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Sri Lanka

Small & Micro Industries Leader & Entrepreneur Promotion Project (I) (II)

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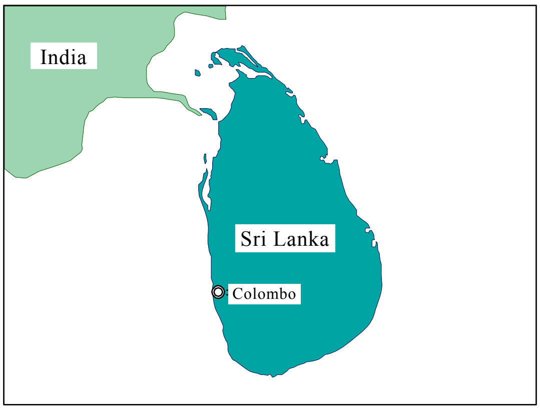
Field Survey: January 2008

1. Project's Profile and Japan's ODA Loan



Map of the project area
(Entire Sri Lanka)

One beneficiary company
(Sewing factory)

1.1 Background

Sri Lanka is an island country located 30 km south of India. With a total area of approximately 66,000 km^2, it is 0.8 times the size of Hokkaido, and has a population of about 19.8 million (as of 2006), or around 16% of the population of Japan. Since its independence in 1948, such as tea, rubber, coconut grown on state-run plantations and rice cultivation for self-sufficiency have been Sri Lanka's principal industries. However, in 1977, the government adopted a policy of liberalizing the economy and as a result, labor-intensive manufacturing and service sectors such as foods/beverages and textiles/apparel began to replace these traditional agricultural products as the most important industries in Sri Lanka. In 1988, the government implemented structural adjustment policies, and in the 1990s, civil order was restored in Sri Lanka (except in the north and east). Thanks to these and other developments, the economy led by the private sector began to grow in a relatively stable manner.

In 1997, in Sri Lanka, there were about 25,000 small and medium-sized enterprises (SMEs) and more than 100,000 micro enterprises, ranging from those in the industrial sector, which made up about 20% of all businesses, to those in the service sector. SMEs and micro enterprises employed 70% of all workers in the private industrial sector and accounted for 55% of its added value. Thus, from the viewpoints of job creation and enhancement of regional industrial infrastructure, high expectations were placed on the development of these businesses. On the other hand, many SMEs and micro enterprises were faced with a host of problems regarding their finance, management and technical capabilities. Particularly acute were the problems of the shortage of medium-to-long-term funds including capital investment and long-term operating capital and the high cost of raising funds.

1.2 Objective

The objective of this project is to improve the productivity, profitability and technical capabilities of SMEs and micro enterprises in Sri Lanka by providing them with financial assistance for business operation and technical transfer at low interest rates; thereby promoting job creation and contributing to balanced economic growth and poverty alleviation.

1.3 Borrower / Executing Agency

Government of the Democratic Socialist Republic of Sri Lanka /
National Development Bank of Sri Lanka (NDB)

1.4 Outline of Loan Agreement

	Small & Micro Industries Leader & Entrepreneur Promotion Project (I)	Small & Micro Industries Leader & Entrepreneur Promotion Project (II)
Loan Amount / Loan Disbursed Amount	5,432 million yen / 5,410 million yen	4,838 million yen / 4,492 million yen
Exchange of Notes / Loan Agreement	June 1997 / August 1997	November 2000 / January 2001
Terms and Conditions - Interest Rate - Repayment Period (Grace Period) - Procurement	 2.3% 30 years (10 years) General untied	 2.2% 30 years (10 years) General untied
Date of (Disbursement) Completion	October 2001	March 2006
Main Contractors	—	—
Consulting Services	—	—
Feasibility Study (F/S), etc.	—	—

2. Evaluation Results (rating: A)

2.1 Relevance (rating: a)

2.1.1. Relevance at the time of appraisal

In the New Industrial Strategy that the Ministry of Industrial Development announced in 1995 against the background of a high unemployment rate, the creation of jobs and earning opportunities was considered to be the main objective of industrialization, and regional industrial expansion, export-oriented industrialization and diversification were targeted. SMEs and micro enterprises were expected to play an important role as leaders in the creation of jobs through the process of regional industrialization. On the other hand, despite the growing need to support SMEs and micro enterprises in their efforts to raise funds, manage their businesses, and develop technical capabilities, the low-interest rate loan project that the World Bank (WB) and the Asian Development Bank (ADB) had carried out over the previous 15 years for SMEs came to an end in 1996.[1] Consequently, there was a need for the continuation of a similar low-interest rate loan project, and the project was thus given high priority at the time of appraisal.

2.1.2 Relevance at the time of evaluation

In the 2002 white paper on SMEs, procuring funds was considered the most important of all the issues faced by SMEs. Consequently, the need for institutional financing, such as funds provided under this project, was keenly felt, and in fact the need for financial and technical support for SMEs and micro enterprises came to be felt even more acutely than at the time of appraisal.[2] Additionally, in the joint WB-ADB investment climate survey conducted in 2004, it was pointed out that access to medium-to-long-term financing was the biggest factor constraining the growth of SMEs.

Furthermore, in its policy summary, the current government (which came to power in 2005) places Sri Lanka's SMEs and micro enterprises as the "nerve center" of the nation's economic development, and cites expansion of financial access as one of the measures that the government should take. As can be seen in the project's performance in Phase III, the demand of SMEs and micro enterprises for medium-to-long-term financing was very high, so the relevance of this project at the time of the ex-post evaluation was high.

To sum up, implementation of this project was consistent with the national development plan both at the time of appraisal and ex-post evaluation. Furthermore, since the financial demand of SMEs and micro enterprises is high, the project's relevance is extremely high.

