Democratic Socialist Republic of Sri Lanka

# Ex-Post Evaluation of Japanese ODA Loan Project

# "Small and Micro Industries Leader and Entrepreneur Promotion Project (III)"

External Evaluator: Hiromi SUZUKI S., IC Net Limited

## 0. Summary

This project aims to develop and expand the production infrastructure and improve the technical and financial management capacity of micro, small and medium-sized enterprises (MSMEs) [1] in Sri Lanka, as well as the financial capacity of Participating Credit Institutions (PCIs) by providing MSMEs with low-interest funds and technical support.

This project was carried out in accordance with the development policy and development needs of the Sri Lankan Government; its consistency with Japan's ODA policy is ensured as well, therefore its relevance is high. This project had two types of outputs: "general loans" and "technical transfer loans." However, while the demand for general loans was high, technical transfer loans made little progress. With no other major changes to the loan scheme, loan terms or target businesses, and because the project was, on the whole, carried out as plan, both in terms of project period and project cost, its efficiency is high. With respect to the effect of the project, although the number of jobs created was significantly higher than planned, because the loan amount per end user was higher than originally expected, the total number of loans did not reach the target number. In addition, because technical transfer loans did not grow as much, the project was not linked to the promotion of exports as well as the strengthening of the technical and financial management capacity of MSMEs With regard to the project impact, when compared with the distribution of the regional gross domestic product (GDP), a more well-balanced distribution of loans by region can be seen. In relation to the industrial distribution, the loans are focused on manufacturing industries and services, which are the industries that were targeted by the project. In sum, the project effectiveness and impact were fair. It should be noted that the executing agency of this project changed immediately before the completion of the project. There were no organizational, technical or financial problems with the executing agency or PCIs which conducted the first round of loans. However, as for the executing agency that is in charge of the forthcoming second round of loans, concerns remain about their organizational and technical capacity because there are few personnel with expertise on MSME management and finance, and therefore sustainability of the project effect is fair.

In light of the above, this project is evaluated to be satisfactory.

[1] The target beneficiaries in this project have been stipulated as "companies whose fixed assets (excluding land and buildings) after the loan do not exceed 20 million rupees." However, with no standard definition in Sri Lanka for micro, small and medium-sized enterprises (MSMEs), and given the fact that the above eligibility criteria for end users includes, not only small enterprises, but also medium-sized enterprises and micro enterprises, it was decided to standardize the target beneficiaries in this ex-post evaluation, not as "small enterprises," but as "micro, small and medium-sized enterprises (MSMEs)."

## 1. Project Description

Figure 1: Machinery Acquired with the Project's loan (Rrice flour factory in Gampaha)

Figure 2: End user's Garment Factory (Kurunegala)

### 1.1 Background

MSMEs in Sri Lanka cover a wide variety of industries such as agriculture, mining, manufacturing, construction and services, and are an important segment for increasing employment, increasing income, reducing poverty and regional development. They also play a major role in the economic growth of Sri Lanka. However, despite the Sri Lankan Government having continuously implemented development policies, institutional improvements and promotion measures related to MSMEs for many years, there had not been sufficient growth in this segment at the time of the project's appraisal around 2004. Possible reasons for this situation were pointed out to be the limited availability of funds for MSMEs for capital investment and long-term working capital; and limited access to funds due to strict loan terms, such as interest rates and collaterals.

On the other hand, following the February 2002 cease-fire agreement, the Sri Lankan Government has been undertaking a variety of initiatives aimed at building peace. In this sense, the "Distribution of Peace," through assistance activities such as support for micro enterprises in the northern and eastern conflict areas, was also a pressing need. Furthermore, with the abolition of the Multi Fibre Arrangement (MFA) at the end of 2004, there were concerns about the impact that such an event would have on the textile industry, which was an important export industry. Consequently, urgent support was needed, not only for the textile industry, but also for the strengthening of competitiveness, development of new markets, as well as new products of the MSMEs. JICA had previously provided highly concessionary funds by means of two-step loans through the Small & Micro Industries Leader & Entrepreneur Promotion Project (I) (1997-2001) and the Small & Micro Industries Leader & Entrepreneur Promotion Project (II) (2002-2006), and in order to meet the MSMEs' needs for funds, and to achieve a well-balanced economic growth, including the growth of MSMEs, there was a substantial need to continue with such assistance through this project.

### 1.2 Project Outline

The objective of this project is: (1) to develop and expand the production base of MSMEs; (2) to improve the technical and financial management capacity of MSMEs; and (3) to improve the financial capacity of the PCIs, by providing MSMEs with low-interest funds and technical support, thereby contributing to the well-balanced economic growth of Sri Lanka.

| | |
|---|---|
| Loan Approved Amount / Disbursed Amount | 9,619 million yen / 9,612 million yen |
| Exchange of Notes Date / Loan Agreement Signing Date | November 2004 / December 2004 |
| Terms and Conditions | Interest rate: 0.75%<br>Repayment period: 40 years<br>(Grace period: 10 years),<br>General untied |
| Borrower / Executing Agency | Government of the Democratic Socialist Republic of Sri Lanka /<br>Ministry of Industry and Commerce (MIC) |
| Final Disbursement Date | December 2010 |
| Related Projects | 【Japanese ODA loans】<br>• "Small & Micro Industries Leader & Entrepreneur Promotion Project I" (Loan Agreement: 1997)<br>• "Small & Micro Industries Leader & Entrepreneur Promotion Project II" (Loan Agreement: 2000)<br>【Technical cooperation】<br>• "Dispatch of Advisors for SME Development and Investment Promotion (2008-2010)" |

## 2. Outline of the Evaluation Study

### 2.1 External evaluator

Hiromi SUZUKI S. (IC Net Limited)

### 2.2 Duration of Evaluation Study

Duration of the Study: September 2012 – July 2013

Duration of the Field Study: January 13–27, 2013 and March 17–24, 2013

### 2.3 Constraints during the Evaluation Study

As a result of the general election in April 2010, government entities in Sri Lanka underwent a major reorganization. As a consequence, the Ministry of Small and Medium Enterprise Development (MSMED), which had been the executing agency for this project since the time of the appraisal, was reorganized into the Ministry of Industry and Commerce (MIC) in July 2010. With this reorganization, handing over of the project from the MSMED to the MIC was not sufficient in many aspects, which became a constraint in conducting the ex-post evaluation. As the project was close to completion, the impact of the ministerial reorganization on the actual implementation of the project was limited, but the biggest constraint in conducting the ex-post evaluation was the lack of ownership by the MIC.

Especially in the beginning of the evaluation study, it took longer than usual to gain the understanding from the executing agency so that it would make the necessary arrangements to receive the evaluation team. This resulted in additional time and effort of the evaluation team in providing proper guidance to the executing agency. Moreover, in reference to the operational indicators of the loans, only data for 2011 were available for all seven Participating Credit Institutions (PCIs) during the period of the duration of the evaluation study. Because actual consecutive annual data for basic operational indicators could not be gathered for all PCIs, the analysis on the actual status and forecast of the project's loan management had to be based on a comparison of two points in time, namely, the target value for 2009 and the actual value for 2011.

## 3. Results of the Evaluation (Overall Rating: B[2])

### 3.1 Relevance (Rating: ③[3])

#### 3.1.1 Relevance to the Development Plan of Sri Lanka

At the time of appraisal, Sri Lanka had established a framework called "Creating Our Future, Building Our Nation: Framework for Economic Growth and Poverty Reduction" (July 2004), whose goal was to achieve poverty reduction through economic growth. To this end, the said framework set a target annual growth rate of 6-8%, increasing new investment from about 25% of GDP to 30% in three years. Aimed at achieving these goals, an emphasis was placed on the role and development of MSMEs as central to economic development. Specific policies were raised for the development of small and medium-sized enterprises (SMEs), including the establishment of the Federation of Chambers of Commerce and Industry of Sri Lanka, SME development centers in each of the 25 provinces and industrial parks in rural areas. Furthermore, the SME Bank was established in 2005 for the purpose of providing SMEs with credit guarantees and loans at preferential interest rates.[4]

The national development policy at the time of evaluation was the "Mahinda Chintana: A Ten Year Horizon Development Framework 2006-2016", which states that the economic growth of the past 25 years has widened income disparities and regional disparities, without contributing to poverty reduction. It aims for a balanced regional development by focusing on four priority areas, namely, increasing investment in regions that are behind in development, developing the SME sector, promoting agricultural development, and further expanding public services. According to this framework, MSMEs[5] are positioned as a driving force, indispensable for the well-balanced economic

