are targeting smaller and earlier-stage companies, despite the inherent higher risk. A major constraint to increased investment is the dearth of investible enterprises where the entrepreneurs have strong financial and operational management skills. Unlike in markets with established VC industries, in Sri Lanka, company directors (including equity investors) are personally liable in case of any default by the company. Therefore, for early-stage companies where the failure risk is extremely high, the appetite to take this risk is extremely low given the limited regulatory protection in case of bankruptcy. The result is that even angel investors or other seed and venture capital providers tend to be quite risk averse in their investment decisions and their decisions depend in great measure on their trust in and relationship with the entrepreneur.

Unlike in other markets, impact investments in Sri Lanka show wide variation in terms of deal size. A reasonable number of deals in each progressive size bracket suggests a growing maturity in the market and potential for development of the industry into a well-coordinated market with impact capital available across the range of capital needs.

FIGURE 18: IMPACT CAPITAL BY DEAL SIZE

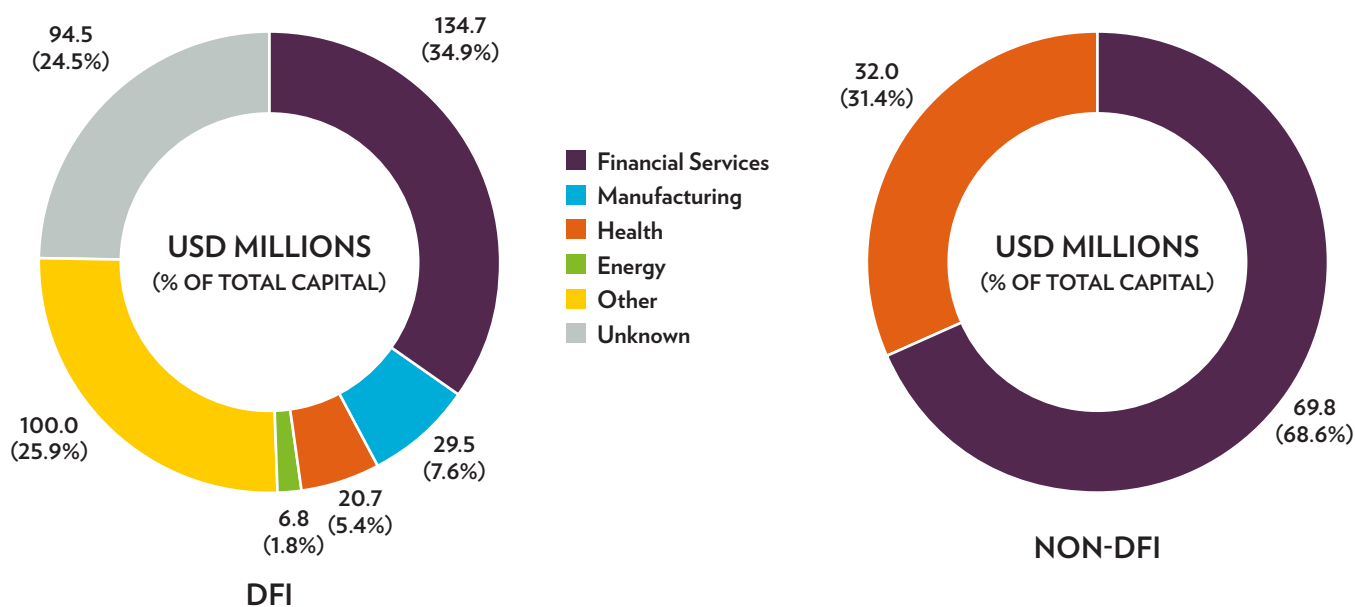


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

## SECTOR

In Sri Lanka, financial services and microfinance have drawn the bulk of impact capital by sector (where “financial services” includes banks and commercial leasing companies). Tourism and hospitality have also been attractive to investors, alongside some investment in high-end private healthcare. It is important to note that even within the financial services/microfinance sector, a handful of companies have been the target of the majority of investments—in part due to the legal structure of many microfinance organizations (as guarantee-limited companies that cannot absorb foreign capital, as will be discussed in later sections) as well as to some level of risk aversion and preference for partnering with investee companies that have already worked with international investors in the past.

FIGURE 19: IMPACT CAPITAL DEPLOYED BY SECTOR



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

**Certain sectors, particularly those that focus on base of the pyramid (BoP) segments, have seen limited interest to date.** The key constraint to increased impact investment in the BoP-focused business models is the scale and capacity to absorb large investment. With the increase in investment activity in relatively small ticket sizes (largely by investors in Ring 2), impact capital directed to businesses focused on the BoP is likely to grow. In particular, we observe an interest in BoP-focused enterprises in the sectors of ICT, energy, healthcare, and technology. At present, with the concentration of actors in large deal sizes, investment in these sectors has been limited.

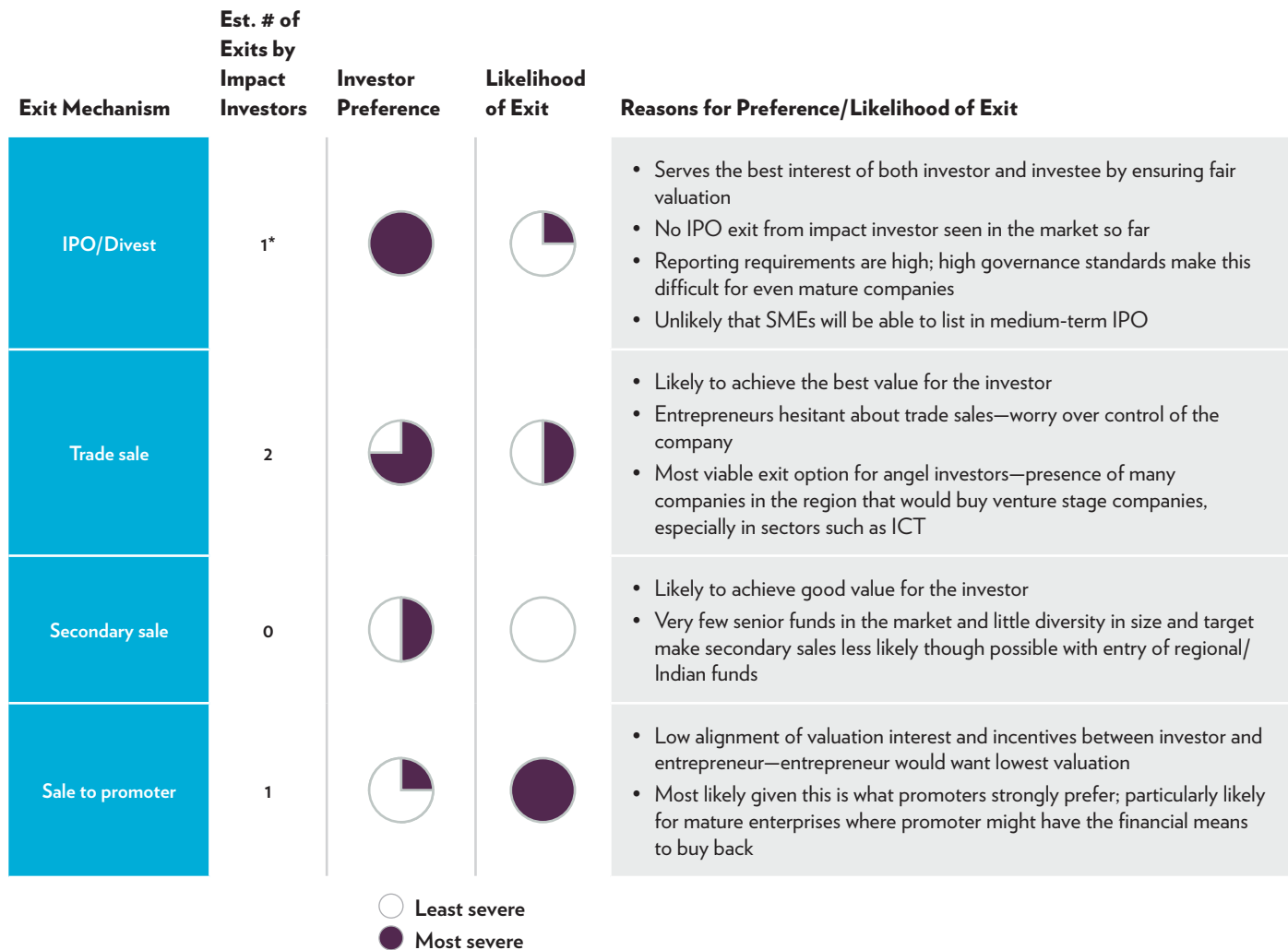
## Return expectations and exit possibilities

**Equity investor return expectations are between 20% and 25%.** Commercial bank interest rates in Sri Lanka are typically pegged at 8%–12%, and other asset classes such as fixed deposits or government securities provide similar returns up to about 12%. Equity investors, on the other hand, expect returns that are adjusted for a higher level of perceived risk. For PE/VC funds, this is usually 20%–25%. This figure might be slightly lower for DFIs, but most impact investors target returns as close to market rates as possible.