2.2 Effectiveness (rating: a)

2.2.1 Output

(1) Loan scheme and financial condition

In this project, two types of loan scheme were adopted; one is a "general loan" and the other is a "technical transfer loan". In both cases, loans were made to SMEs and micro

[1] Small and Medium Industry Project

[2] Other issues faced by SMEs include infrastructure development, the legal system, access to information and advice, links with the market, and management development services.

enterprises (sub-loan), the end users, through 11 participating credit institutions (PCIs),[3] and these institutions received refinancing from the National Development Bank (NDB), the project's executing agency. The summary of the sub-loan schemes and their sub-loan terms are described below, and both were implemented as planned at the time of appraisal. However, because the Development Finance Corporation of Ceylon (DFCC), which took part in the project as one of the PCIs, was a government-funded credit institution similar to NDB, it was determined that DFCC should receive the same treatment as NDB. Consequently, DFCC received a sublease (from the Sri Lankan government via NDB) under the same conditions as those under which NDB received its sublease from the government. Both NDB and DFCC themselves became PCIs and made loans to end users.

By and large, NDB, as the executing agency, performed the operation and maintenance of the project in a satisfactory manner. In particular, PCIs highly praised the fact that loans were approved on average in a fairly short time of three weeks, and, in addition to NDB's high level of competence, PCIs pointed out that NDB communicated and coordinated operations smoothly with PCIs. However, in Phase I, because there was a lack of understanding between NDB and PCIs regarding the amount of funds that were still available for use, some sub-loans that PCIs had promised to make to clients had to be canceled due to lack of funding. In order to prevent loss of their creditability and clients, a number of PCIs began making sub-loans similar to those made under this project with their own funds.

[3] The 11 PCIs were: National Development Bank (NDB), Development Finance Corporation of Ceylon (DFCC), Bank of Ceylon, People's Bank, Commercial Bank of Ceylon, Seylan Bank, Hatton National Bank, Sampath Bank, Regional Rural Development Bank-Kurunegala, Regional Rural Development Bank-Kegalle, Regional Rural Development Bank-Kandy

Figure 1: Loan Scheme of the SMEs & Micro Industries Leader and Entrepreneur Promotion Project

General Loan (Low-interest loans for small enterprises for business operation)	Technical Transfer Loan (Low interest and interest free loans for small enterprises for technical training, consulting, quality control equipment)
JBIC	**JBIC**
↓ Interest: Phase I: 2.3%, Phase II: 2.2%	↓ Interest Phase I: 2.3%, Phase II: 2.2%
↓ Loan period: 30 years (grace period: 10 years)	↓ Loan period: 30 years (grace period: 10 years)
Sri Lankan Government	**Sri Lankan Government**
↓ Interest: 5.3%, loan period: 15 years (grace period: 10 years)	↓ Interest: 0%, loan period: 7 years (grace period: 10 years)
National Development Bank (NDB)	↓ Phase I: 100% sublease
↓ Interest: 6.3%	↓ Phase II: 75% sublease, 25% grant to beneficiaries
↓ Loan period: Same as PCIs' loan period to beneficiaries	**National Development Bank (NDB)**
↓ Loan ceiling: 70% of the amount of the loan PCIs makes to beneficiaries	↓ Interest: Phase I: 0%, Phase II: 1%
	↓ Loan period: 7 years (grace period: 2 years)
Participating Credit Institutions (PCIs)	**Participating Credit Institutions (PCIs)**
↓ Interest: 12.3–14% (decided by PCIs)	↓ Interest: Phase I: 0%, Phase II: 3.0%
↓ Loan period: within 10 years (grace period: within 2 years)	↓ Loan period: 7 years (grace period: 2 years)
↓ Loan ceiling (upper limit: 75% of the project cost):	↓ Loan ceiling:
↓ Phase I: 5 million rupees, Phase II: 7 million rupees	↓ Phase I: 100% of the project cost, with the following limits
	↓ Training & consulting: 10,000 dollars
	↓ Quality control equipment: 20,000 dollars
	↓ Phase II: 75% of the project cost (grant: 25%)
End user (SMEs and micro enterprises)	**End user (SMEs and micro enterprises)**

(2) Actual loan

Table 1 shows the number of sub-projects and the total loan amount actually disbursed. For the general loan in Phase I, the interest rate was set at a lower rate than the market, so that demand increased and more sub-loans were disbursed than planned. Nearly the entire amount of sub-loans available under this project was disbursed by 2000. In Phase II, approval of nearly the entire amount of sub-loans available under this project was completed within 12 months after the project was launched, and by 2002, more than 80% was disbursed. Subsequently, since the market interest rate from 2003 to 2004 dipped below the interest rate adopted under this project (annual interest rate of 12.3–14%), sub-loans that had been approved were cancelled one after another. After that, in 2005, Phase III was launched in which loans were disbursed at low interest rates (upper limit on annual interest rates set at 9%) based on the lower market rates that prevailed at the time. As a result, Phase II was completed with a disbursement rate of 89%.

At the time of appraisal, sub-loans were supposed to be disbursed over a period of five years in Phase I and three years in Phase II, but in both phases, about 85% of the available sub-loans were disbursed in two years.

In both Phase I and Phase II, the technical transfer loan was not used very much, and the loans actually disbursed were less than 15% of the amount that was planned at the time of appraisal. Since only a few enterprises used the technical transfer loan in Phase I, in Phase II, to lessen the burden on the beneficiary companies, some of the loans were made as grant in aid, and to give incentive to PCIs, the interest rate on the loans was raised to 3%. Despite these efforts, the usage rate remained low. In an interview conducted among the executing agency, PCIs and beneficiary companies, the following were cited as reasons why the technical transfer loan was not used very much.