[2] A: Highly satisfactory, B: Satisfactory, C: Partially satisfactory, D: Unsatisfactory
[3] ③: High, ②: Fair, ①: Low
[4] Absorbed into the Lanka Puthra Bank in 2007.
[5] Currently, there is no uniform definition for MSME in Sri Lanka. The main MSME definitions that exist are the following four: (1) Mahinda Chintana: a "Small and Micro enterprise" is defined as having annual sales between 100 million to 2 billion rupees, or fixed assets between10 million to 400 million rupees. (2) Central Bank of Sri Lanka: A "Small enterprise" is defined as a company with annual sales of 600 billion rupees. (3) NEDA: A "Micro enterprise" is defined as a company with five or less employees and fixed assets of 5 million rupees or less excluding land and buildings. A "Small enterprise" is defined as a company having more than five to less than 100 employees and fixed assets of 100 million rupees or less excluding land and buildings. A "Medium enterprise" is defined as having more than 100 to 300 employees and fixed assets of more than 400 million rupees. (4) Department of Census and Statistics: classification is based on number of employees, but definition varies between type of statistics.

growth of Sri Lanka. It proposes to provide MSMEs with comprehensive support including financial, management, marketing and technical support, as well as by promoting links with large-scale enterprises and multinational enterprises in Sri Lanka, and by adopting appropriate quality standards, environmental standards and tariffs, so as to protect MSMEs from unfair competition from low prices and low quality products. In 2006, the National Enterprise Development Authority (NEDA) was established under the MIC as the responsible body of the Small and Medium Enterprise Policy. NEDA's specific action plans include formulation and implementation of the Small and Medium Enterprise Policy and the Micro Enterprise Policy[6], enabling better access for SMEs to finance, development of a credit guarantee scheme, introduction of a credit rating scheme, promotion of Business Development Services (BDS[7]), provision of information related to management, marketing and technical training, and mediation with BDS providers. On the other hand, in the "Monetary and Financial Sector Policies for 2013 and Beyond – Road Map 2013," which was announced by the Central Bank of Sri Lanka in January 2013, measures for strengthening support for SMEs include the provision of loans at preferential interest rates, simplification of loan procedures, training to build financial management capacity, and comprehensive support for new MSME businesses.

As mentioned above, given that the MSME sector within the Sri Lankan economy has consistently occupied an important position from the outset of the appraisal to present, and given that it has always been viewed as an important sector of the Sri Lankan national development plan, the consistency between this project and Sri Lanka's development policy can be said to be ensured.

### 3.1.2 Relevance to the Development Needs of Sri Lanka

SMEs in Sri Lanka play an extremely important role in increasing employment, increasing income, reducing poverty and regional development. Especially in the manufacturing industry, according to the 2009 industrial statistics[8], SMEs accounted for 94% of all enterprises, 31% of all employment, and 37% of industrial production value added. Even compared to the 96%, 32% and 20% at the time of appraisal, it is clear that SMEs still play an important role in the Sri Lankan economy.

At the time of appraisal, with the support of international donors such as JICA and the Asian Development Bank (ADB), the Sri Lankan Government had continuously implemented development policies, institutional improvements and promotion measures related to SMEs, and a framework was in the process of being developed. Despite this, the growth of SMEs was not enough in comparison to large-scale enterprises. There was a strong need for access to financial services by SMEs, especially for medium-term and long-term funds (capital investment, long-term working capital, etc.). This is

[6] Under the guidance of the Advisor for SME Development and Investment Promotion from JICA, the Small and Medium Enterprise Policy (draft) was prepared in September 2009, but has not been enforced at the time of evaluation

[7] Business Development Services (BDS) are services that provide assistance for the growth and competitiveness of businesses. It includes services such as support for training, consulting, marketing; providing business information, legal and accounting services as well as technical development support. However, it excludes financial support (JICA, "Follow-up Study Report of the Mining and Manufacturing Industry Project" August, 2003, p.87)

[8] The Census of Industries defines SMEs as those enterprises with up to 100 employees. Department of Census and Statistics, "Census of Industries 2003/04" and "Annual Survey of Industries 2010.

clear from the fact that the allocation of the funds under the Small & Micro Industries Leader & Entrepreneur Promotion Project (II) (hereafter referred to as the previous phase), which is the second phase of the project subject to this evaluation, finished in less than two years, much earlier than originally anticipated. There were a number of factors underlying these needs. One, the volume of loans offered by the state-owned development banks, whose objective is the provision of medium-term and long-term funds, was no more than 10% of the total of financial institutions. Therefore, when MSMEs borrowed from commercial banks, their lack of collateral meant a large margin was applied to the market interest rate, and hence their access to funds was limited. Second, there was no long-term lending because the long-term finance market was undeveloped. Third, financial institutions lacked the ability to identify good standing SMEs. These factors had still not changed that much at the time of evaluation. Because the long-term finance market was undeveloped, SME financing was dependent on donor funds like this project. In addition, loan terms continue relying on using land and buildings as collateral. Among other factors that still exist from the time of the appraisal are; insufficient MSMEs financial management knowledge; insufficient managerial and technical skills and know-how necessary for the development and marketing of new products; no efficient value chains have been created; upstream and downstream linkages with large-scale domestic and foreign enterprises are still limited as well as market scale.

As mentioned above, two of the main factors hindering the growth of MSMEs, both at the time of appraisal and the ex-post evaluation, are their insufficient access to finance and their inadequate management skills, knowledge and know-how. Therefore, the provision of low-interest funds for the purpose of developing and expanding the production infrastructure of MSMEs and improving their technical and financial management capacity through this project is consistent with the development needs of MSMEs.

#### 3.1.3 Relevance to Japan's ODA Policy

The Country Assistance Policy for Sri Lanka (2004) and the Mid-Term Strategy for Overseas Economic Cooperation Operations (1999), which were current at the time of appraisal, mentioned support for strengthening private-sector access to funds and for strengthening supporting industries through the development of SMEs. In the JICA's Country Assistance Strategy for Sri Lanka, support that covers MSMEs are also included under the priority areas such as "support for nation-building and improvement of living conditions," "improving the capacity to acquire foreign currency" and "poverty alleviation." As can be seen, Japan's aid policies for Sri Lanka have included the development of MSMEs, improvement of MSMEs' access to funds, and development of regional and local industries as policy objectives, and hence the consistency between this project and Japan's ODA policy has been ensured.

In light of the above, this project has been highly relevant to the country's development plan, development needs, as well as Japan's ODA policy, therefore the relevance is high.

## 3.2 Effectiveness (Rating: ②)

This project was carried out as a two-step loan, whereby the borrower, namely the Sri Lankan Government, re-lends funds to MSMEs through Participating Credit Institutions (PCIs). Eligible MSMEs were companies whose fixed assets, excluding land and buildings, after the loan do not exceed 20 million rupees. Target sectors were manufacturing industry and services, and/or businesses that would contribute to the promotion of exports and employment creation. Two categories of loans were provided: "general loans" for developing and expanding the production base of MSMEs; and "technical transfer loans" for improving their technical and financial management capacity (for details please refer to "3.4.1.1 Loan Scheme"). There was a strong need for the former, and as mentioned below, it led to the development and expansion of production infrastructure of MSMEs. However, the latter failed to take off, and did not lead to improvements of technical and financial capacity in the way intended by the project.

### 3.2.1 Quantitative Effects (Operation and Effect Indicators)

With respect to the operational indicators at the outset of the appraisal, the planned values in the fifth year following the commencement of loans (2009) were set, using the 2003 actual values in the Phase II of the project as the baseline (reference value). As for the effect indicator, the forecast value was similarly set based on the 2003 actual value of Phase II of the project. However, since only three out of seven PCIs were able to provide actual values for 2009 for each of the indicators[9], for this evaluation, the weighted averages of the actual values for 2011 of all seven PCIs for the cumulative cash recovery rate, infection number ratio (ratio of non-performing sub-loans to total number of loans) and principal infection ratio (ratio of non-performing sub-loans to the total amount of all outstanding loans) were calculated, and compared with the planned values[10].

[9] The MIC, which is the new executing agency, made an effort in 2012 to collect the operational and effect indicators of each PCI for various years, however, it failed to provide a clear formula for these indicators. As a result, the collected data was calculated based on different formulas, with the exception of three PCIs, these data could not be used for this ex-post evaluation. During the ex-post evaluation a request was made to the remaining four PCIs to recalculate, however, due to time constraints, this was not possible.

[10] In this project the participation of each PCI in the total amount of loans vary significantly: while there is a PCI with a share of 40%, there is a PCI with just 1%. In reference to these three indicators, it was necessary to reflect such differences in share, thus instead of a simple arithmetic average it was decided to use a weighted average.

Table 1: Operational and Effect Indicators

| Indicators | 2003 Reference value** | 2009 Planned value*** | 2011 Actual value+ |
|---|---|---|---|
| **Operational Indicators** | | | |
| Number of loans | 4,083 | 8,937 | 4,749 |
| Total amount of loans (million rupees) | 3,511 | 9,112 | 9,245 |
| Average amount per loan (thousand rupees) | 860 | 1,020 | 1,950 |
| Cumulative cash recovery rate (%) | 92% | 92% | 95% |
| Infection Number Ratio (Ratio of non-performing* sub-loans to total number of loans (%) | 5.6% | 5.6% | 6.7% |
| Principal Infection Ratio (Ratio of non-performing* sub-loans to the total amount of all outstanding loans, %) | 3.3% | 3.3% | 7.4 % |
| **Effect Indicator** | | | |
| Number of jobs created at MSMEs (persons) | 18,672 | 37,000 | 66,312 |

Source: Reference and planned values are based on appraisal documents. Actual values are based on information provided by the executing agency and PCIs

* "Non-performing" refers to those debts in arrears by six months or more.