**Some entrepreneurs have stated concerns about having limited access to below-market impact equity, which they believe should have lower financial return expectations to account for the value of the social/environmental impact.** For example, agricultural enterprises articulate a preference for a greater share of their profit/value return to the farmers, resulting in a lower return to investors as well as difficulty in incorporating a dividend payout. However, in general, low investor competition in the market increases confidence that these high returns will be possible.

**In terms of exits, investor preferences are not always aligned with likely mechanisms, given the contextual and circumstantial realities (Figure 20).** As commonly seen in other countries, IPO is the preferred means of exit, but has not been used widely among impact investors to date. There have been no exits through IPO for impact investments (with the exception of one investment in a publicly listed company, which was later exited). Instead, trade sale and owner buyback are more viable exit options.

FIGURE 20: INVESTOR PREFERENCE FOR EXIT MECHANISMS IN SRI LANKA



Source: Dalberg analysis; \* Note: Thus far, the market has not seen a genuine IPO exit; in this case, the investee company was already a publicly listed company before impact equity investment.

## Impact measurement

**With respect to impact measurement, impact investors tend to use established measurement systems for their investments in Sri Lanka.** Given that there is only one Sri Lanka-specific fund and the majority of investors in Sri Lanka have more established investments elsewhere in the region, there are very few nuances to impact measurement specific to Sri Lanka, differentiating this market from the others.

DFIs and funds receiving DFI capital tend to have more defined metric systems (generally, an ESG framework) to measure impact, with job creation as a key metric. For funds, measuring impact is typically seen as a lower priority than managing the business and financial aspects of their investments. Social impact is primarily measured by economic metrics (for example, number of jobs created, products sold,



and amount of money disbursed) with the assumption that economic impact will have social impact.

Anecdotal assessment, including stories of lives touched and benefits to entrepreneurs, is often used while funds are in the process of developing tailored metrics for a specific investment.

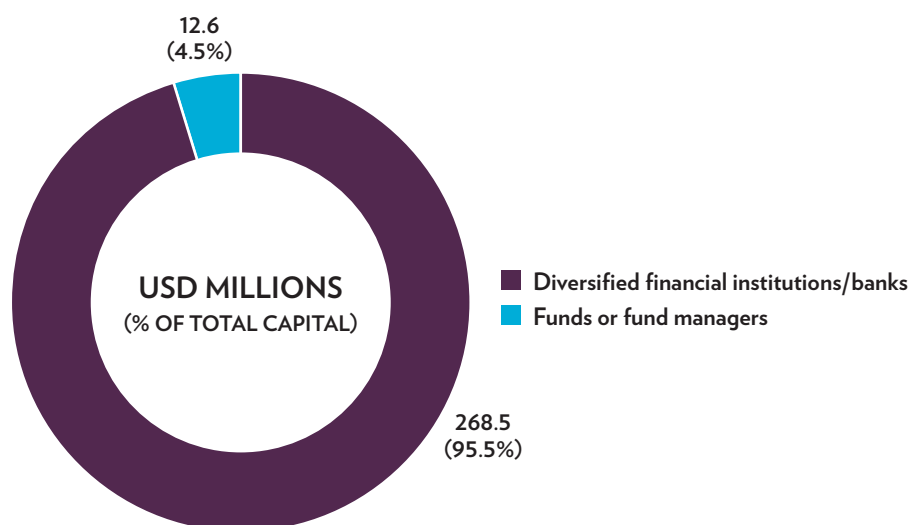
## Beyond the impact investing market

**The peripheral set of investors (Ring 2) primarily includes commercial banks making SME loans with DFI capital.** This capital makes up nearly 96% of investments among impact-related investors (whose activity is related to impact investing but who lack either an explicit impact intention or measurement). The remaining USD 12.6 million has been deployed by funds and fund managers. For commercial bank loans, we see the following trends:

- Debt and guarantees are the only instruments used.
- Sector selection depends on the lender, but most are sector agnostic.
- Growth stage varies, but in order to meet requirements for securing a commercial bank loan, a firm requires operating history; therefore, this capital is most likely absorbed by SMEs that are at growth or mature stage.
- Deal size is small, as SMEs can only absorb limited amounts of capital.

**Beyond SME loans, impact-related funds are deploying capital primarily through long-term debt.** About USD 12.5 million has been deployed by these investors as long-term debt (more than five years) and about USD 90,000 through equity.

FIGURE 21: IMPACT-RELATED CAPITAL DEPLOYED BY INVESTOR TYPE (USD MILLIONS)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

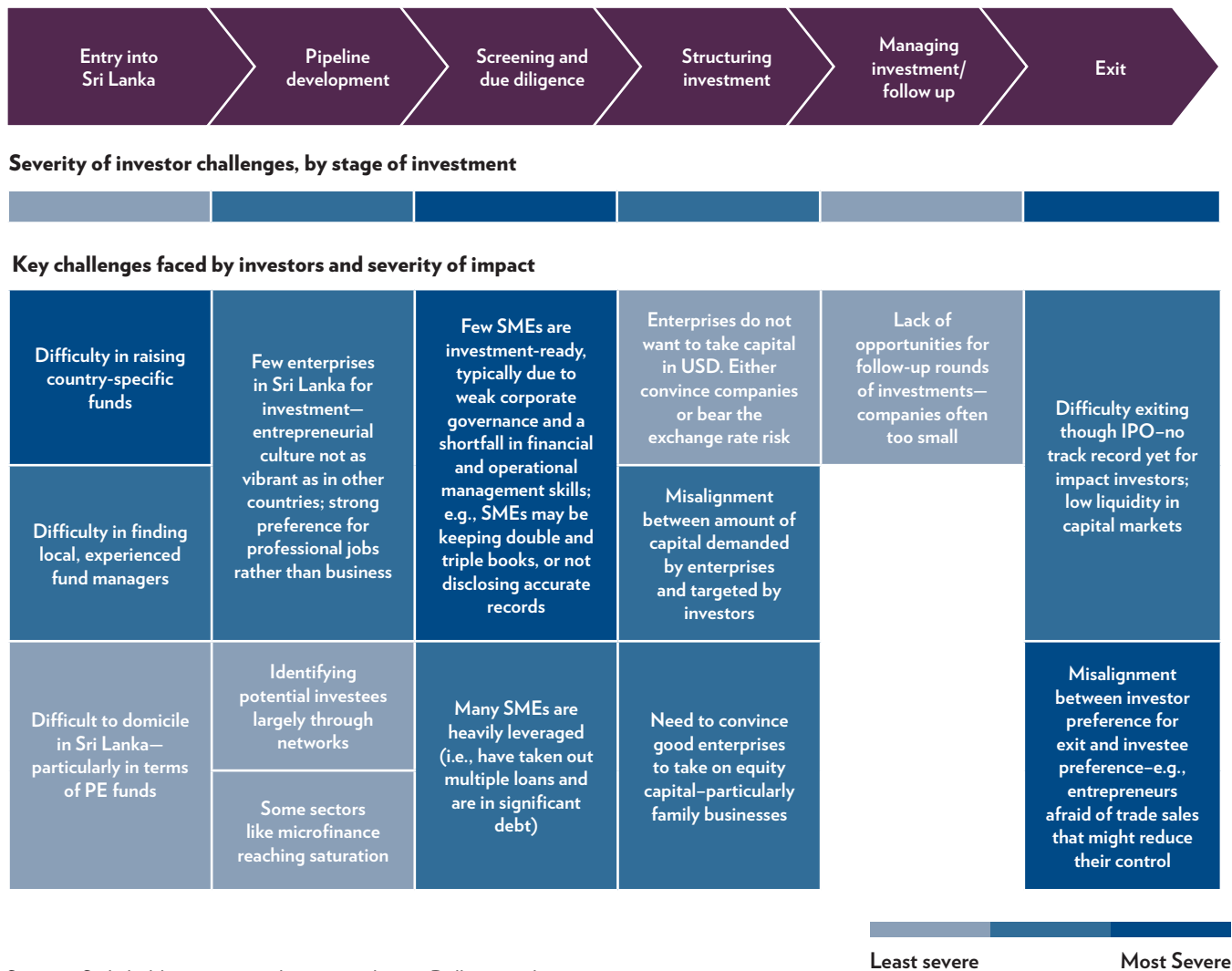
## Challenges facing impact investors in Sri Lanka

**At the entry level, a key challenge faced by fund managers in Sri Lanka is the difficulty in raising a country-specific fund.** It is difficult for fund managers to set up country-specific funds because the minimum investment sizes required by DFI/IFIs are quite high (USD 5-10 million), and also must be below a maximum share of the overall fund (often around 20%). Therefore, funds must raise a substantial amount of capital from other investors to secure DFI/IFI capital. However, several fund managers are currently trying to raise country-specific funds, armed with a greater understanding of the market than those who were unsuccessful at their attempts following the end of the civil war. Fund managers and entrepreneurs seeking capital believe that these country-specific funds will be important additions to the landscape since, at present, regional funds for South Asia tend to focus strongly on India and little capital is available for neighboring countries like Sri Lanka. While fundraising for Sri Lanka has proven to be challenging, investors looking to gain exposure through direct investments find Sri Lanka to be one of the easier markets in the region to enter—as reflected in the high levels of direct investment by a range of impact investors.