Figure 2: Amount of Annual Refinancing of General Loans by NDB

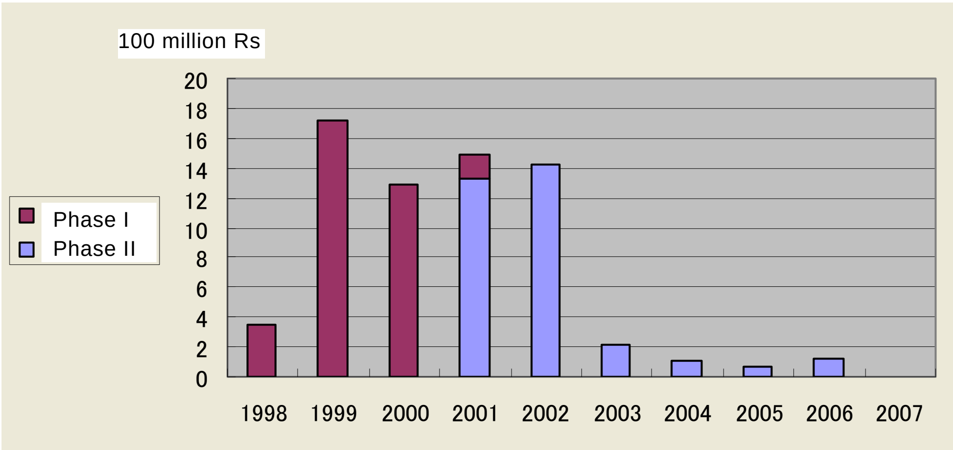


Table 1: Number of Sub-Projects and Total Loan Amount

	No. of Sub-Projects	Total Loan Amount		
		Planned (100 million yen)	Actual (100 million yen)	Planned/Actual Ratio
General Loan				
Phase I	5,757	52.0	53.9	104%
Phase II	3,878	46.0	42.3	92%
Total	9,635	98.0	96.2	98%
Technical Transfer Loan				
Phase I	26	2.4	0.15	6%
Phase II	61	2.3	0.54	23%
Total	87	4.7	0.69	15%
General Loan + Technical Transfer Loan				
Phase I	-	54.4	54.1	99%
Phase II	-	48.3	42.8	89%
Total	9,635	102.7	96.9	94%

Source: NDB Project Completion Report

*Actual total loan amount in this table is different from loan disbursed amount by JBIC. It is because of a loss from the difference of quotations.

- Training courses in which SMEs and micro enterprises usually participate cost only about 20,000–30,000 rupees (about 250–350 dollars), or only 1/30–1/40 of the upper limit for a technical transfer loan (10,000 dollars for training and consulting). Given the procedure cost, targets for the technical transfer loan are hard to find. It can be said that the conditions for receiving the technical transfer loan under this project were more appropriate for enterprises larger than those for receiving the general loan.

- In Phase I, PCIs did not fully understand the scheme of the technical transfer loan.[4]
- In Phase I, since the technical transfer loan was provided interest-free, there was no profit margin for the PCIs. Consequently, the latter were reluctant to take it up, and because the approval process was strict and the procedure was bothersome, the PCIs and the clients avoided it.[5] (In Phase II, the interest rate was set at 3%.)
- There were not enough advertisements and publicity campaigns targeting client companies[6].
- In Phase I, group training, which was used heavily in previous projects, could not be used.[7]

In order to promote the technical transfer loan in Phase II, the executing agency endeavored to approach the Sri Lanka Standard Institute, the Industrial Technology Institute, and the National Engineering & Research Development Center. Thanks to these efforts, the technical transfer loan amount disbursed in Phase II exceeded the amount disbursed in Phase I.

(3) Characteristics of sub-projects

(a) Scale of beneficiary companies

In keeping with the idea that beneficiaries under this project (which makes sub-loans at interest rates lower than those of the market) should be limited to the smaller of SMEs,

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[4] The technical transfer loan is provided to help cover the cost of procuring quality control equipment (testing equipment) as well as conducting training courses and hiring consultants in technical, managerial and financial aspects. Although the objective of the technical transfer loan is clearly stated in the manual the executing agency distributed, staff members of nearly all of the PCIs understood the objective of the technical transfer loan to be limited to support for development of techniques for production and quality control, so that hardly no one used this loan for receiving technical services in business management and finance. It can be pointed out that the term “technical transfer” may have deepened the misunderstanding.

[5] The technical transfer loan is highly concessionary, and so in order to prevent misappropriation of funds, the executing agency carried out a rather thorough screening based on reliable documentation.

[6] Although the executing agency endeavored to spread knowledge about the technical transfer loan by preparing a pamphlet and providing training for PCIs, according to a sample survey of companies that benefited from the general loan, 90% of the client companies were not aware of the existence of the technical transfer loan.

[7] In previous projects supported by WB and ADB, group training was conducted targeting a plurality of client companies of PCIs, which encouraged the companies to participate in training. However, the technical transfer loan under this project was structured to provide loans to individual business proprietors, not for activities conducted by multiple business proprietors or PCIs. Thus, group training could not be conducted under this project.

the amount of fixed assets (after the loan, excluding land and buildings) of the companies eligible for the general loan was set below 10 million rupees in Phase I and below 14 million rupees in Phase II.[8]

Table 2: Distribution of Beneficiary Companies by Number of Employees

	Fewer than 10 employees	10–49 employees	50 or more employees
Phase I	95%	4%	1%
Phase II	88%	10%	1%

Table 3: Distribution of Beneficiary Companies by Asset Value

	Less than 2 million rupees	2–5 million rupees	More than 5 million rupees
Phase I	64%	20%	16%
Phase II	51%	22%	27%

According to the results of the sample survey,[9] in Phase I, 7.3 years was the average age of the beneficiary companies and the average number of employees was 8.9. The average value of fixed assets without land and buildings was 5.25 million rupees, and about 70% of these companies were believed to be micro enterprises.[10] In Phase II, as can be seen in Tables 2 and 3, in terms of the average number of employees and amount of fixed assets, the percentage of large enterprises was higher in Phase II than in Phase I, while the percentage of micro enterprises was estimated to be slightly smaller.