** Actual value (baseline) as of 2003 during the previous phase.

*** Forecast value for the fifth year following the commencement of loans.

\+ Weighted average of seven banks.

With regard to the operational indicators, at the outset of the appraisal, it was forecasted that loans averaging 1.02 million rupees would be provided to each of the 8,937 end users, which was more than double the reference number of 4,083 end users. However, in fact, loans averaging 1.95 million rupees were provided to each of 4,749 end users, which is virtually the same number of end users as the 2003 reference value. Despite achieving the planned value for the total amount of loans, the number of end users receiving direct assistance was only 53%, considerably less than the planned value. The cumulative cash recovery rate was 95% achieving the target, but the infection number ratio (6.7%) was slightly lower than the planned value. On the other hand, the principal infection ratio was 7.0% exceeding the planned value of 3.3% by far. All in all, the result fell short of planned operations. As mentioned below, because the infection number ratio was less than 3.3% for three out of seven PCIs, no significant issues can be foreseen for the future.

Looking at the effect indicator, the number of jobs created was 173% of the planned value (66,312 jobs) which is a considerable effect.

3.2.2 Qualitative Effects

3.2.2.1 Initially Anticipated Qualitative Effects

Following are the four qualitative effects that the project was expected to have on MSMEs and PCIs. Evaluation was conducted based on the information gathered through interviews to end users[11], PCIs as well as the results of the impact evaluation survey of the first round of loans.[12]

(1) Increase the capital investment of MSMEs: According to the end user survey, 90% of respondents stated that they had increased production capacity thanks to loans provided by this project, and 80% stated that they had achieved improvements in production techniques. Similarly, the impact evaluation survey points out comments from end users such as “productivity improved and production costs were reduced”, “we were able to purchase efficient machinery”, and thus the project has been shown to be sufficiently effective in increasing the capital investment of MSMEs.[13]

(2) Increase the amount of exports by MSMEs: By improving the production capacity and quality through the project loans, exports by MSMEs were expected to be promoted. However, the end user survey confirmed that there were zero cases in which the loans led to increased exports. The majority of end users sell their products wholesale to local retail stores. There were some end users that have started doing business with large-scale domestic enterprises, but these have not led to exports.

(3) Improve the technical and financial management capacity of MSMEs: The aim of this project was to improve the technical and financial management capacity of end users by utilizing technical transfer loans for the employment of BDS providers. However, there were only six technical transfer loans, accounting for less than 1% of all loans. The factors behind this situation are that the demand for general loans was high; PCIs’ efforts to promote technical transfer loans through publicity, provision of information and awareness campaigns did not lead to stimulation of needs; and when compared to the necessity for capital investment, the MSMEs’ needs for technical transfer was relatively low. According to the interview-based survey to end users, some of the factors that respondents gave as current weaknesses of their own enterprise included: management and/or financial aspects (76%), marketing (26%), quality of products (16%) among others.

[11] The direct interview-based survey of end users was carried out on 50 enterprises from mid-January to mid-February 2013. The 50 enterprises were sampled considering region, industry and number of employees.

[12] Taking into consideration the experiences from the project’s Phase I and II and with the purpose of periodically monitoring the effects of the project, the previous executing agency conducted an Impact Evaluation Survey in 2010 for the loans provided in 2009. The external evaluators were two lecturers from the University of Sri Jayewardenepura. The content of the survey was as follows: of the 480 loans given in 2009 (approximately 1 billion rupees), 140 end users were selected a year later in 2010 to be interviewed on the effect of eight items (employment creation including women’s participation, new businesses, increase in sales and productivity, improvement in business, reduction of transaction costs, improvement in profitability, training / human resource formation and introduction of IT systems. Technical transfer loans were not covered in the survey). (Jayantha Fernando, A. Anil and A.G. Dayananda. *Impact Monitoring Survey report on Small and Micro Industries Leader and Entrepreneur Promotion Project (III), Final Report.* March 2011)

[13] According to the impact evaluation, approximately 50% of end users who received loans in FY2009 responded that they used the loan on purchasing equipment.

Seventy-six percent of end users also responded that they hoped to utilize BDS providers for technical guidance on marketing and production process. This result reflects the fact that, although companies have the need, the project did not lead to support the improvement of the technical and financial management capacity of end users as intended. One particular result that was also obtained in the impact evaluation survey was that "there is still room for improvement in the MSMEs accounting and finance capacities." On the other hand, according to the results from the PCIs questionnaire survey, all seven banks responded that the financial capacity of end users had "improved." The reasons given were "since it is necessary for MSMEs to prepare financial statements and business plans in applying for the loan, their capacity improved through opportunities of getting advice from banks and accountants", "many end users have taken the opportunity of the loan to purchase and utilize accounting software." With regard to improvements in technical capacity, similarly all seven banks responded that the capacity of end users had "improved very much." The reason given for this was that, in the majority of cases, the loans had been used to purchase materials and equipment, and because end users were now able to purchase new equipment, they were also sometimes required to undertake the training that accompanied the new equipment (offered by manufacturers and providers). In sum, although a certain degree of improvement in technical and financial management capacity through the project can be recognized, the technical transfer loans did not lead to support the improvements in these capacities.

(4) Improve the financial capacity of PCIs: The PCIs have already participated in the previous phases of this project, namely "Small and Micro Industries Leader and Promotion Project I and II" (1997-2006), thus improvements in their financial capacity are thought to have already been realized at the time the project was completed. When asked about the effects of the project at the moment of completion in the questionnaire-based survey, five PCIs responded that their capacity had "improved very much" due to such effects as expansion of their loan portfolios and improvements in their liquidity. The remaining two banks responded that effects had been "improved to a certain extent" because the number of loans was limited; and because the PCI had already been actively lending to MSMEs since Phase I and II of this project and their financial capacity had already been improved, so there were no particular effects worth pointing out. As for the five banks that considered that their financial capacity had improved, the skills that were most improved were credit risk analysis and loan screening.

In the impact evaluation survey, other effects such as improvement in women's employment opportunities and reduction of opportunity costs were also mentioned in addition to the above four qualitative effects that were expected at the appraisal stage.

#### 3.2.2.2 Effects from Cooperation with Other Aid Schemes

With respect to other aid schemes related to this project, the "Advisor for SME Development and Investment Promotion" was dispatched to NEDA for a two-year period from December 2008 to December 2010 as a technical cooperation project. The main activities of the advisor were to review the legal system, policies and measures related to SME development, to identify and analyze the needs related to SME promotion, to check the authority and resources of NEDA, and to check the policies and support measures of other related organizations. The purpose of the work conducted by the advisor was to establish the legal framework and structures necessary for the further growth of the SME sector. Thus, it was not possible to confirm the direct cooperation and synergistic effects with this project. However, it can be said that the advisor's recommendations related to human resources development for managers (establishment of an SME Development Support Centre) and SME financial policies (in particular, the introduction of an SME Credit Guarantee System) as future issues to be addressed by Sri Lanka will be very useful in implementing similar projects in the future.

## 3.3 Impact

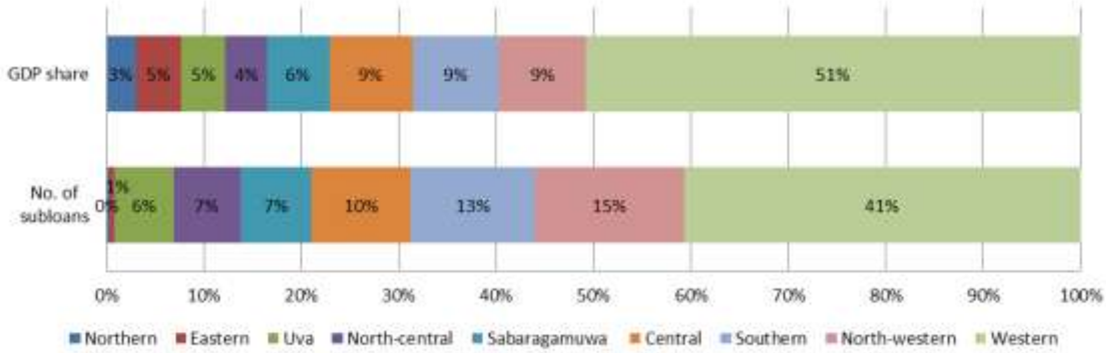
### 3.3.1 Status of the Impacts

Following are the three intended impacts of this project.