Key constraints to the growth of the industry include the following:

- Lack of entrepreneurial culture with a low respect for entrepreneurship and a preference for white collar jobs, which makes identification of viable enterprises challenging
- Misalignment between amount of capital demanded by enterprises and investment sizes preferred by investors
- Low level of financial and operational management skills in most enterprises (common across the region) that makes it difficult to convert opportunities into actual investments
- Limited or uncertain exit opportunities given a) the different preferences and incentives of investors and entrepreneurs; and b) the low likelihood of IPOs.




FIGURE 22: KEY CHALLENGES ACROSS THE INVESTMENT LIFECYCLE IN SRI LANKA



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

In an effort to improve entrepreneur capacity and investment readiness of businesses, investors in most other countries in the region have taken an increasingly active role in providing technical and managerial support as well as strategic guidance. This has not been a common approach in Sri Lanka, and given the relatively thin ecosystem, this remains a key challenge.

FIGURE 23: INVESTORS PROVIDING NON-FINANCIAL SUPPORT IN ADDITION TO CAPITAL

Key Enterprise-side Gaps Identified by Investors	Severity of Gap	Investor Offering Non-Financial Support	Services Offered
Lack of entrepreneurial culture		<ul style="list-style-type: none"> <li>International Finance Corporation</li> </ul>	<ul style="list-style-type: none"> <li>Advisory team provides TA to clients</li> <li>Web-based SME toolkit</li> </ul>
Poor operational/financial management		<ul style="list-style-type: none"> <li>Lankan Angel Network</li> </ul>	<ul style="list-style-type: none"> <li>Provides mentorship and linkages along with some funding to selected entrepreneurs</li> <li>Runs the yearly venture engine competition, a funding competition</li> </ul>
Lack of access to information/networks		<i>Equity investors take board seats and may provide strategic support, but in Sri Lanka, this tends to not be particularly active or “hands-on”</i>	

Sources: Stakeholder interviews; Dalberg analysis

## Looking forward

Fund managers are currently trying to raise USD 100 million for investments in Sri Lanka, in addition to capital being raised regionally (some of which will probably be deployed in Sri Lanka). While these funds will not likely have both active impact intent and measurement (and therefore would be in Ring 2 rather than be considered impact investors), their precise mandates and strategies have yet to be defined. Success stories arising from the activities of these funds could play an important signaling effect for the impact investing industry more broadly.

FIGURE 24: COUNTRY-SPECIFIC FUNDS LOOKING TO LAUNCH IN SRI LANKA BY THE END OF 2014<sup>12</sup>

	SIZE	INVESTMENT TARGETS	LPS	RATIONALE/NOTES
Fund 1	TBD; potentially USD 50 million	<ul style="list-style-type: none"> <li>SMEs</li> <li>Sector agnostic</li> <li>Deal size: USD 2–6 million</li> </ul>	<ul style="list-style-type: none"> <li>3 DFIs</li> <li>3 domestic institutional investors</li> <li>GP capital</li> </ul>	<ul style="list-style-type: none"> <li>DFIs understand country and risk, wanting to move into smaller deals</li> <li>Prefer smaller fund with good deals for the first fund</li> </ul>
Fund 2	Target USD 20–25 million	<ul style="list-style-type: none"> <li>SMEs</li> <li>Sector agnostic</li> <li>Deal size: USD 3–5 million</li> </ul>	Onshore and offshore HNWI's	<ul style="list-style-type: none"> <li>See a gap in small-cap investments</li> <li>HNWI's interested as they see strong potential in Sri Lanka</li> </ul>
Fund 3	Target USD 75 million	<ul style="list-style-type: none"> <li>SMEs</li> <li>Sector agnostic</li> <li>Deal size: USD &gt;2 million</li> </ul>	Confidential	<ul style="list-style-type: none"> <li>Building track record with small pledge fund before launch</li> <li>Will retain pledge fund for smaller (USD &lt;1 million) deals</li> </ul>

<sup>12</sup> Note: Funds were yet to be launched at the time of study.

# NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

## Overview of impact enterprise ecosystem in Sri Lanka

**As in other markets in the region, we see only a small share of impact capital deployed into impact enterprises<sup>13</sup> (outside of the microfinance sector).** A few investments have been made by angel investors into impact enterprises, but investors who require larger deal sizes have largely shied away, again with the exception of microfinance investors. In fact, even within the microfinance sector, one enterprise in particular has absorbed a significant share of impact capital—12 investors have collectively invested USD 127 million (26% of the total impact capital in Sri Lanka) into this institution.

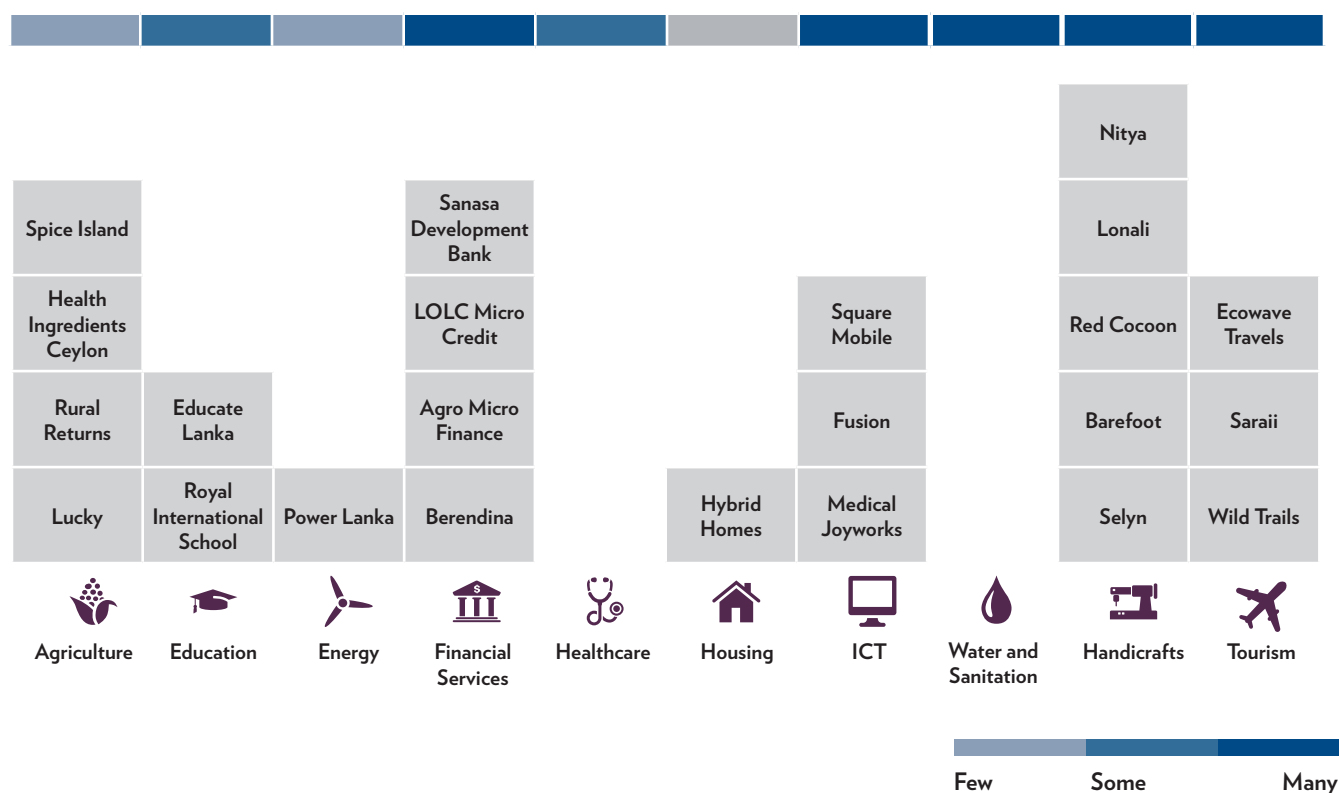
**Outside of impact enterprises, a large portion of impact capital has flowed into SMEs and, to a lesser extent, enterprises that may not have a clear impact mandate but are operating in sectors that provide basic services.** The commercial banks in the peripheral impact-related ring have substantial SME portfolios since this is viewed as profitable and DFIs and IFIs have backed these portfolios. In addition, several new funds currently being established will target SMEs. Impact capital has also flowed into enterprises that provide basic services, such as education and healthcare. However, given the strong government provision of basic services (particularly for the low-income segments of the population), there is minimal need for private intervention in these sectors. As a result, the amount of capital flowing to such enterprises is smaller than the capital being invested in SMEs.