The fact that eligibility conditions were expanded can be cited as one reason why large enterprises received more loans in Phase I than in Phase II.[11]

(b) Scale and use of the loan

Capped at 75% of the project cost, the sub-loan ceiling for companies was set at 5 million rupees in Phase I and 7 million rupees in Phase II. The average sub-loan disbursed in Phase I was 890,000 rupees, while in Phase II, it was 990,000 rupees. However, if the rise in prices is taken into consideration, the average sub-loan disbursed in Phase II decreased by about 12% from the average sub-loan disbursed in Phase I. In Phase I,

[8] At the time of Phase I appraisal, in Sri Lanka, companies with fixed assets (excluding land and buildings) worth less than 20 million rupees were classified as SMEs. Additionally, in Phase II, taking the rise in prices into consideration, this base amount was raised.

[9] In 2004, a sample survey of 307 beneficiary companies in Phase I was conducted. In 2006, a sample survey of 54 beneficiary companies in Phase II was conducted.

[10] In the 2002 white paper on SMEs, companies with fixed assets of 1 million rupees or less (excluding land and buildings) were classified as micro enterprises. Aside from this, in terms of industry statistics, companies with five or fewer employees were classified as micro enterprises.

[11] Although in Phase II the eligibility conditions were 40% more lenient than in Phase I, prices rose by 26% in this period (1998–2001); thus, in reality the eligibility conditions were expanded by 11%.

although 48% of the total amount of the sub-loan was to be paid back during the loan period of 5–10 years, in Phase II, 83% was to be repaid during the same loan period. None of the sub-loans made in either Phase I or Phase II were to be repaid within two years. Actually, there were sub-loans that were repaid before the time limit for the repayment date. Thus, it may be feasible to shorten the loan period.

With regard to use of the loan, the sample survey conducted in Phase I found that about one-third of all sub-loans were used to purchase real estate, another third were used to make capital investments, and the remaining third were used to make other initial investments or to cover running costs.

(c) Distribution of the sub-loan by sector and by area

As shown in Figure 3, this project covered a wide range of 18 sectors. Given the number and scale of companies participating in the project, nearly 40% of the beneficiary companies were in commerce and transport services such as shops and restaurants, auto repair, car leasing, as well as passenger and freight transport. Another 40% or so were in manufacturing including food processing, beverages, tobacco, metal and wood processing, garments and apparel. And the remaining 20% were divided more or less evenly between construction and construction materials on the one hand, and stockbreeding, gardening, fish farming and fisheries on the other. Sri Lanka's GDP composition (as of 2003) was 20% agriculture, 26% industry and 54% service. It can therefore be said that a disproportionate amount of sub-loans were made to companies in the secondary industry.

Figure 4 compares the provincial distribution of the number of sub-projects and sub-loan amount with the provincial distribution of GDP. While 30 to 40% of the sub-loans were concentrated in Western Province, which accounts for half of Sri Lanka's GDP, in other provinces, such as North Western, Southern and North Central Provinces, there were a disproportionate number of sub-projects when compared with their respective GDP. All in all, the regional distribution of the sub-loan under this project contributed somewhat to the promotion of regional industrialization.

Figure 3: Distribution by Sector of the Sub-Projects Number and Loan Amount

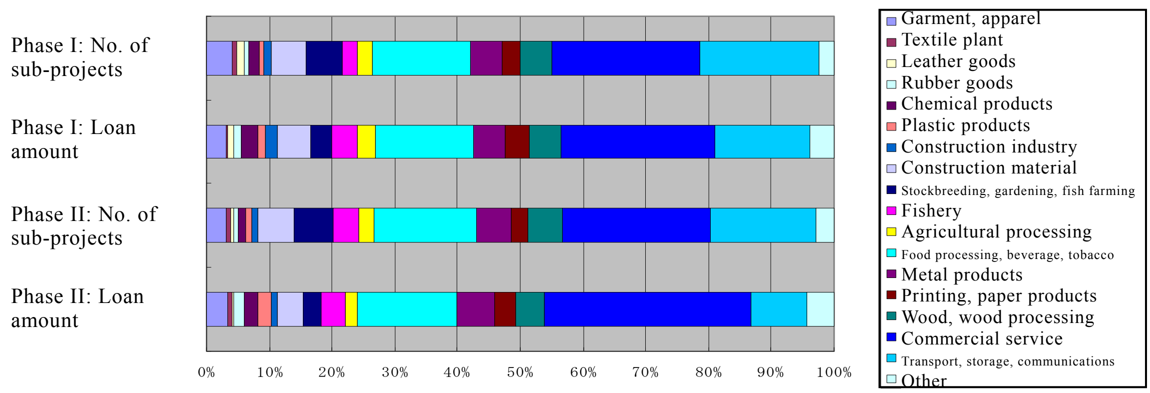
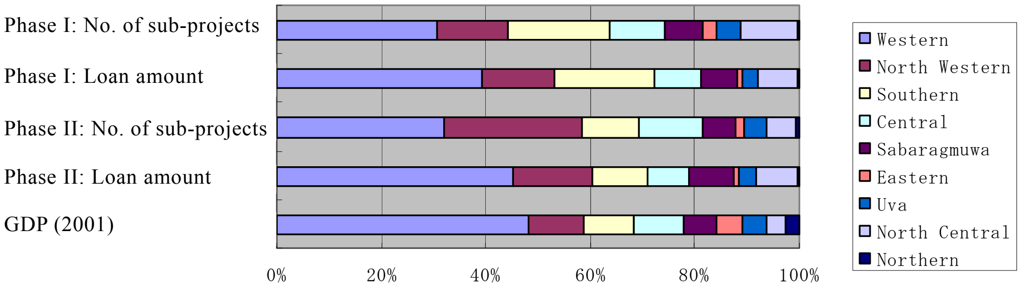


Figure 4: Comparison of the Provincial Distribution of Sub-Project Number and Loan Amount with the Provincial Distribution of GDP



2.2.2 Project period

The implementation of the project was completed in November 2002 in Phase I and in March 2006 in Phase II. This was according to the original plan to set the deadline for implementing the loan within five years from the time the loan agreement came into force.