(1) Well-balanced economic growth of Sri Lanka[14]

As shown in Figure 3, 41% of the sub-loans in this project were concentrated in the Western Province (Colombo, Gampaha and Kalutara), with the remainder 15% being distributed in the North Western Province (Kurunegala and Puttalam), 10% in the Southern Province (Galle and Matara in particular), and 8% in the Central Province (Kandy in particular). However, by comparing the regional distribution of loans against the provincial distribution of GDP, we can see that, in fact, the provincial distribution of sub-loans is more well-balanced than the provincial distribution of GDP, apart from in the conflict areas of the Northern Province and the Eastern Province. Nevertheless, it is difficult to ascertain the degree to which the project contributed to the regional economies as well as the precise causal relationship.

[14] Although there is no specific definition for "well-balanced" in the appraisal documents, since the mitigation of any sense of unfairness among regions is mentioned, this ex-post evaluation focused on regional disparities and biases of industrial distribution.




Source: Central Bank of Sri Lanka, *Economic and Social Statistics of Sri Lanka 2012*

Figure 3: Comparison of the distribution of project loans and GDP provincial distribution

On the other hand, looking at the distribution of number of loans across different industries, agriculture, livestock and fishery industries accounted for 9%, manufacturing industry for 50%, and services for 41%. In other words, manufacturing and service industries, which were the industries targeted by the project, accounted for 91% of the total number of loans, meaning that the project was conducted as planned in terms of industrial distribution.

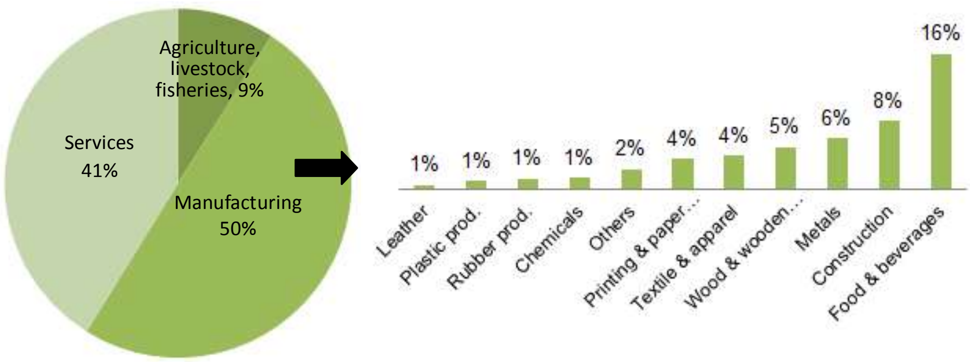
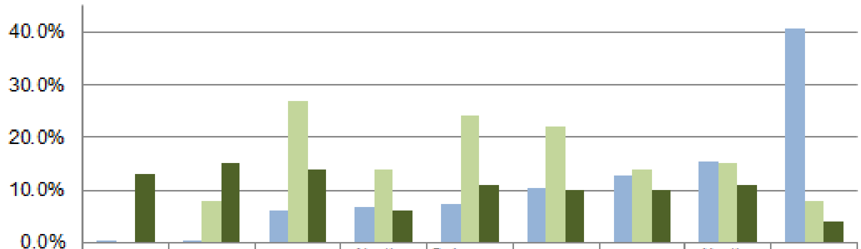



Figure 4: Distribution of number of project loans by type of industry

(2) Alleviation of poverty through low-income earners and the impoverished benefitting from the loans and through the creation of jobs

As described earlier, the number of jobs created by this project was significantly higher than planned, at well over 60,000 as of 2012. Since there is no clear data on whether the indirect beneficiaries employed by the end users of this project can be classified as being impoverished, it is not possible to accurately ascertain the degree of poverty alleviation resulting from low-income earners and the impoverished having received the benefits of the loans and through job creation from this project. Comparing the distribution of number of loans through the project against the distribution of the Head Count Index (HCI), although the number of sub-loans were concentrated in the Western Province, which had the lowest HCI in 2006, in 2009, one year prior to the conclusion of the project, the HCI in the other provinces (except the Eastern Province) had also improved. The Sri Lankan Government has been undertaking a variety of initiatives aimed at poverty alleviation, and although it is not possible to pinpoint the direct causal relationship between this project and the HCI's improvement, it appears that the project contributed as one of those initiatives, albeit in a limited manner.




| | Northern | Eastern | Uva | North-central | Sabaragamuwa | Central | Southern | North-western | Western |
|---|---|---|---|---|---|---|---|---|---|
| No. of subloans | 0.3% | 0.5% | 6% | 7% | 7% | 10% | 13% | 15% | 41% |
| HCI2006/07* | 0% | 8% | 27% | 14% | 24% | 22% | 14% | 15% | 8% |
| HCI2009/10 | 13% | 15% | 14% | 6% | 11% | 10% | 10% | 11% | 4% |

Source: Department of Census and Statistics Sri Lanka, Poverty Indicators 2006/07 and 2009/10
* There is no 2006/07 HCI data for the Northern Province as it was a conflict area.

Figure 5: Distribution of project loans and HCI

(3) Establishment of peace and promotion of reconstruction by including former conflict areas in the scope of the project

An impact initially anticipated in the project was "to distribute peace in a visible form to the people of Sri Lanka, to mitigate any sense of unfairness among regions and ethnic groups, and to contribute to the establishment of peace and promotion of reconstruction, by including former conflict areas in the scope of the project." However, it was May 2009 when the end of hostilities was declared, and because about 90% of loans in this project had already been approved by then, it was unavoidable that the share of sub-loans in the former northern and eastern conflict areas was limited to 0.3% and 0.5% respectively.[15]

### 3.3.2 Other Impacts

An environmental expert was included among the staff at the Project Management Unit (PMU), and appropriate environmental and social considerations were taken in selecting the sub-projects based on the "Environmental Guidelines of the Japan Bank for International Cooperation"(April 2002, hereafter referred to as "JICA Environmental Guidelines"). In the site visits conducted at some MSMEs during the ex-post evaluation, it was confirmed that on the whole, appropriate environmental

[15] In Sri Lanka, over a 25-year period from 1983, the Liberation Tigers of Tamil Eelam (LTTE) was in a state of civil war with the government as it waged a campaign for the separation and independence of the northern and eastern areas. The LTTE was an anti-government armed group of the minority Tamil people, who live mostly in the north and east of Sri Lanka. However, in May 2009, the government forces repressed the LTTE, bringing the civil war to an end (Ministry of Foreign Affairs, "Country and Regional Affairs" (http://www.mofa.go.jp/mofaj/area/srilanka)).

and social considerations were taken in the operation and management of the equipment acquired through the project[16].

In addition, it was confirmed through interviews to PCIs that in this project there were no land acquisition and resident relocation.

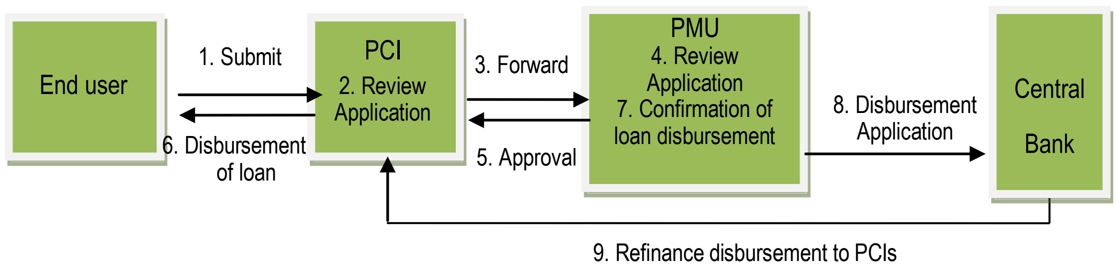
In light of the above, this project has somewhat achieved its objectives, therefore its effectiveness is fair.

### 3.4 Efficiency (Rating: ③)

#### 3.4.1 Project Outputs

##### 3.4.1.1 Loan Scheme

The project was implemented as a two-step loan as shown in Figure 6.




Source: Based on appraisal documents and interviews to PCIs

Figure 6: Loan Scheme of the Project

As for the loan terms set by the PCIs to the end users, they were set as planned. All PCIs set a maximum interest rate of 9%, a repayment period of maximum10 years (with a grace period of two years), and a maximum loan amount of 10 million rupees (maximum 75% of project cost). The target end users were those enterprises whose fixed assets after the loan (excluding land and buildings) were 20 million rupees or less, with priority given to loans that contribute to the manufacturing industry and services as well as export promotion and job creation. In terms of businesses targeted, the condition was that the business be one for which the loan would be contribute to qualitative and quantitative improvements in production capacity, improvements in operational capacity, and better added value to products or services.