**Unlike some of the other regional markets, Sri Lanka has a growing impact enterprise landscape.** This growth is driven in part by organizations converting out of traditional NGO models as well as by an increasing recognition and understanding of the impact enterprise approach itself. This growing landscape may result in enterprises that serve as good targets for impact investors in the future as they scale.

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<sup>13</sup> For the purposes of this study, we define impact enterprises as those that have articulated a core objective to generate positive social or environmental impact (as a part of their operating model rather than an ancillary activity) and seek to grow to financial viability and sustainability.

FIGURE 25: ENTERPRISE ACTIVITY BY SECTOR, WITH EXAMPLES



Sources: Stakeholder interviews; Dalberg analysis

As illustrated in Figure 25, impact enterprises to date are heavily concentrated in a handful of sectors: food/agriculture, financial services (predominantly microfinance), handicrafts and fashion, and tourism.

Agriculture is an attractive sector for entrepreneurs as Sri Lanka is still considered an agriculture-based economy and hence, the potential for impact is high. Although the contribution to employment from agriculture is lower than it is from services, many of those employed in the formal sector continue to retain ties to agriculture and return to farms for a portion of the year. As a result, the number of livelihoods affected and the potential to increase incomes are significant. Most models are built around improving supply chains and access to markets, as well as around specialty/niche products.

In the financial services sector, the microfinance model ballooned in the mid-2000s. This could be attributed to the large amounts of capital channeled through MFIs to support recovery and reconstruction after the tsunami. There are currently over 10,000 microfinance branches across the country, though these are not evenly distributed—Northern Province has only 5% of branches, while Southern Province has 24%.<sup>14</sup>

<sup>14</sup> "Microfinance Sector in Sri Lanka," South Asia Microfinance Network, <<http://www.samn.eu/index.php?q=mfssrilanka>>.

**There is a significant opportunity to leverage traditional skills held by women in various handicrafts (e.g., textiles, cosmetic products, and paper products) to create livelihoods.** Entrepreneurs with an impact focus are therefore drawn to the handicrafts sector and are developing varied models that enable women to work from homes/villages or from workshop bases, depending on their preferences. The creation of these locally based workshops is occasionally articulated as an alternative for women who would otherwise migrate to work in garment factories.

**Tourism is an extremely attractive and vibrant sector and is attracting heavy investment.** For impact-oriented entrepreneurs, Sri Lanka's natural beauty and attractiveness to tourists can be leveraged for social and environmental impact through models that stress environmental protection and responsible sourcing of inputs for hospitality enterprises (such as restaurants sourcing local ingredients to reduce the use of water in growing crops).

**There is little enterprise activity in the healthcare and education sectors as the government is a dominant provider of both services.** Public provision of these services is widespread, and quality standards are fairly satisfactory, making it difficult for private providers to develop a financially viable offering and model with an impact intention. Enterprises without an impact mandate have developed in the high-end private market, as high prices make businesses very profitable, but the low-cost market remains sparse given the public alternative.

**Housing and water are also heavily publically dominated in Sri Lanka and thus, are not attractive for impact investors.** New enterprises with some environmental objectives are emerging in the housing market, but these are very small sectors at present.

**In Sri Lanka, there is less variation in the theories of change (ToC) of impact enterprises.** Incorporation of BoP and/or marginalized populations into the supply chain is a predominant approach, which strongly reflects the concentration of enterprises in the agriculture and handicrafts sectors. Employment creation is not a commonly articulated impact thesis except when framed as livelihood creation for agricultural communities or handicrafts producers.

**Two models for launching microfinance organizations have been observed.** These models are as follows: 1) institutions founded as NGOs (particularly in the late 1980s and early 1990s, with a second surge after the 2004 tsunami with the availability of grants and subsidized loans); and 2) institutions spun out from commercial banks and finance companies who saw the opportunity in reaching an untapped market and were able to leverage existing capital and experience to align with government priorities and incentives.

**For other enterprise sectors/types, we see the following three types of founding entrepreneurs:**

- Foreigners/diaspora/Sri Lankan returnees from abroad, who tend to be familiar with the concept of impact-oriented business. Examples include Good Market, Barefoot, and Rural Returns.
- Sri Lankans from business families whose organizations have always operated with combined social impact and commercial objectives but never defined as such or



knew of the term and who are now adopting the language of impact enterprise. Examples include Biofoods, Saraketa, and Selyn.

- Rural entrepreneurs, who have comparatively lower levels of formal education and weaker English skills and who do not independently articulate a social mission, but who are being organized by aggregators/other actors who are working to build retail and processing supply chains.

Older impact enterprises and family businesses tend to be structured as private limited companies, as it is the “traditional” incorporation mechanism and allows profits to be taken out of the company. The newer impact enterprises tend to be structured as guarantee limited companies, as the founders believe the restriction against drawing profits from the company allows a stronger focus on social mission.

## Access to finance

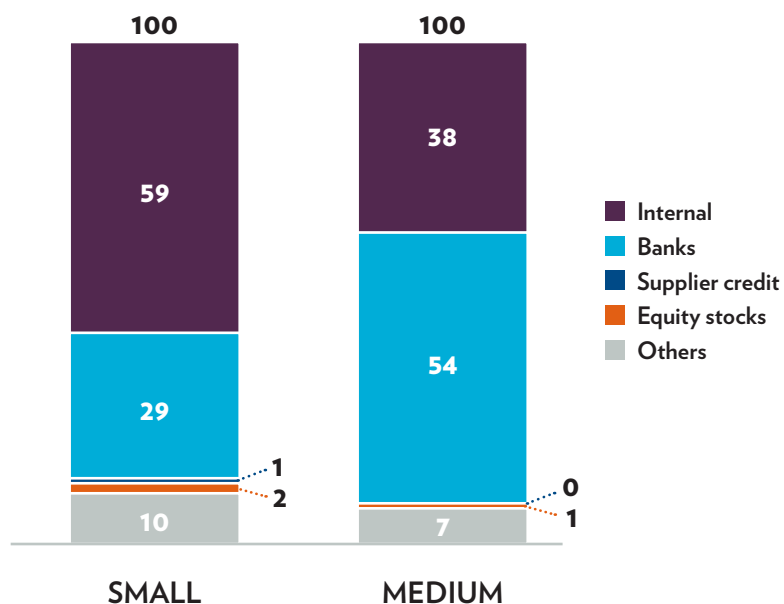
**Incorporation status also affects access to capital.** Without shareholders, guarantee limited companies cannot take equity and cannot access international debt by law. Therefore, with a lack of local impact capital, it is difficult for these enterprises to access any impact capital.

FIGURE 26: ACCESS TO FINANCE BY ORGANIZATION INCORPORATION STATUS

	INSTRUMENT	GUARANTEE LIMITED	PRIVATE LIMITED
DOMESTIC	Equity	N	Y
	Debt	Y	Y
	Grant	Y	N
FOREIGN	Equity	N	Y
	Debt	N	Y
	Grant	Y	N

Irrespective of the incorporation status, most small enterprises in Sri Lanka (impact enterprises and others) struggle to access institutional capital and hence, are heavily reliant on internal financing. Although internal financing may be sufficient once an enterprise is generating revenue, this financing strategy makes it difficult to reach a stage where an enterprise is generating robust revenue, and constrains the ability to scale over time.