2.2.3 Project cost

In Phase I, a total of 5.41 billion yen worth of loans was actually disbursed or 99% of the 5.44 billion yen that was originally planned. In Phase II, 4.28 billion yen worth of loans was actually disbursed or 88% of the 4.83 billion yen that was originally planned. As discussed earlier, in both Phase I and Phase II, the amount of technical transfer loan actually disbursed was substantially less than what was planned. The excess funds were allocated for the disbursement of the general loan. The total amount of loans actually disbursed for general and technical transfer loans in Phase I and Phase II was 9.69 billion yen, or 94% of the 10.27 billion yen that was originally planned.

To sum up, in this project, the amount refinanced was nearly equivalent to the planned amount of refinancing, and both the project period and cost were within the planned period and cost. Thus, the project is judged to have been implemented effectively.

2.3 Effectiveness (rating: a)

2.3.1 Improvement in productivity and profitability

In the sample survey, 68% of the companies surveyed said that their production and sales total increased more than 20% as a result of the investments made under this project.[12] Compare to before and after the project, the overall production and sales total

[12] The sample survey for Phase I was conducted in November 2004 on 307 companies to which researchers were dispatched to conduct interviews. The sample survey for Phase II was conducted in May 2006 on 54

increased on average by about 50%. The main effects of the sub-projects: 82% of the beneficiary companies said that their “production and sales total increased,” and 78% of the same said that their “production capacity increased.”

As a result of the investments made under this project, about one third of companies raised their labor productivity by 20% or more. As a whole, labor productivity appears to have risen by about 20%. 25% of the companies said that their “production cost decreased” as a result of the investments made under this project.

No data were available to directly measure profitability. However, since profitability will inevitably improve if production increases and productivity improves, in Phase I, at least around 30% of the companies that realized both increased production and improved productivity, and in Phase II, around at least 40% of the companies that realized both are presumed to have improved their profitability

Thus, as a result of increased production capacity, productivity and so on, during the 4–6 years after the investments were made under this project, about 70% of the companies made some sort of reinvestment, more than 20% of the companies made investments that were larger in scale than those they made under this project.

2.3.2 Improvement in technical and management capabilities

In the sample survey, 55% of the companies said, “We improved the quality of our products as a result of the loan project”, 41% said, “We introduced new products and services” after receiving the loan under this project. In addition, 35% of the companies keep an annual accounting record, while 45% keep a simple accounting record, but 20% do not keep any accounting records.

In Phase I, only 6% of beneficiary companies made use of some form of training or consulting services, and only 8% employed an accountant. Only 1 out of 307 companies sampled in the survey made use of the technical transfer loan to obtain a high level quality control standard such as ISO and SLS (Sri Lankan Standard). Additionally, not a single case was reported where a company used the technical transfer loan for the improvement of economic or financial management. Judging from the total number of sub-projects implemented, only 1% of the companies that benefited from the general loan made use of the technical transfer loan.

In summary, although it is judged that nearly half of the companies improved their technical capabilities as a result of the investments they made under this project, hardly

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companies to which questionnaires were sent and researchers were dispatched to conduct interviews. The questionnaire used for the Phase II survey was prepared by revising the one used for the Phase I survey, but the items included in the two questionnaires are not necessarily the same. In this ex-post evaluation, the results of these surveys, which were conducted by JBIC, are carefully examined and, within a reasonable scope and wherever possible, presented as an integrated whole.

any of this improvement was contributed to by the technical transfer loan. Moreover, while the level of financial management capability among beneficiary companies is generally low, it is quite unlikely that they strengthened this capability by participating in this project.

2.3.3 Degree of success of sub-projects

According to the judgment of researchers who conducted the sample survey for Phase I, 46% of the 307 companies that were surveyed achieved a degree of success that exceeded their expectations, 35% more or less achieved their goals. On the other hand, 11% failed to achieve their goals, and the corporate performance of 8% of companies actually decreased. And yet, 90% of business proprietors believe that they benefited from receiving loans under this project. Additionally, companies where the loan project succeeded had the following characteristics: they were older, had more collective assets, and had previous experience obtaining funds from banks. Moreover, expanded projects have a better chance of success than do new projects.

In the sample survey for Phase II, all of the 54 companies that were surveyed succeeded in improving their business performance, and 85% proceeded to make reinvestments after the initial investment. Moreover, 30% of proprietors of beneficiary companies were confident that they would be able to improve their performance going forward, and 60% were optimistic about the future.

The success or failure of sub-projects is reflected in the repayment performance. Given the proportion of sub-loans with arrears and non-performing loans five years after the commencement of the loan, it can be seen that there were fewer problems regarding repayment in Phase II than in Phase I. In either case, the percentage of non-performing loans is low, ranging from 2–6%.

Table 4: Ratio of Sub-Loans with Arrears and Non-Performing Loans
Five Years after the Commencement of the Loan

(Loan commencement) Five years after loan commencement	Phase I (April 1998) End of 2002	Phase II (May 2001) End of 2005
Ratio of sub-projects with arrears	9.0%	1.5%
Ratio of outstanding loans in sub-projects with arrears	8.6%	1.4%
Ratio of non-performing sub-projects	2.5%	1.6%
Ratio of outstanding loans in non-performing sub-projects	6.1%	2.2%

Note: Ratios are all in relation to the total number of sub-projects or total loan amount.
Non-performing sub-projects: Sub-projects with arrears for more than 6 months

All things considered from the above discussion, it can be judged that, overall, about 90% of the sub-projects were successful. Moreover, the following two factors may be cited as reasons why Phase II was more successful than Phase I: (1) the sub-projects implemented in Phase I were impacted by the economic downturn of Asia from 2001–2002;[13] (2) the amount of sub-loans disbursed in Phase II was smaller than the amount disbursed in Phase I, so there was less risk accompanying the loans in Phase II than in Phase I.