In this project, two categories of loans were provided: "general loans" as funds for the purchase of fixed assets such as buildings and materials purchase of vehicles, and long-term working capital, excluding acquisition of land and commercial buildings for rent out purposes; and "technical transfer loans" to cover the costs of management, financial and technical training, costs for employing consultants, and costs for purchasing quality-control equipment. Technical transfer loans were

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[16] However, during the ex-post evaluation site survey, a specific case where a PCI (mainly the branch level staff) gave instructions to improve treatment of smoke and safety management of employees was identified. It should be noted that these issues were due to equipment other than the ones purchased with the loan of this project.

designed to primarily support the intangible aspects of general loans, but very few were given—only six of 4,749 loans (Table 2).[17]

Table 2: Number of sub-loans, approved amounts and disbursed amounts by PCI

| PCI | Small and Micro Industries Leader and Entrepreneur Promotion Project (III) | | | | | |
|---|---|---|---|---|---|---|
| | | | | Technical transfer loans | | |
| | Number of loans* | Approved amount (million rupees) | Disbursed amount (million rupees) | Number of loans | Approved amount (million rupees) | Disbursed amount (million rupees) |
| Bank of Ceylon | 827 | 1,757 | 1,577 | 2 | 4 | 4 |
| Commercial Bank of Ceylon | 1,561 | 4,218 | 3,702 | 0 | 0 | 0 |
| DFCC Bank | 937 | 1,880 | 1,678 | 2 | 5 | 5 |
| Hatton National Bank | 78 | 190 | 134 | 0 | 0 | 0 |
| National Development Bank | 368 | 801 | 691 | 0 | 0 | 0 |
| Regional Development Bank | 340 | 184 | 149 | 0 | 0 | 0 |
| Sampath Bank | 632 | 1,532 | 1,358 | 2 | 5 | 5 |
| Total | 4,749 | 10,562 | 9,245 | 6 | 14 | 14 |

*According to the PMU database, the number of approved loans was 4,805. This table has been prepared based on data adjusted after comparing the PMU database against the information provided by each PCI.

Similarly, there were few technical transfer loans during the first two phases of this project. As recommendations to promoting technical transfer loans, it was suggested that the cost of PCI procedures be curbed; that there be publicity, information provision and awareness rising; and that there be more coordination between PCIs and technical training service providers. However, it was clear from interview-based surveys of end users and PCIs that the idea of paying for training and technical services had still not taken root right after this phase of the project had started, and that expenditure on human resources development and the like was not recognized as an investment. Although PCIs did engage in publicity, information provision and awareness rising, these were not sufficient to the development of needs, and so did not result in the utilization of technical transfer loans.

#### 3.4.1.2 Characteristics of End Users[18]

As mentioned before, target end users were those enterprises whose fixed assets after the loan (excluding land and buildings) were 20 million rupees or less. However, there were no specific plans

[17] Given the lack of progress in the take up of technical transfer loans, in 2007, part of the technical transfer loans were transferred to general loans. After this, the executing agency also applied for the disbursement of technical transfer loans as general loans, and given that Japanese ODA loans for both categories had the same terms and conditions, fund allocation for both types of loans was consolidated into one in July 2009 (when the project's progress was at 77%). Given these developments, it is not possible to ascertain the precise number of technical transfer loans and the purposes for which they were used.

[18] Some characteristics (number of employees, net sales) could not be precisely ascertained using the database provided by the PMU. A request was made to the PCIs to provide information on these characteristics in the questionnaire-based survey for PCIs based on a 10% sample of the total number of loans of each PCI. Information was provided by all banks, except the Regional Development Bank (RDB). The total sample size (number of loans) was 1,896. The RDB was unable to respond before the end of the survey period because it would have required the collection of pre-merger data. Although the sample size of the end user survey conducted separately was 50, similar results were obtained for end user's characteristics.

set on how the loan should be used (i.e. creation or expansion of a business), and on the size of the MSME based on the number of employees.

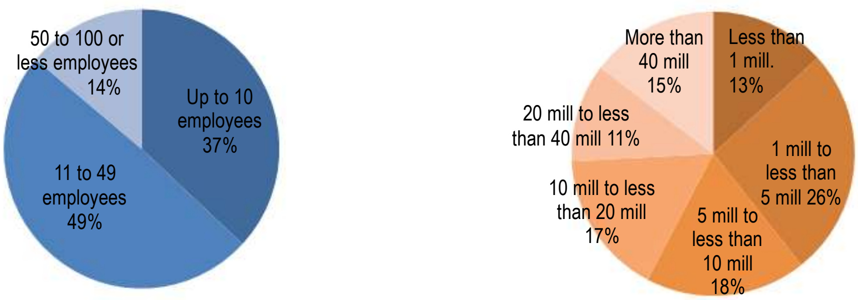
As shown in Table 3 below, those cases where the end user's investment purpose was to start a new business accounted for 24% of the total of approved loans.[19] The main factors that loans to new business were limited were that most PCIs gave loans to end users who were already part of their customer base, and that most entrepreneurs considering starting up a new business did not own any land, buildings or other tangible fixed assets which were required as collateral.

Table 3: Number of approved loans by type of business

| Type of business | Number of approved loans | |
|---|---|---|
| New business | 1,158 | 24% |
| Business expansion | 3,647 | 76% |
| Total | 4,805 | 100% |

Source: Based on the PMU database.

As shown in Figure 7, the distribution of end users by number of employees and sales scales of enterprise covered by this project were micro enterprises of ten employees or less (37%), small enterprises of between 11 and 49 employees (49%), and medium-sized enterprises of between 50 and 100 employees (14%), showing that the project reached the targeted scale of companies. As for the distribution of net sales, sales of 10 million rupees or less accounted for 58%, which was the majority.

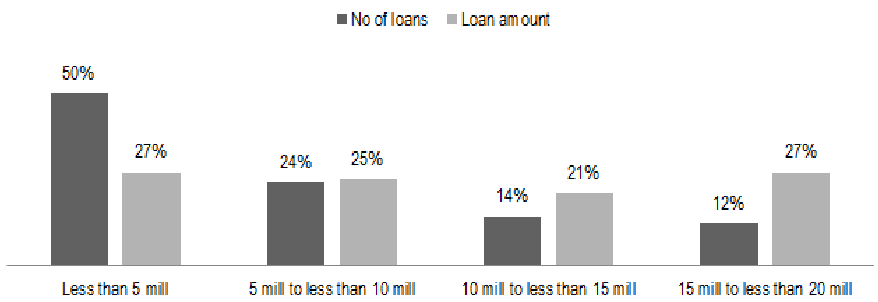



Source: Based on the results of the PCI questionnaire survey (for details refer to foot note 17)

Figure 7: Distribution of end users by the number of employees and net sales (rupees)

On the other hand, the distribution of loans according to the scale of fixed assets was as shown in Figure 8. In terms of the number of loans, 50% of end users were enterprises with fixed assets of 5 million rupees or less; whereas in terms of the amount of loans, there was roughly an even distribution of 20-27% regardless of the scale of fixed assets. In this project, different from the previous phases, the objective was to reduce the loan amount per end user, so as to include more end users. In this respect, it was necessary to provide more loans to companies with fixed assets of up to 5 million rupees.

[19] The only verifiable information on new business and business expansion was the number of approved loans from the PMU database. As for the information by disbursement it was impossible to collect it even from PCIs databases.



Source: Based on PMU and PCI databases.

Figure 7: Distribution of project loans by end user’s amount of fixed assets (rupees)

3.4.2 Project Inputs

3.4.2.1 Project Cost

All project costs were covered by the Japanese ODA loan. Actual project cost was 9,612 million yen, lower than the planned value of 9,619 million yen.

3.4.2.2 Project Period

The project period was as planned at the outset of the appraisal. It covered a total of 72 months, from the signing of the loan agreement on December 7, 2004, to the final disbursement date of December 9, 2010.

Both project cost and project period were mostly as planned, therefore efficiency of the project is high.

3.5 Sustainability (Rating: ②)

3.5.1 Institutional Aspects of Operation and Maintenance

3.5.1.1 Institutional Aspects of Operation and Maintenance of the First Round of Loans

a. PMU: The executing agency during implementation was established in the then MSMED. This previous PMU was strengthened with additional personnel as planned at the time of the appraisal, and was staffed with a total of 20 members, including finance and environmental experts and a disbursement coordinator. Based on the interview surveys of PCIs and of individual loan managers, it can be surmised that staffing was satisfactory. Based on the reports of each PCI, the PMU had built and managed a database on all loans given to end users, providing necessary guidance to PCIs with low recovery rates.
b. PCI: Of the 11 banks that had initially been listed as candidate PCIs at the time of appraisal, a total of seven banks participated as PCIs: Bank of Ceylon, Commercial Bank of Ceylon, DFCC Bank, Hatton National Bank, National Development Bank (NDB), Regional Development Bank (RDB)

and Sampath Bank.[20] Since all banks had also been participating as PCIs (as the executing agency in the case of the NDB) during the first two phases of the project, they had already accumulated experience and expertise. Thus no significant issues were identified with regard to their ability to screen individual loans[21] and their capacities to manage loans (manage end user loan data, check the progress of businesses covered by the loans, visit borrowers, etc.). Every year and every half-year, in addition to checking whether each PCI had cleared the selection criteria, the PMU also verified the business conditions and loan recovery status of the PCIs. Accordingly, PCIs maintained a certain level of capacity, and hence there are no major problems with regard to the operation and maintenance capacity of PCIs.

c. Policy Coordination Committee: This committee was established as a body to review MSME-related policies, and to make adjustments in order for this project to be operated while maintaining consistency with those policies. The committee was comprised of the executing agency, the Department of External Resources (ERD, Ministry of Finance and Planning), the Industrial Development Board (IDB), the Central Environmental Authority (CEA), the Small Business Chamber of Commerce (SBCC), the PMU and PCIs, and it was expected to meet once a year. According to the interview-based survey of PCIs, the committee was established and convened meetings as planned.[22]

#### 3.5.1.2 Institutional Aspects of Operation and Maintenance of the Second Round of Loans (the Revolving Fund)

a. PMU: The executing agency in charge of monitoring the recovery of the first round of loans as well as the operation and management of the second round of loans of the revolving fund is the PMU established in the MIC. Management of loans of the first round of loans is also among the responsibilities of the current PMU, but according to interviews to the PMU and PCIs, it was clear that this has not been done as required.