FIGURE 27: PERCENTAGE OF FIRMS ACCESSING DIFFERENT SOURCES OF CAPITAL, BY COMPANY SIZE AND PERSPECTIVES OF ENTERPRISES (PERCENTAGE OF TOTAL RESPONSES, 2011)

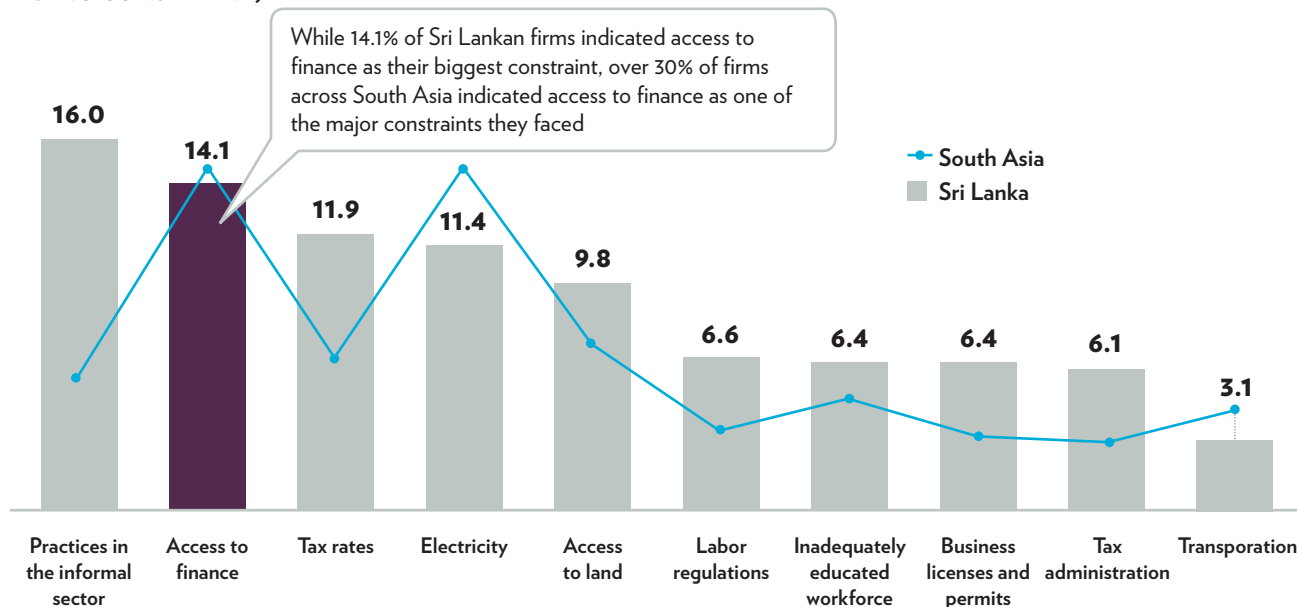


Sources: Enterprise Survey, IFC and World Bank, 2011; Stakeholder interviews; Dalberg analysis

## Challenges to enterprise growth

As has already been touched upon, access to finance is one of the top reported constraints to growth by enterprises in Sri Lanka. According to the IFC and World Bank Enterprise Survey, 14.1% of the firms indicated access to finance as their biggest constraint, and over 30% of the firms indicated access to finance as one of the top three constraints that they faced.

**FIGURE 28: CONSTRAINTS TO ENTERPRISE GROWTH IN SRI LANKA (PERCENTAGE OF RESPONDENTS CITING AS LEADING CONSTRAINT)**



Sources: Enterprise Survey, IFC and World Bank, 2011; Dalberg analysis; Note: 610 enterprises included in the surveys—52% small, 29% medium, and 19% large enterprises; 34% from the Western Province, 19% from the North-Western Province, 11% from the Central Province, the remaining 36% from all other provinces; approximately equal split between five sectors (food, garments, other manufacturing, retail, and services).

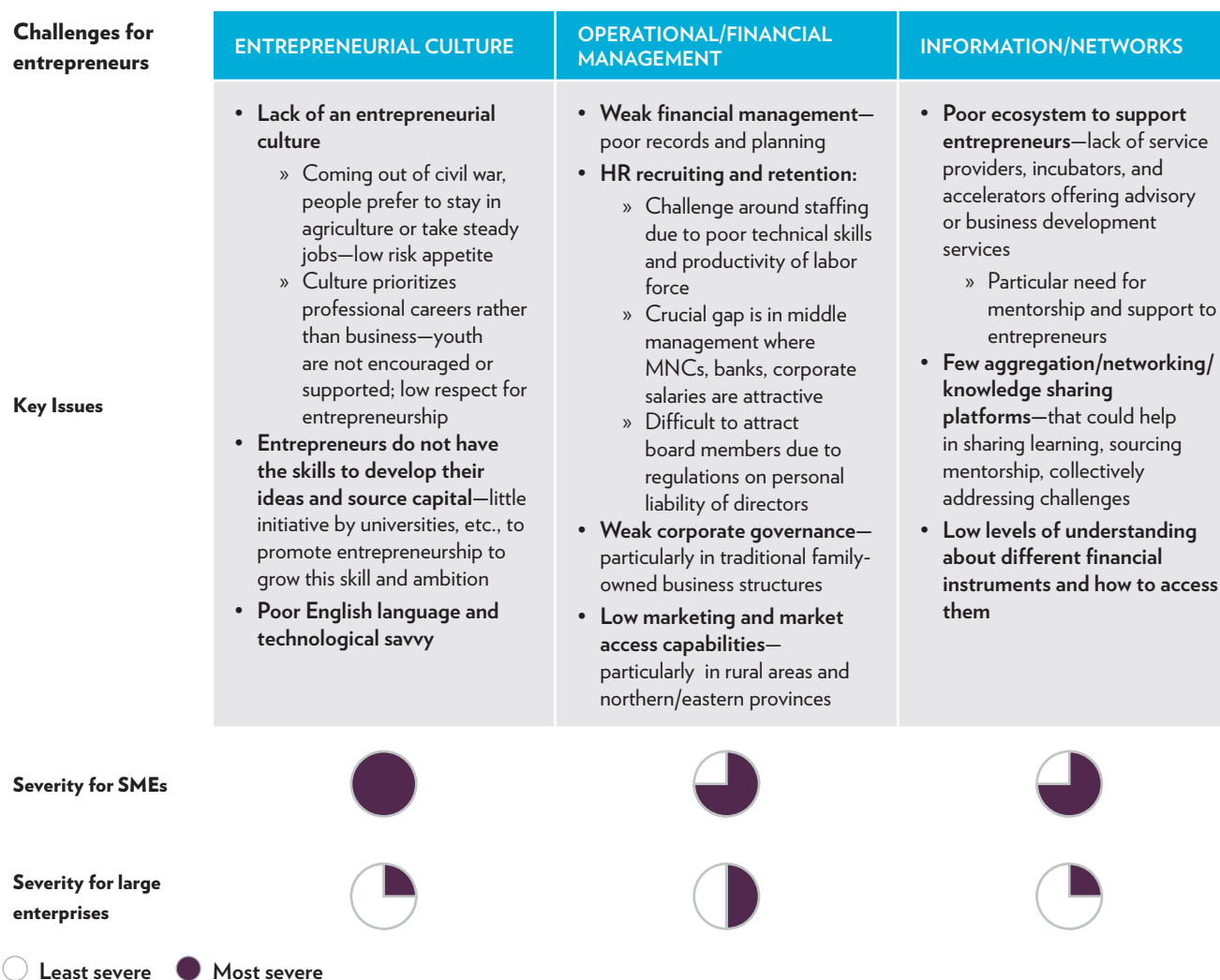
In addition to the challenges reported in the enterprise survey, entrepreneurs, and ecosystem support, actors report three additional constraints:

1. **Entrepreneurial mindset and culture:** Entrepreneurial mindset was particularly emphasized as a challenge unique to Sri Lanka, where there is a strong preference for white collar jobs (e.g., working for banks, government agencies, or multinational corporations) over entrepreneurship or business.
2. **Business skills:** Gaps have been identified in marketing/access to markets and human resources management—both recruiting and retention. In terms of market access, there are at least two main challenges. First, entrepreneurs do not know how to access markets outside their immediate areas and conventional customers (e.g. larger cities or even overseas markets). Second, they typically do not have the capacity to identify and implement solutions to constraints to reaching these markets, such as improved packaging for perishable goods in the agriculture sector.

3. Access to information and networks: There are few aggregators or networking and knowledge-sharing platforms that can help enterprises in sharing, learning, sourcing mentorship, and collectively addressing common challenges.