2.3.4 Summary of the effectiveness of the project

From the foregoing, it can be seen that nearly one-third of the beneficiary companies improved their productivity and profitability, virtually 70% reinvested after the initial disbursements, roughly half of the beneficiary companies improved their technical capabilities (however, this was not contributed to by the technical transfer loan), and about 90% of the sub-projects were successful. From these assessments, it is believed that this project has been highly effective.

2.4 Impact

2.4.1 Job creation

The 9,300 companies that received loans for their sub-projects were the direct beneficiaries of this project.[14] These companies are thought to represent about 30% of all SMEs and micro enterprises registered in Sri Lanka, and an estimated 150,000 employees, including the newly hired employees described below, are now working in these companies.

At the time of appraisal, 30,000–35,000 jobs in Phase I and 13,600 jobs in Phase II were expected to be created, for a total of 43,600–48,600 new jobs.[15] Additionally, adding up the data contained in the project plan each beneficiary company prepared when it applied for the loan reveals that the loan project planned to create 15,000 new jobs in Phase I and 19,000 in Phase II, for a total of 34,000 new jobs.

According to an estimate made on the basis of the sample surveys conducted in this project,[16] it is believed that a total of approximately 40,000 new jobs were created in Phase I and Phase II combined. This represents 80–90% of the number planned at the time of appraisal, but is equivalent to only 0.6% of the number of employees in Sri Lanka as a whole. The ratio of male to female in the new jobs is 2:1 in favor of males.

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[13] In Sri Lanka as a whole, both the manufacturing sector and the service sector recorded negative growth in 2001, and in 2002, the manufacturing sector experienced a low 1% growth rate. The service sector retained its growth at an annual growth rate of 5–8% in 2002, while the manufacturing sector resumed growth in the same 5–8% range in 2003.

[14] A little less than 10% of the beneficiary companies of Phase II are believed to be the same as those companies that also received benefits in Phase I.

[15] The target value for job creation in Phase II was established on the basis of the actual value of the project proposals the beneficiary companies prepared in Phase I.

[16] This estimate was made on the basis of the results of the sample survey. It assumed that 4.5 people would be hired for every 1 million rupees loaned to a company.

2.4.2 Export increase

According to the sample survey, 17% of beneficiary companies export part or all of what they produce. In terms of production and value of sales, 10% are exported. During the three-year period between before and after the sub-project, the value of exports increased by nearly 40%. A rough estimate based on these data reveals that, thanks to this project, beneficiary companies were able to increase the value of their exports by about 4 billion rupees per annum during the three years from 2003 to 2006. This is equivalent to roughly 0.7% of the total value of Sri Lanka's exports during the same three-year period.

2.4.3 Improvement of SMEs and micro enterprises' access to funds

As a result of this project, many of the PCIs were able to gain new clients among SMEs and micro enterprises, which, prior to the project, were not regarded as viable clients. Under this project, it is believed, many SMEs and micro enterprises were able to gain access to new medium-to-long-term loans. Additionally, according to the sample survey of beneficiary companies, for 53% of these companies, the loans they received under this project marked the first time they had ever received loans from a bank.

Of the 11 PCIs, eight have established and are operating their own loan programs targeting SMEs to complement the loan program set up by donors of this project and other projects. Two of those programs were launched directly as a result of this project. It is true that loans to SMEs and micro enterprises have been generally accepted and taken root in Sri Lanka's banking sector, and it can be said that aid projects like the one taken up in this ex-post evaluation have played a significant role in that process.

For SMEs and micro enterprises that this project targeted, raising funds for making medium-to-long-term investments is a major constraint in management.[17] It is believed that by contributing, directly and indirectly, to the improvement of access by SMEs and micro enterprises to loans, this project has played a vital role in promoting Sri Lanka's SMEs and micro enterprises.

2.4.4 Capacity building of PCIs

Through their involvement in this project, employees of PCIs accumulated a vast amount of experience regarding loan projects geared toward SMEs and micro enterprises. Hearings with PCIs revealed that at least three PCIs believe that theses experiences are the significant achievement of this project. Furthermore, it has been confirmed that the involvement in donor programs, including the involvement in this project, contributed to

[17] According to the sample survey, in this project, about 40% of the beneficiary companies regard "strengthening their competitiveness and cultivating new markets" as the main constraints they face in running their business, and another 35% or so regard "raising funds for expanding their production and production capacity" as their main constraint.

the capacity-building of credit institutions through, among other things, strengthening of their stance on making loans to SMEs and establishment of separate departments responsible for making loans to SMEs.

2.5 Sustainability (rating: a)

2.5.1 Loan repayment

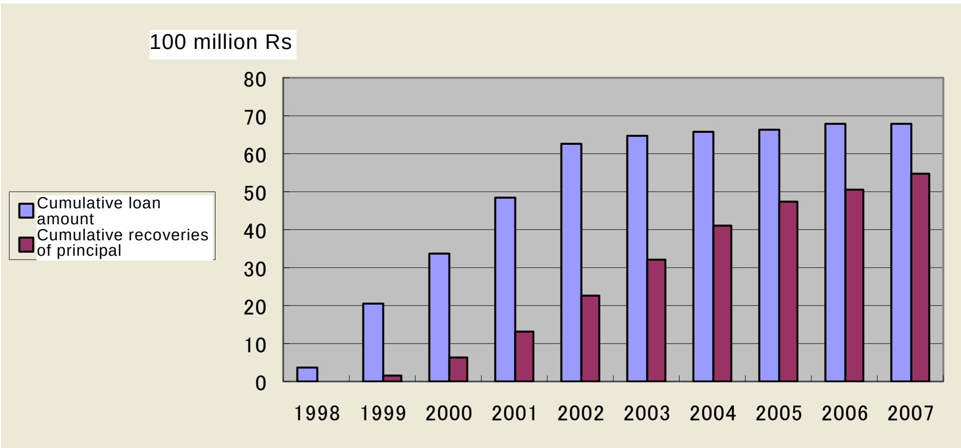
By the end of 2007, about 81% of the cumulative loan amount in Phase I and Phase II was collected (see Figure 5).