In reference to the second round of loans, the plan at the time of appraisal was to set up an account called the "Small & Micro Industries Leader & Entrepreneur Promotion Project Revolving

[20] Of these 11 candidate banks, three ended up not participating. The Seylan Bank and the Sabaragamuwa Development Bank failed to meet the selection criteria for PCIs (have reported profits for at least the last two years, have a non-performing loan ratio of less than 10%, and have a ratio of non-performing loans to the total amount of all loans of less than 15%). As for Ruhunu Development Bank, agreement could not be reached. In May 2010, the Kandurata Development Bank and the Wayamba Development Bank merged with four other regional development banks into a single bank, designated as the Regional Development Bank. The Hatton National Bank became eligible in July 2006.

[21] Refers to the screening of aspirant enterprises, taking into account their economic profitability and financial stability. Specific items to be evaluated (return on investment, liquidity, debt coverage, etc.) had been agreed upon in the operating instructions between the PCIs and the PMU.

[22] It had been intended that the minutes of the Committee proceedings would be kept by both the executing agency and JICA. However, because these minutes could not be obtained during this survey, some of the facts could not be confirmed based on such minutes.

Fund (III)" at the Central Bank, and to manage the second round of loans.[23] Loans were to be managed with the same terms, conditions and objectives as the first round of loans, with the operation and maintenance also to be carried out by the previous PMU that managed the first round of loans. Nevertheless, despite there being demand for loans on the part of enterprises, the second round of loans had not been launched as at the time of evaluation, and neither had operation of the revolving fund.

Because their sense of ownership of this project had not reached an adequate level when the MIC took over this project, it was found through interviews that the priority within the ministry for commencing operation of the revolving fund had been not so high. However, it should be noted that the MIC did prepare a document called the "Credit Assistance Project for the SME Sector" as a plan for commencing the revolving fund in May 2011, and submitted this together with its Operating Instructions to the Ministry of Finance and Planning. The Operating Instructions described the detailed requirements of the second round of loans shown in Table 5. The "loan terms" and "loan categories and objectives" remain unchanged, but the other items have been updated to reflect the lessons learned and recommendations of the previously mentioned impact evaluation survey. From August 2011, although time was necessary to make revisions and adjustments between the MIC and the Ministry of Finance and Planning, specifically to the loan terms and the operating structure, and official approval to commence the revolving fund was received from the Ministry of Finance and Planning on January 30, 2012. With approval granted, initially the aim was to start the revolving fund in May 2012. However, a request was received from the Attorney General asking for changes to the wording of the loan agreement, and a request was received from the Department of External Resources (Ministry of Finance and Planning) asking for changes to the loan details. As at the time of this ex-post evaluation, the MIC was awaiting the decision of the Cabinet. The expected start date was April 2013. The details of the second round of loans are indicated in Table 4. The "loan terms" and "loan categories and objectives" remain unchanged; the other items do reflect many of the lessons learned and recommendations of the aforementioned impact evaluation survey. [24] However, in reference to the technical transfer loans which were not taken up as expected throughout all the phases of the project, concrete details on its role and promotion methods (trainings to PCI staff, orientation meetings and promotional activities to MSMEs, linkage between PCIs and BDS) are not included.

[23] Refers to using a revolving fund to manage the surplus funds arising due to the gap between the repayment period of loans to end users (10 years) and the repayment period of the Japanese ODA loan (40 years), and to provide those funds again to other SMEs as secondary or as second round of loans. It should be noted that the ex-post evaluation report of the project's Phase II stated that there were delays in starting the operation of some of the Phase II secondary loans. The NDB, which was the executing agency during this phase, confirmed that although there had been delays, these had concluded in December 2012.

[24] In the plan prepared in May 2011, it was proposed to clearly define the industries eligible for loans as well as the allocations to new businesses and to female entrepreneurs. It also proposed including a societal role in the selection criteria for PCIs in order to encourage participation by regional development banks that have experience lending to the non-manufacturing sectors and to micro enterprises in the northern and eastern areas. However, these proposals were not reflected in the Operating Instructions.

Table 4: Implementation details of the revolving fund

| | |
|---|---|
| Loan terms | I. Sri Lankan Government refinance to Participating Credit Institutions (PCIs)<br>• Interest rate: General loans: 4.5%, technical transfer loans: 3%<br>• Repayment period: 10 years (grace period: 2 years)<br>II. Sub loans from PCI to end users<br>• Interest rate: General loans: maximum of 9%, technical transfer loans: 5%<br>• Repayment period: General loans shall not exceed 10 years (grace period: 2 years); long-term working capital and purchase of vehicles: shall not exceed five years. Technical transfer loans shall not exceed 7 years (grace period: 2 years) |
| Loan categories and objectives | • General loans: improving production capacity, improving product quality, strengthening competitiveness<br>• Technical transfer loans: improving the accounting, business and technical skills of end user personnel through the use of consulting services, and purchasing equipment for managing quality |
| Target beneficiaries | • Enterprises whose fixed assets after the loan (excluding land and buildings) are 1.5 million rupees or less |
| Priority industries | • Textiles, apparel, packaging, rubber, leather, food, timber and mining<br>(A total of 17 industries are included in the industries eligible for loans, such as tea, coils and crafts, but the MIC has defined those listed above as priority industries.) |
| Priority regions | • The Western Province has already received adequate support, and the loans given to this province shall be limited to a maximum of 20% of the total amount. Support shall be provided to other provinces, and in particular, to rural areas. |
| Target business | • Priority to be given to new business.<br>• Business in which the loan would be conducive to qualitative and quantitative improvements in production capacity, improvements in operational capacity, or better added value to products (and/or services) |
| Target items | • Funds for the purchase of fixed assets such as buildings and materials, funds for the purchase of vehicles, and long-term working capital (excludes funds for acquiring land and commercial buildings for rent out purposes). |
| Maximum loan amount | • General loans: 5 million rupees. 80% of the costs to be funded by the project and 20% by the PCIs.<br>• Technical transfer loans: 2.5 million rupees |

Source: "Small and Micro Industries Leader and Entrepreneur Promotion Project (III) Operating Instructions," MIC, version provided in March 2013.

With regard to the institutional aspects of operation and maintenance of the revolving fund, the current PMU is staffed with a total of seven personnel: one project director, three assistants and three office workers. In order to strengthen the PMU, plans are in place to hire one deputy project director, a financial expert and a monitoring officer. As for the members of the previous PMU they were dismissed because the MSMED itself was dissolved and because of the policy that, regardless of the type of project, priority should be given to civil servants over external human resources if continuous employment is to be provided by a project. Recognizing the loss in expertise caused when the previous PMU was dissolved, the new PMU plans to appoint a public servant as the deputy project director.

b. PCI: All PCIs that have the interest in participating in the revolving fund should clear the PCI selection criteria. The PMU plans to be monitoring the PCI’s management and loan recovery status.
c. Policy Coordination Committee: The same organizational arrangements are expected to take place as the first round of loans. According to interviews, JICA is also to be participating in the Committees meetings.

3.5.2 Technical Aspects of Operation and Maintenance

(1) PMU: The three assistants at the current PMU are all university graduates, but few of them have the necessary knowledge on SME management and finance thus it would be difficult to describe the current PMU as being equipped with the skills necessary to operate and maintain the revolving fund. If these personnel are going to continue carrying out the operation and maintenance, then it is imperative that they upgrade their skills through training, etc. At the time of the evaluation, these personnel were not given the opportunity to attend trainings on SME management and finance. Furthermore, the only document that would serve as a manual for the operation and maintenance of the revolving fund was the operating instructions of the project. In addition, there was no shared data system common to the PMU and PCIs by which the details of individual sub-loans can be input and output. Since such details were managed using Excel, there is room for improvement with regard to the development of a proper IT infrastructure. Specifically, the introduction of a Management Information System (MIS) is needed.