Interestingly, poor English language and technical skills were highlighted as compounding all the three abovementioned issues. The Government of Sri Lanka's Sinhala-medium mandate for schools means that English is poorly grasped by many entrepreneurs. This situation limits access to information and the ability to engage with foreign investors. Similarly, poor technical skills make it harder for entrepreneurs to access information and online networks.

FIGURE 29: BUSINESS CONSTRAINTS TO ENTERPRISE GROWTH



Sources: Stakeholder interviews; Dalberg analysis

In terms of access to finance, not unexpectedly, we see the most severe constraints in the earlier stages of growth. The constraints are particularly severe in the venture stage in Sri Lanka since formal venture capital is scarce and entrepreneurs rely on informal sources for their early capital needs (as in many of the other countries studied).

FIGURE 30: CONSTRAINTS TO ENTERPRISE ACCESS TO FINANCE IN SRI LANKA



#### Severity of access to finance challenge, by stage of growth



#### Key challenges faced and severity of impact

##### Identifying sources of capital

Limited formal sources of capital for start-ups; most seed funding from friends and family

Limited number of capital sources outside banks

Enterprises' lack of formal knowledge of sources, amount or type of finance needed

For impact enterprises, difficulty in identifying investors with aligned values; entrepreneurs perceive risk that values will shift

VCs have low risk appetite and are not willing to compromise on returns for social enterprises

##### Appropriateness of capital

Terms of bank loan not appropriate—requires operating history, existing cash flows, and asset collateral; short grace periods

Low levels of understanding of non-debt instruments and which is most appropriate for needs/stage

Deal size often not aligned to capital needs—whether debt or equity preference for large deals versus entrepreneurs who are often looking for smaller sizes

"Missing middle" deal size—very small amounts accessible through MFIs, informal channels; small needs for growth and scale up hard to access

High "cost" of reporting, disclosure during and after IPO

##### Accessing capital

Companies have weak financial records and corporate governance, increasing risk aversion of investors

While capital is available, access is difficult due to limited knowledge and capacity (e.g., in writing business plans, communicating with loan officers/investors, etc.)



Sources: Stakeholder interviews; Dalberg analysis

Figures 31 and 32 highlight the varied drivers of preference for, and barriers to, accessing different instrument types. As in other markets, entrepreneurs in the early stages have a strong preference for grant funding. However, interestingly in Sri Lanka, there is sufficient understanding of equity and debt for there to be some enterprise interest in equity, unlike in other markets where the instrument is largely unknown.

**For growth stage and mature companies, debt is strongly preferred as it enables retention of greatest independence and control.** Interestingly, there is a greater wariness of equity capital by leaders of mature companies. Mature companies in Sri Lanka tend to be family businesses that have been successful but that still have a fairly conservative business perspective and are therefore less open to shareholding by equity investors, who they worry will “take over the business.” That said, this perspective is starting to change with the new generation becoming leaders in these companies. In the case of newer impact enterprises that are being established by young returnees, diaspora, and foreigners, we see a greater understanding of and openness to equity capital.

**FIGURE 31: SEED AND VENTURE STAGE ENTERPRISES' PREFERENCES FOR CAPITAL**

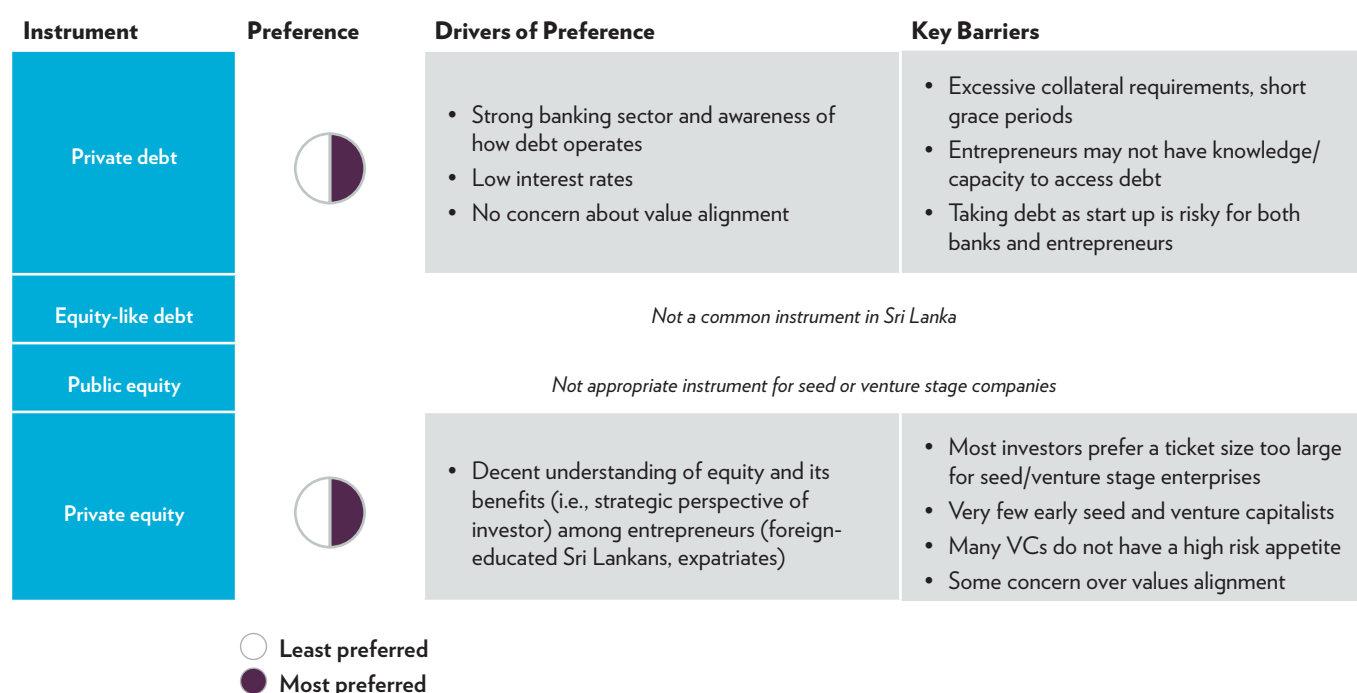








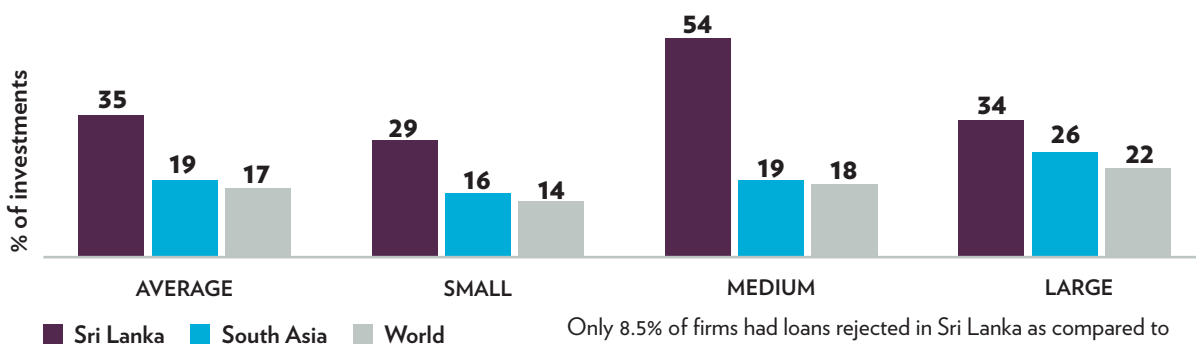
FIGURE 32: GROWTH STAGE AND MATURE ENTERPRISES' PREFERENCES FOR CAPITAL

Instrument	Preference	Drivers of Preference	Key Barriers
Private debt		<ul style="list-style-type: none"> <li>Relatively easy to access—banks comfortable lending to growth and mature companies that have collateral and operating history</li> <li>Strong awareness of how debt operates</li> <li>Low interest rates</li> </ul>	<ul style="list-style-type: none"> <li>High collateral requirements</li> </ul>
Equity-like debt		<ul style="list-style-type: none"> <li>Less risky for investors; and they can convert to equity if company does well</li> </ul>	<ul style="list-style-type: none"> <li>Not a common instrument offered by investors</li> <li>Little understanding among enterprises</li> </ul>
Public equity		<ul style="list-style-type: none"> <li>Prestige that comes with being a listed company</li> <li>Creates exit option for promoter</li> </ul>	<ul style="list-style-type: none"> <li>Not much liquidity in capital market</li> <li>High volatility in the public equity markets</li> <li>Culturally, companies are built for generations, entrepreneurs unwilling to divest/dilute and often do not want to open the company to public scrutiny</li> </ul>
Private equity		<ul style="list-style-type: none"> <li>Increasing understanding of benefits of equity—investors offering additional support</li> </ul>	<ul style="list-style-type: none"> <li>Enterprises reluctant to give up equity in their company—need education and convincing by investors</li> <li>Few private equity investors</li> <li>Ticket size, even in mature companies, is small for many investors (e.g., DFIs)</li> </ul>

 Least preferred  
 Most preferred

Despite these constraints, there have been various reports of high rates of over-leverage, particularly in mid-sized to large companies. Highly liquid banks are willing to lend without stringent diligence processes, leading to significant over-borrowing, which makes further investment by equity providers difficult.