2.5.2 Use of revolving funds

This project planned to further increase the number of end users of its loans by investing, as revolving funds, funds that accumulate as a result of the differences that exist among the loan period of loans made to the Sri Lankan government (30 years), the loan period of those made to the executing agency of this project (15 years), and the loan period of sub-loans made to end users (maximum 10 years).

The revolving fund in NDB accrues by repayment from the PCIs other than DFCC. In DFCC, the revolving fund occurs by repayment from the end users. There have so far been 662 loans that use only the revolving fund in NDB in Phase I.[18]

Figure 5: Cumulative Loan Amount and Cumulative Recoveries of Principal (Phase I + Phase II)



Source: Questionnaire result from NDB

[18] The market interest rate in the second half of 2003 when the NDB began disbursement of the revolving funds in Phase I declined by about 5% compared to the rate in 1998–1999 when the project disbursed the loan in Phase I, which fell below the interest rate on loans made from the revolving fund. Consequently, disbursement of the revolving funds did not make much headway.

Table 5: Use of Revolving Funds

	Balance (at the end of 2006, Mil. Rs)	Disbursement (at the end of 2007)	
		No. of Loans	Disbursed amount (Mil. Rs.)
NDB			
Phase I	1,561.3	662	694.6
Phase II	1,798.7	0	0.0
DFCC			
Phase I	268.1	0	0.0
Phase II	605.1	0	0.0

In the Central Bank of Sri Lanka, the revolving fund in Phase I and Phase II accrues by repayment from NDB; however, it is just starting to be used.[19]

In the loan agreement concluded under this project, it was agreed that the loan interest rate for end-users on the revolving funds should be in the 12.3–14.0% range. However, additional disbursement of the revolving funds was suspended after the disbursement of the revolving fund in NDB in Phase I was launched due to the declining market interest rate since 2003 and the launch of Phase III, which led to the availability of loans at different interest rates under the same program. The disbursement of additional revolving funds was suspended because it took time to coordinate the views of the relevant agencies regarding the terms and conditions of the loan that would ensure their smooth disbursement. Since the consensus was reached among the stakeholders at the end of 2007, all of the revolving funds existing in the Central Bank of Sri Lanka, NDB and DFCC are expected to be disbursed during 2008.[20]

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[19] The balance amount of the revolving fund in the Central Bank of Sri Lanka was 1.232 billion rupees in Phase I and 510 million rupees in Phase II at the end of June 2006.

[20] In the Phase III project appraised in December 2003, the interest rate for end-users was set as low as 9%, which was lower than in Phase I and Phase II. Consequently it was anticipated that disbursement of the revolving fund in Phase I and Phase II would not progress much due to demand being concentrated on the Phase III fund. Given this concern, at the time of appraisal, both JBIC and the government of Sri Lanka agreed on applying the same terms and conditions to the entire revolving fund from Phase I through Phase III. However, NDB and DFCC did not participate in the agreement, and since they had maintained an operation policy independent of the government, NDB initiated disbursement of the revolving fund from Phase I under the same condition as the main fund as originally agreed at the time of the Phase I appraisal. Meanwhile, in DFCC, as the occurrence of the revolving fund had not been assumed at the time of appraisal, disbursement was not started without certain agreement of the disbursement itself.
In 2007, the loan fund for Phase III became depleted and more disbursement of the revolving fund was sought to meet the vital demand for funds; therefore, JBIC, the government of Sri Lanka, NDB and DFCC coordinated various opinions on the loan condition and reached a new agreement at the end of 2007. The revolving fund of Phase I that had already been started to be disbursed continued to be disbursed under the same condition as in the main project, and in the revolving fund of Phase II and those of Phase III, disbursement is slated to be started using a single interest rate that is pegged to the market interest rate, with the proviso that the interest rate for end users be reviewed once every sixth months.

Under the aforementioned agreement, a single interest rate pegged to the market was adopted, so that now smooth disbursement of the revolving funds can be expected. However, since the period for using the revolving funds was limited, delays in its commencement are believed to have led to reduction in the actual disbursement of the funds.

2.5.3 Executing agency

(a) Participating credit institutions (PCIs)

Except for Seylan Bank and People's Bank, the nine PCIs, including NDB, the executing agency, have achieved the criteria for the capital adequacy ratio (more than 10%) set by the Central Bank of Sri Lanka in 2006. Thus, financial sustainability is assured.

The capital adequacy ratio of Seylan Bank is 9.9%, which nearly satisfies the Central Bank of Sri Lanka's criteria. Indicators such as the deposit balance and the recurring profit and return rate tend to be improving. Thus, there is no reason to be concerned about the financial sustainability of Seylan Bank. Although the capital adequacy ratio of the People's Bank is only 5.0%, because the deposit balance and recurring profit have been increasing since 2001 and the nonperforming loan rate and return rate are also improving, there is no need to be anxious about its financial sustainability. What's more, since the People's Bank is a public-sector credit institution, it is assured of financial support from the government, should the need arise.

As for repayments of loans under this project, nearly all of the PCIs achieved a cumulative principal collection rate of 95% or higher in Phase I and Phase II.[21] And since the nonperforming rate remained at a low 5%, there is no problem in the financial sustainability of the PCIs.

(b) Beneficiary companies

According to the researchers who carried out the sample survey, half of the beneficiary companies in Phase I have so far realized steady and rapid growth, and believe that they have a good future. Furthermore, over 30% of the beneficiary companies have grown moderately but steadily, and expect to continue growing at a constant pace. In this way, going forward, over 80% of the companies expect to grow at a constant pace, and if one takes into account the fact that 60% of the companies reinvested within six years after the implementation of the project, it can be said that the sustainability of the loan project is generally satisfactory.

[21] Cumulative principal collection rate = (cumulative recoveries of principal) / (cumulative recoveries of principal + arrears of principal at the end of the period)

Given that 90% of the company owners in Phase II are optimistic about the future, and 85% of the companies made reinvestments after the initial investment, sustainability of the Phase II project can also be regarded as satisfactory.