(2) PCI: There are no significant issues with regard to implementing and managing the revolving fund in this project. Five of the seven PCIs have more than 20 years of experience in SME finance, and the other two banks have from 16 to 20 years of experience. Also, all of the banks have participated either as a PCI or as the executing agency since Phase I of this project, and are very familiar with the schemes of the project. According to the interview-based survey of PCIs, four out of seven PCIs mentioned credit analysis as an area that needs further improvement, and steps for improvement have already been taken through OJT and other training. Each PCI’s training achievements are disclosed in their annual reports. Furthermore, their training has become more substantial, covering such topics as SME finance, loan scoring, financial statement analysis, risk management and preparation of business plans among others. The training is targeted at participants both inside and outside the PCIs, such as the SME banking managers at PCI branches as well as SME owners. In sum, there are no particular problems with regard to the skills at PCIs for operating the revolving fund.

### 3.5.3 Financial Aspects of Operation and Maintenance

(1) PMU: In the 2013 national budget, a total of 1,900 million rupees has been budgeted for the operation and maintenance of the revolving fund for the four years from 2012 to 2015 as part of the MIC budget (approved already by the Parliament), securing the financial sustainability.

(2) PCI: The Central Bank of Sri Lanka requires all financial institutions to have a capital adequacy ratio (the ultimate ability of a financial institution to make payments) of at least 5%. However, all PCIs have already a ratio of at least 10% (Table 5). All banks, apart from the RDB, have a high loan-deposit ratio, and all banks have a ratio of non-performing loans between 2-4%, meaning that all PCIs are mostly stable. According to the domestic ratings provided by the rating agency, Fitch Ratings Lanka Ltd., the RDB has a rating of BBB+, and the other six banks are rated at least AA, serving as further evidence of the stability of these banks. It is worth mentioning that the RDB has been appointed by the government as the main financial institution to cater the MSMEs. Thus, their financial status is expected to further improve through financial support from the government. In sum, the financial sustainability of the PCIs is secured and no issues are foreseen in the management of the first round of loans of this project.

Table 5: Main PCI indicators (FY2011)

| Financial institution | Rating* | Capital adequacy ratio** | Loan-deposit ratio (%) | Ratio of non-performing loans (%) |
|---|---|---|---|---|
| BOC | (AA+ Stable) | 11.6 | 80 | 3.2 |
| CBC | (AA Stable) | 12.1 | 83 | 4.1 |
| DFCC | (AA Stable) | 28.0 | 93 | 4.0 |
| HNB | (AA- Stable) | 14.5 | 82 | 3.9 |
| NDB | (AA Stable) | 11.3 | 130 | 1.4 |
| RDB | (BBB+ Stable) | 10.8 | 10 | 2.3 |
| Sampath | (AA- Stable) | 10.2 | 87 | 2.7 |

* Fitch National Rating, as of January 2013
** Capital Adequacy Ratio Tier I

### 3.5.4 Status of the Repayment of Debt

Table 6 indicates the data on the delinquent and non-performing loans for FY2011, for which information was available for all PCIs. Six banks had a capital recovery ratio of more than 90%, while BOC's ratio was 88% slightly below compared to the rest. DFCC had a Principal Infection Ratio of 16%, slightly higher than the rest of the PCIs. Based on the financial status of the PCIs, it could be said that the project's ratio of non-performing loans could have been kept at a lower rate. However, since no year on year data on the basic operational indicators could be collected for all PCIs, analysis on the management of the loans, based on the trend of operational indicators could not be conducted. However, as mentioned earlier, it can be said that the financial sustainability of all PCIs is secured.

Table 6: Ratio of delinquent and non-performing loans of the project for FY2011

| Financial institution | Infection Number Ratio (Ratio of non-performing* sub-loans to total number of loans) | Principal Infection Ratio (Ratio of non-performing* sub-loans to the total amount of all outstanding loans) | Cumulative loan recovery rate** |
|---|---|---|---|
| BOC | 12.4% | 2.5% | 88.0% |
| CBC | 3.3% | 4.4% | 97.5% |
| DFCC | 4.8% | 16.0% | 97.0% |
| HNB | 0.0% | 0.0% | 94.7% |
| NDB | 12.2% | 8.4% | 93.0% |
| RDB | 3.0% | 3.8% | 93.0% |
| Sampath | 9.9% | 11.1% | 94.1% |

* Non-performing: debts in arrears by six months or more
**Cumulative loan recovery rate = Cumulative amount of capital recovered ÷ Cumulative amount of loans.

In sum, although financial sustainability of the project is secured, some problems have been observed in terms of the institutional and technical aspects of the operation and maintenance, therefore the sustainability of the project effect is fair.

## 4. Conclusion, Lessons Learned and Recommendations

### 4.1 Conclusion

This project aims to develop and expand the production infrastructure and improve the technical and financial management capacity of micro, small and medium-sized enterprises (MSMEs) in Sri Lanka, as well as the financial capacity of Participating Credit Institutions (PCIs) by providing MSMEs with low-interest funds and technical support.

This project was carried out in accordance with the development policy and development needs of the Sri Lankan Government; its consistency with Japan's ODA policy is ensured as well, therefore its relevance is high. This project had two types of outputs: "general loans" and "technical transfer loans." However, while the demand for general loans was high, technical transfer loans made little progress. With no other major changes to the loan scheme, loan terms or target businesses, and because the project was, on the whole, carried out as plan, both in terms of project period and project cost, its efficiency is high. With respect to the effect of the project, although the number of jobs created was significantly higher than planned, because the loan amount per end user was higher than originally expected, the total number of loans did not reach the target number. In addition, because technical transfer loans did not grow as much, the project was not linked to the promotion of exports as well as the strengthening of the technical and financial management capacity of MSMEs With regard to the project impact, when compared with the distribution of the regional gross domestic product (GDP), a more well-balanced distribution of loans by region can be seen. In relation to the industrial distribution, the loans are focused on manufacturing industries and services, which are the industries that were targeted by the project. In sum, the project effectiveness and impact were fair. It should be noted that the executing agency of this project changed immediately before the completion of the project. There were no organizational, technical or financial problems with the executing agency or PCIs which conducted the first round of loans. However, as for the executing agency that is in charge of the forthcoming second round of loans, concerns remain about their organizational and technical capacity because there are few personnel with expertise on MSME management and finance, and therefore sustainability of the project effect is fair.

In light of the above, this project is evaluated to be satisfactory.

## 4.2 Recommendations

### 4.2.1 Recommendations to the Executing Agency

(1) In order to smoothly carry out the management and maintenance of the revolving fund, the PMU needs to be organized by securing personnel with expertise in SME management, finance and IT among other areas. Since the project director already has numerous duties besides this project, it is necessary that the deputy project director specialize in the management, operation and maintenance of the revolving fund, establishing a structure in which duties can be carried out in an efficient manner.

A Management Information System (MIS) connecting the PMU with PCIs needs to be introduced in order to manage the sub-loans of the revolving fund more accurately and efficiently. Since there are a large number of loans and since the amount of information on each sub-loan is also large, there are limits to managing these data using Excel. It is inefficient and lacks accuracy.

(2) After starting the operations of the revolving fund, a study should be carried out, similar to the impact evaluation survey conducted in 2010. Such a study will make it possible to check whether there are any sectoral or regional biases and whether effects have emerged, enabling adjustments as necessary. Any basic information that would contribute to future policies in the MSME sector should also be shared with NEDA.

(3) The revolving fund loan scheme is not designed to secure the active use of the technical transfer loan. Once after reconsidering the lessons learned and recommendations from the project’s Phase I to Phase III, it is necessary to clarify the role of the technical transfer loan, and procedures should be added to the loan scheme if deemed necessary. Specifically, in reference to technical transfer loans the following operational and market development efforts can be considered: (1) provide training to PCI staff (especially the bank employees at the branch level who will handle these loans) on promotional procedures such as marketing and advertising; (2) conduct orientation sessions on technical transfer loans to MSMEs; and (3) provide a bridge between MSMEs and BDS provides in coordination with NEDA who is in the process of creating a BDS database.

### 4.2.2 Recommendations to JICA

In regard to the institutional organization for the management, operation and maintenance of the revolving fund, it is necessary to verify the organizational structure of the PMU in greater detail. Specifically, the number and specialization of the PMU staff should be verified so as to assess whether the organizational structure is adequate for the management of the revolving fund. In addition, because in most of the cases PMUs are set up on a provisional basis for the purpose of implementing specific projects, it tends to hire external human resources instead of public officers, which results in extremely high job mobility. Although the executing agency has already taken into consideration this point, and has plans to secure a public officer rather than external human resources, it is necessary to monitor this particular matter. Furthermore, participation in the Policy Coordination Committees that will be held periodically is recommended in order to monitor the lending status as well as the loan repayment status.

## 4.3 Lessons Learned

(1) In cases where an executing agency change occurs, the new executing agency needs to be given a proper, detailed explanation of the project, so that, even if the project is just about to be completed, the new executing agency's ownership of the project can be strengthened. Specifically, procedures to reconfirm and share the details of the loan agreement can be agreed between the parties, so that a sustainable organizational structure can be established from the early stages after the executing agency changes.