FIGURE 33: SHARE OF INVESTMENTS FINANCED BY BANKS/BORROWINGS, BY ENTERPRISE SIZE (2011)



Only 8.5% of firms had loans rejected in Sri Lanka as compared to 16.3% in South Asia and 14.5% globally. Moreover, 0% of medium-size enterprises had loan applications rejected suggesting that access to bank credit less difficult.

Sources: Stakeholder interviews; Indika Hettiarachchi, "Time to reduce borrowings in Sri Lankan enterprises (Data from World Bank/IFC 2011 data)," 2010; Dalberg analysis

# ENABLING IMPACT INVESTING: THE ECOSYSTEM

**Sri Lanka's government has made strong efforts to create a conducive environment for foreign investment.** Sri Lanka's Ease of Doing Business Ranking is much better than that of other countries in the region, with the regional average being 121. Chinese and Indian investors in particular have responded positively and are investing heavily in Sri Lanka.

FIGURE 34: WORLD BANK "DOING BUSINESS" RANKINGS FOR SRI LANKA

	DB 2014 RANK	DB 2013 RANK	CHANGE IN RANK
<b>Overall DB rank</b>	<b>85</b>	<b>83</b>	<b>-2 ↓</b>
<b>Starting a business</b>	<b>54</b>	<b>47</b>	<b>-7 ↓</b>
Dealing with construction permits	108	116	+8 ↑
<b>Getting electricity</b>	<b>91</b>	<b>107</b>	<b>+1 ↑</b>
Registering a property	145	136	-9 ↓
Getting Credit	73	71	-2 ↓
<b>Protecting investors</b>	<b>52</b>	<b>51</b>	<b>-1 ↓</b>
Paying taxes	171	175	+4 ↑
<b>Trading across borders</b>	<b>51</b>	<b>54</b>	<b>+3 ↑</b>
Enforcing contracts	135	136	+1 ↑
Resolving insolvency	59	51	-8 ↓

Change in rank largely due to improvements in other countries

Improved due to process improvements at utility—important especially for manufacturing industries

Sri Lanka ranks 52, below Bangladesh, Pakistan, and India

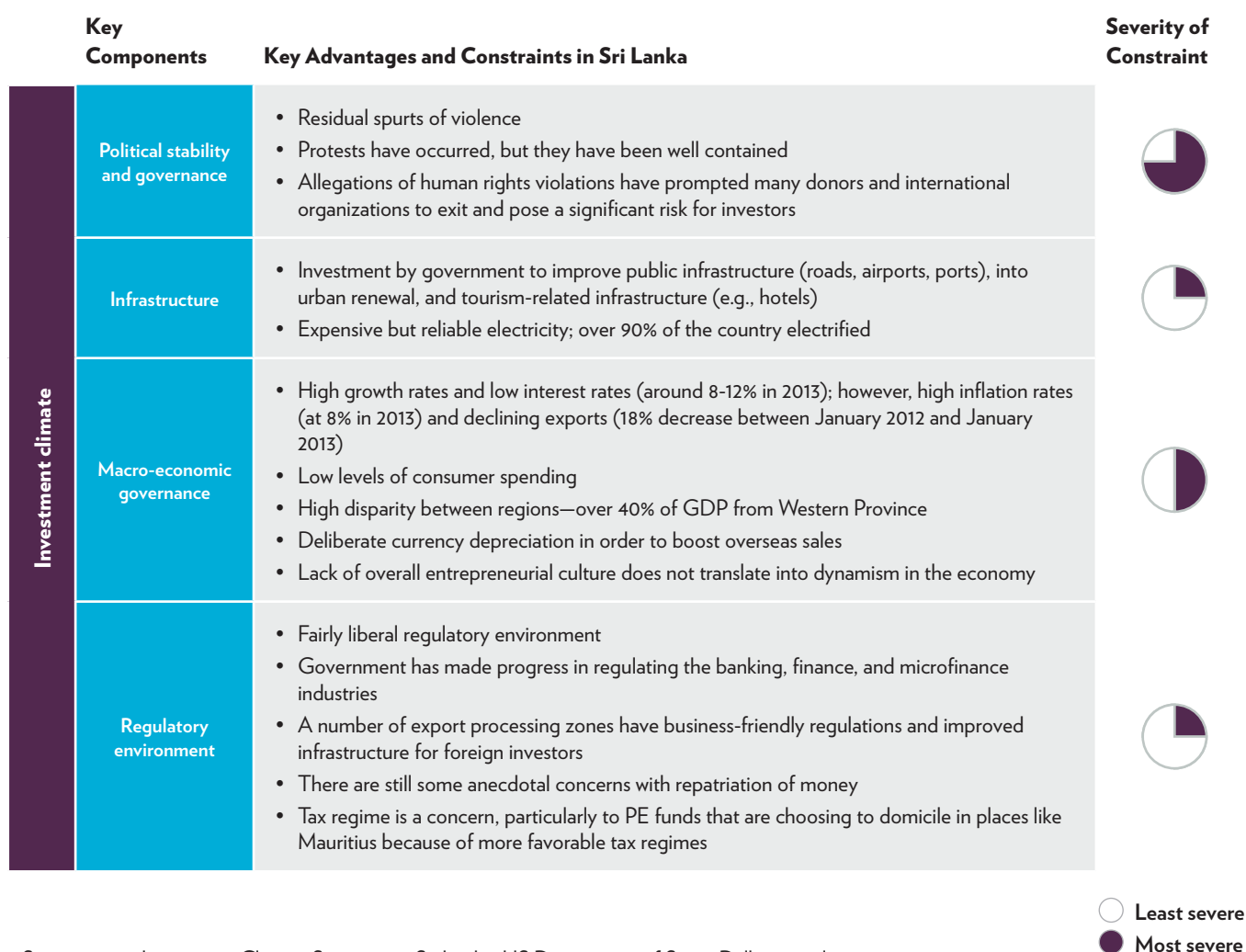
Given the small size of the Sri Lankan domestic market, for enterprises to gain real scale it likely needs to be offshore—ease of cross border trade will be key

Source: World Bank Doing Business Rankings

However, despite this relatively strong performance on key business environment elements, as well as strong infrastructure and conducive regulatory frameworks, other considerations such as uncertainty about security, potential issues in legal protection for investors, and allegations of human rights violations continue to deter some investors.