(2) During Phase I and II of this project, utilization of the technical transfer loan did not proceed as expected, and the reasons and issues surrounding this situation were already identified through project management at the project implementation stage. Therefore, it can be said that activities and procedures that would help and complement the technical transfer loans, such as pre-establishing the ratio of general and technical loans; market development efforts (e.g. strengthening PR activities and organizing orientation sessions for MSMEs by the executing agency and PCIs); and bridging MSMEs and service providers of training and technical services, could have been included at the appraisal stage of Phase III of the project.

**BOX: The Results of Examining the Ripple Effects of Two-Step Loan Projects**

The ripple effects of two-step loan projects were examined for three projects that were selected out of the FY 2012 Ex-Post Evaluations, namely the "Micro, Small and Medium Enterprises Energy Saving Project" in India, the "Small and Micro Industries Leader and Entrepreneur Promotion Project (III)" in Sri Lanka, and the "Small and Medium-Sized Enterprises Finances Project (II)" in Vietnam, all of which are yen-loan projects. The following are the three main areas studied.

- The relationship between the subject projects and the degree to which the business development service (BDS) market has developed in the respective countries[25]

- The macro-political and financial effects of two-step loan projects
- Whether or not local Japanese-affiliated companies benefited from the projects through supply chains which include end users

**1. The Relationship between Two-Step Loan Projects and the Degree to Which the BDS Has Developed**

The following explains the degree to which the BDS market has developed and the characteristics of the BDS providers in the three countries.

In Vietnam, it is reported that BDS sales account for about 1.5% of GDP. The main tasks of the BDS providers include the following: mediating clients and assisting market development; creating personal connections between companies; giving advice on government rules and regulations; training; consulting on marketing, management strategies and business management; and assisting with the preparation of financial statements. Government-managed agencies, trade associations and business organizations preceded other types of organizations in providing BDS, but their services had some room for improvement[26]. The number of private BDS provider companies has gradually increased in recent years and they have begun to provide high-quality services to relatively large corporations. In India, there are various actors who provide BDS including government agencies, business organizations, private firms, research institutes, NGOs, and individuals. BDS providers provide services in various fields such as accounting and marketing, assistance for export procedures, and training programs. More than 14,000 BDS providers are registered on the web portal operated by the Small Industries Development Bank of India (SIDBI). In Sri Lanka, it is reported that there are between 300 and 500 BDS providers nationwide. They are generally classified into government-managed providers, private providers, and NGOs. There are no significant differences in the types of services provided, but the fees and quality levels vary significantly.

Next, when we look at the overall situation of these three countries regarding the relationship between BDS and end user companies in two-step loan projects, it cannot be said that the end user companies have been utilizing BDS frequently but the end users who ever used BDS replied that the BDS were effective. In addition, end users, including those that had not used BDS, expressed an interest in using it from now on. Although there are a certain number of BDS providers in Vietnam, only one company out of 50 replied that it contacted a (private) BDS provider to receive advice on business in the questionnaire survey. BDS was not essential for the development of vast majority of end users. There are, however, quite a few end users

[25] For the purpose of this detailed analysis, BDSs were defined as follows. In principle, BDSs are services which help companies to grow and become competitive. They include training, consulting, marketing assistance, information provision, legal and accounting services, technical development and dissemination. However, they do not include financial assistance ("The Follow-up Study Report for Projects in Mining and Manufacturing Industries" [Japan International Cooperation Agency, August 2003], p. 87).

[26] In interviews, many stakeholders stated that the content of seminars and consulting provided by government-managed agencies, trade associations and business organizations is very basic and not practical. On the contrary, private BDS providers seem to have many MBA holders and deliver services that meet the international standards.

which are interested in the use of BDS in the future. In India as well, except for the services of daily administration such as accounting and tax reporting, the use of BDS for the purpose of business improvement is limited.(Eight companies out of 45 replied that they used BDS.) The fact that micro, small and medium enterprises (MSMEs) do not know the existence of BDS and how to access BDS providers is a major obstacle to BDS utilization. Meanwhile, more than a half of the end users who did not use BDS are interested in the future use of BDS. In Sri Lanka, the questionnaire survey confirmed that the use of BDS by end users is limited and only 3 companies out of 50 used BDS. A major problem is that MSMEs are not familiar with what a BDS is and how they can access it. However, many end users want to use BDS when their business becomes stable.

Although JICA implemented relevant projects for supporting BDS providers in Vietnam and Sri Lanka, these projects did not create any particular synergistic effect with the two-step loan projects. The reason is that the projects were conducted separately and no joint activities between them were organized. In India, such relevant project for supporting BDS providers has not been implemented by JICA.

Accordingly, the two-step loan projects have realized a certain level of effect even without BDS, as confirmed by the individual ex-post project evaluations. However, it does not mean that MSMEs in all three countries have no need for BDS. It is still possible that, in the future, MSMEs will actively utilize BDS to enhance the quality of their businesses. The following three factors should be regarded as basically common in all three countries: (1) MSMEs have needs for BDS after growing to a certain level; (2) it is confirmed that utilizing BDS has provided a certain level of effect; and (3) matching between MSMEs with needs for BDS and BDS providers is not sufficient but can be improved, because companies are interested in the use of BDS.

**2. Macro Policies and Two-Step Loan Projects**

The two-step loans carried out in the three subject projects have not provided any ripple effects in the governmental policies of India or Sri Lanka; this was confirmed by the interviews with officials responsible for financial policies. Nor do they seem to have provided any clear effects in the policies of Vietnam. However, according to officials of Vietnam's Ministry of Finance and Ministry of Planning and Investment, the success in JICA's two-step loan projects in the country appears to have had a certain amount of influence on the recently announced plan of “SMEs (Small and medium-sized enterprises) Development Funds”.

In all three countries, we were unable to confirm any particular effect such as increased financing to MSMEs by financial institutions which did not participate in the two-step loan projects. Financing by the two-step loan projects is not remarkably different to existing schemes of private financial institutions for financing companies except for the fact that financing in India was limited to investment in the procurement of energy-saving equipment. On the other hand, there are advantages to the two-step loan projects such as having relatively low interest rates for Vietnam and India, and a longer repayment period in Sri Lanka.

**3. Beneficial Effects to Local Japanese-Affiliated Companies of Two-Step Loan Projects**

In Sri Lanka, there is no local Japanese-affiliated company in the end users' supply chain. We confirmed the presence of a few local Japanese-affiliated companies in the end user companies' supply chain in Vietnam and India by conducting questionnaire surveys to end users, but it is very rare that local Japanese-affiliated companies are customers of end users. In conclusion, we were unable to fully confirm benefits for Japanese-affiliated companies by the two-step loan projects.

**Comparison of the Original and Actual Scope of the Project**

| Item | Original | Actual |
|---|---|---|
| 1. Project Outputs | | |
| A) General loans | | |
| a. Loan scheme | Two-step loan | As planned |
| b. Loan terms | | |
| • Interest rate | About 8-9%, maximum of 9% | 9% |
| • Repayment period | Not exceeding 10 years (grace period: 2 years) | As planned |
| • Maximum loan amount | 10 million rupees (maximum 75% of project cost) | As planned |
| c. Target beneficiaries | Companies with fixed assets after the loan (excluding land and buildings) of 20 million rupees or less | As planned |
| d. Target sectors | Manufacturing and service industries. Priority given to loans conducive to export promotion and job creation | As planned |
| e. Target business | Business in which the loan would be conducive to qualitative and quantitative improvements in production capacity, improvements in operational capacity, or better added value to products (services) | As planned |
| f. Target items | Funds for the purchase of fixed assets such as buildings and materials, funds for the purchase of vehicles, and long-term working capital (not including funds for acquiring land or commercial buildings for rent out purposes) | As planned |
| g. Maximum loan amount | 10 million rupees. 25% of project cost borne by end users | As planned |
| B) Technical transfer loans | | |
| a. Loan scheme | Two-step loan | As planned |
| b. Loan terms | | |
| • Interest rate | About 8-9%, maximum of 9% | 2% |
| • Repayment period | Not exceeding 10 years (grace period: 2 years) | Not exceeding 7 years (grace period: 2 years) |
| • Maximum loan | Less than 2.7 million rupees. 25% | Maximum amount was as |

| | | |
|---|---|---|
| amount<br>c. Target beneficiaries<br><br>d. Target items | of project cost borne by end users.<br>End users of current of future general loans<br>Costs for management, financial and technical training, costs for employing consultants, and costs for purchasing quality-control equipment | planned. No burden to end users.<br>As planned<br><br>As planned |
| 2. Project Period | December 2004 – December 2010 (72 months) | As planned |
| 3. Project Cost<br>Foreign currency<br>Local currency<br><br>Total<br>Japanese ODA loan portion<br>Exchange rate | <br>0 million yen<br>9,619 million yen<br>(7,820 million rupees)<br>9,619 million yen<br>9,619 million yen<br><br>1 rupee = 1.23 yen<br>(as of October 2003) | <br>0 million yen<br>9,612 million yen<br>(9,603 million rupees)<br>9,612 million yen<br>9,612 million yen<br><br>1 rupee = 0.99 yen<br>(average between December 2004 and October 2010) |