FIGURE 35: ECOSYSTEM CONSIDERATIONS FOR INVESTORS

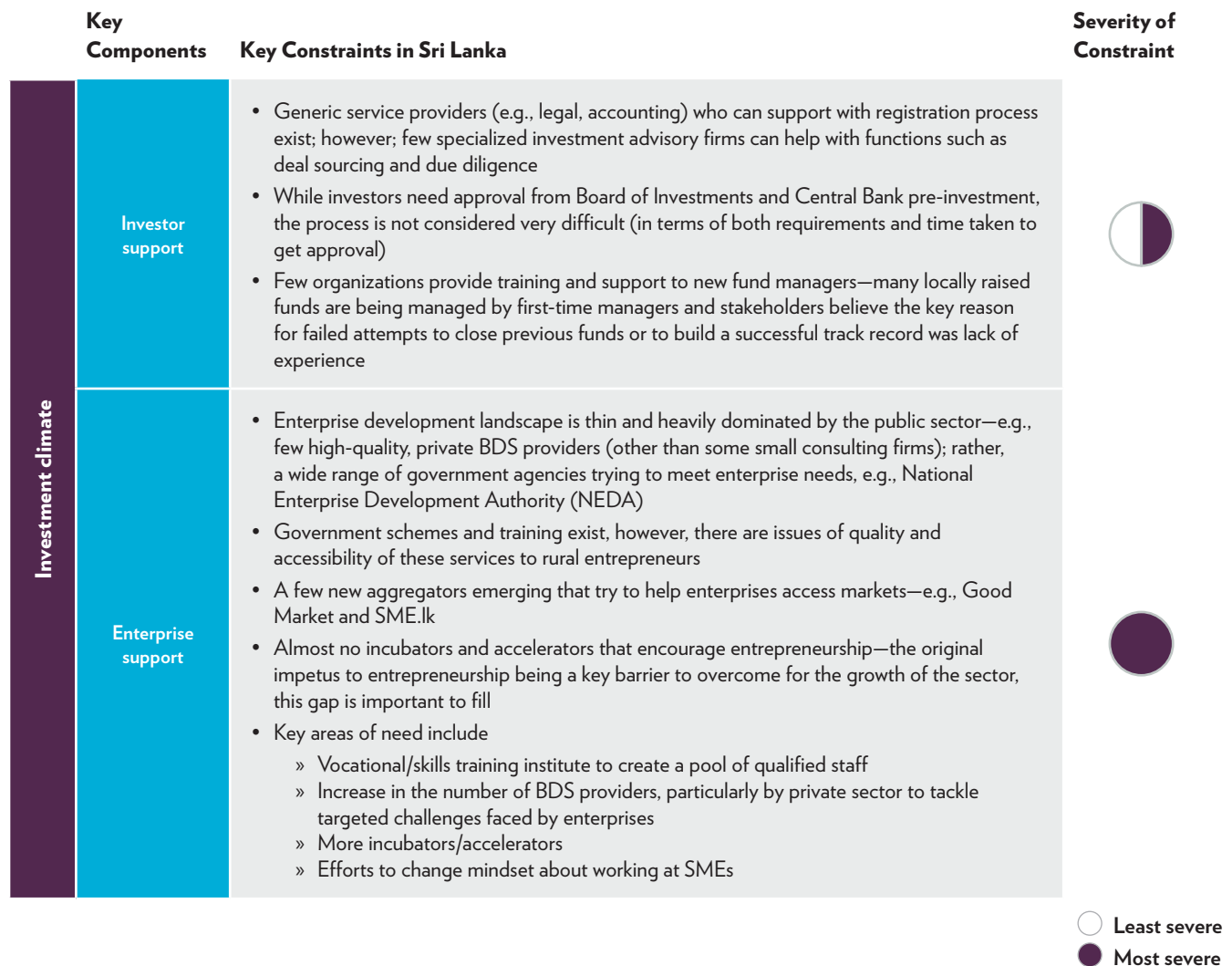


Sources: 2013 Investment Climate Statement—Sri Lanka, US Department of State; Dalberg analysis

Beyond the macro considerations, at political and economic levels, key to the successful growth and development of the impact investing industry are the support systems and enablers for investors and enterprises. In general, this landscape is extremely sparse in Sri Lanka. For example, while a few providers of professional services are active in the market, there are few specialized providers of investor support services (e.g., deal sourcing and due diligence). More important, the enterprise support landscape is thin and heavily dominated by the public sector, which is a concern for entrepreneurs who are uncertain of the quality of service given the large mandate on small teams of staff. Further, these services are not accessible to rural entrepreneurs.<sup>15</sup>

<sup>15</sup> “Female entrepreneurship and the role of business development services in promoting small and medium women entrepreneurs in Sri Lanka,” Oxfam, IPS, 2014.

FIGURE 36: STATUS OF INVESTOR AND ENTERPRISE SUPPORT SERVICES IN SRI LANKA

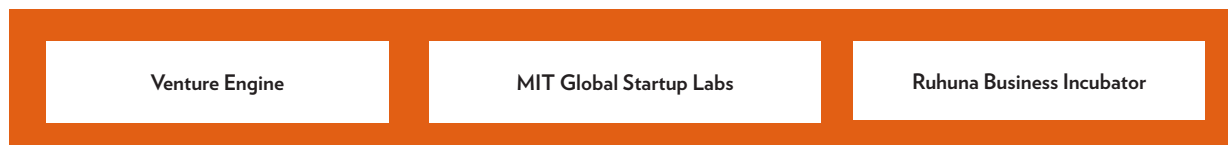


Sources: “Female entrepreneurship and the role of business development services in promoting small and medium women entrepreneurs in Sri Lanka,” *Oxfam, IPS*, 2014; Dalberg analysis

Considering this enterprise development landscape, overall, there are very few players active in the market. Interestingly, in recognition of this gap, some domestic microfinance banks are now starting to provide business planning and financial record keeping training to support entrepreneurs (at a subsidized rate). Commercial banks are increasingly interested in providing a similar service to their clients.

FIGURE 37: LANDSCAPE OF ENTERPRISE DEVELOPMENT SUPPORT IN SRI LANKA

**Incubators/Accelerators**



**Advisory Services**



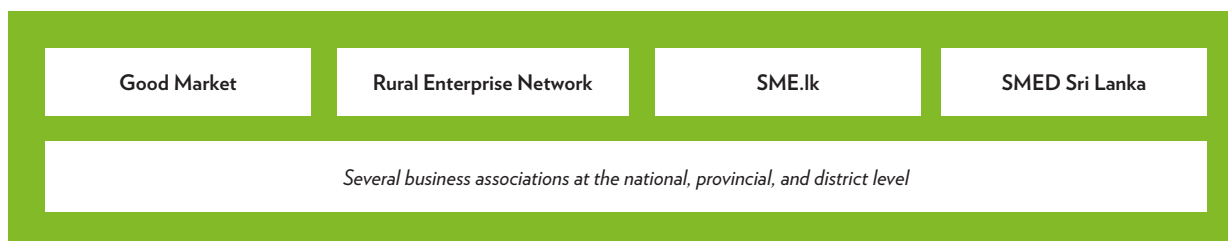
**Credit Rating Services**



**TA Providers**



**Aggregators**



# AREAS FOR FURTHER RESEARCH

In order to deepen the understanding of the impact investing market in Sri Lanka, we believe there is a need for further research in at least three specific areas. First, as in other countries, the role of the diaspora in the entrepreneur and investor community in Sri Lanka is worth further study. While it is evident that, currently, the most mature entrepreneurs are those who have returned to the country from abroad, it would be interesting to develop a more nuanced understanding of the effect of this diaspora on both the supply and demand aspects of impact capital.

Second, with a growing yet sizeable market in comparison to population size, further exploration of the fund economics for country-specific funds would be valuable. For example, for a market with a small population and currently limited entrepreneurial culture, a deeper understanding around the saturation point, turnover, and life cycle of a Sri Lanka-focused fund would support an understanding of the domestic challenges and opportunities.

Finally, our current understanding is that the support system for enterprises in Sri Lanka is yet to fulfill the needs—there are very few incubators or accelerators that provide advisory support services. Not only this, but perhaps a more deliberate, innovative engagement with potential and early stage entrepreneurs (such as business plan competitions or other catalytic activity), would encourage the entrepreneurial spirit in Sri Lanka. A more focused assessment of the feasible options within the local context could help shape the ecosystem for investors and investees in the future.

# ANNEXES

## Annex 1—Interview participants

### FUND OR FUND MANAGERS

- Niroshan Kurera, *Etimos Lanka Pvt. Ltd.*
- Indika Hettiarachchi, *Jupiter Capital Partners*
- Chandrien De Mel, *Lanka Ventures PLC*
- Chanaka Wickramasuriya, *LR Global*

### DFIS/IFIS

- Kamal Dorabawila and Dinesh Warusavitharana, *IFC*

### INSTITUTIONAL INVESTORS

- Senaka Kakiriwaragodage, *National Development Bank PLC*

### ECOSYSTEM PLAYERS

- Steve Francone, *Good Market*
- SA Deepthi Kumari, *National Enterprise Development Authority*
- Hastitha Assiriyage, *SME.lk*

### ENTERPRISE

- Anura Atapattu, *Berendina Microfinance*
- Ausha Alles, *Bradix*
- Saman Kathuritathne, *Herbal Health Ceylon*
- Charith Jagoda, *LOLC Micro Credit Limited*
- Charitha Ratwatte Jr., *Rural Returns*
- Selyna Peiris, *Selyn Handlooms*
- Amanda Kiessel, *Sevalanka Foundation*
- Ara Pararajasingham, *Sunshine Holdings*

## Annex 2—Survey respondents

### FUND OR FUND MANAGERS

- Niroshan Kurera, *Etimos Lanka Ptv. Ltd*
- Augustin Vitorica, *GAWA Capital*

### ENTERPRISE

- *Shri Jayawardanapura*
- *The Bread Company*
- *WOOD 4 KIZ*
- *Flow Health Bar*