To sum up, although disbursement of the revolving funds under this project was delayed, it can safely be said that this did not adversely affect the sustainability of the project.

3. Conclusion, Lessons Learned and Recommendations

3.1 Conclusion

From the foregoing, it can be said that this project is highly praiseworthy.

3.2 Lessons Learned

- It takes more than 10 years to implement the two-step loan, including the revolving funds. If the interest rate for end-users is fixed, depending on the fluctuation of the market rate, its relative advantage may change greatly. Also, if different fixed rates are offered in the same loan program, the demand will be concentrated on financial resources that are offered at lower interest rates, which risks undermining the efficient use of other financial resources. Periodic review and adjustment of the final interest rate linked to the market rate could avoid this situation.
- If part of the loan is used for training and technical services for SMEs and micro enterprises, the procedural cost for the clients should not be too large for the size of the required funds. Additionally, in order to promote the use of such funds, information dissemination, promotion and publicity activities for clients, coordination with providers of training and technical services are important. Additionally, in order to reduce the cost of procedure, rather than separating the general loan from the technical transfer loan, as is done in this project, it may be advisable to consider including training and technical services in the general loan.

3.3 Recommendations

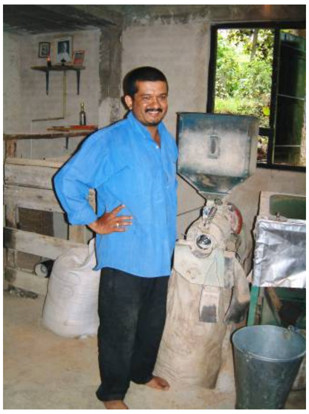
- Based on the agreement among JBIC, the government of Sri Lanka, NDB, and DFCC, disbursement of the revolving funds, which has yet to be started, should be started without delay.

Comparison of Original and Actual Scope

Item	Planned	Actual
(1) Output	Phase I: General loan: 5.2 billion yen Technical transfer loan: 240 million yen Phase II: General loan: 4.6 billion yen Technical transfer loan: 230 million yen	Phase I: General loan: 5,757 sub-projects 5.39 billion yen Technical transfer loan: 26 sub-projects 15 million yen Phase II: end of October 2004 General loan: 3,878 sub-projects 4.23 billion yen Technical transfer loan: 61 sub-projects 54 million yen
(2) Project Period	Phase I: August 1997–July 2002 (60 months) Phase II: January 2001–December 2005 (60 months)	Phase I: August 1997–November 2002 (64 months) Phase II: January 2001–Mach 2006 (63 months)
(3) Project Cost Exchange rate	 Phase I: 5,432 million yen Phase II: 4,838 million yen Phase I: 1 rupee = 2.14 yen (at time of appraisal) Phase II: 1 rupee = 1.44 yen (at time of appraisal)	 Phase I: 5,410 million yen Phase II: 4,492 million yen Phase I: 1 rupee = 1.54 yen (1997–2002 average) Phase II: 1 rupee = 1.31 yen (2001–2006 average)

Examples of Beneficiary Companies

Name of company: Muhandiram Ralalagr Priv Mirihalla (Sole proprietorship, rice milling and flour-milling business)
Location: Kandy, Central Province
Loan project:
Objective: Purchase of a rice milling machine and chili milling machine for expansion of flour-milling business
PCI: People's Bank Approval: September 1998 Loan amount: 150,000 Rs
Loan conditions: Interest rate 12%, repayment 60 months, no grace period



In 1990, the owner of the company built a rice mill next to his home and launched a flour-milling business. Prior to this project, he had received loans on two occasions totaling 100,000 rupees. At first, he had one rice milling machine. Since then, in 1992, he began using a stone remover. His earnings hovered around 200 rupees per day.

He received a loan under this project to install a rice milling machine, a chili milling machine, and a rice polisher. His earnings increased to about 700 rupees per day. Using the loan to buy the three machines was a resounding success. He operates the company with wife. During the busy season before and after the New Year, he hires two part-timers.

In 2003, he made another 700,000-rupee investment and built a warehouse and a store. The warehouse is used to store rice in. He buys rice when the price is low, and sells it when the price rises. The store is leased to a third party. However, since the scarcity of rice caused by the dry weather has made it difficult to forecast its supply and demand, he has cut back on his rice purchase. Because of the rice shortage, his earnings have dropped to about 300 rupees per day for the past six months. His bank urges him to apply for another loan, but because of the unstable market, he is reluctant to do so.

Name of company: Abans Service Agent (Repair service for air conditioners and refrigerators [for both professional and home use])
Location: Gampaha, Western Province
Loan project:
Objective: Procurement of a vehicle for making house calls
PCI: People's Bank Approval: 1998 Loan amount: 440,000 Rs

In 1995, a couple started a repair shop for refrigerators and air conditioners. Before taking out the loan, the husband and three employees engaged in the repair service. Earnings hovered around 25,000 rupees per month.

In 1998, the couple received a loan to buy a car and started a house call service. There are six other workers along with the couple. Earnings increased to around 35,000 rupees per month. At the beginning, the couple thought of leasing a car.

However, with the interest rate at 25% for leasing, the bank urged the couple to take out a loan under this project. It took about two months to complete the paperwork. However, there was one drawback: the amount of loan the couple could apply for was restricted by the amount of collateral they could put up.

In 2004, the couple bought a second car using a loan from another bank. They now employ 10 workers. Their monthly earnings have increased to about 125,000 rupees. After starting the house call service, the company became a service distributor for a leading sales company of home electric appliances. The employees receive training at the main office of the sales company. For the future, the couple is aiming to become a dealer for a Chinese manufacturer of air conditioners.

<u>Name of company:</u> Niki Garments (Sewing of underwear, shirts, etc. and import and sale of sewing cloth)
<u>Location:</u> Kandy, Central Province
<u>Loan project:</u>
Objective: Purchase of electrically-operated sewing machines
PCI: Bank of Ceylon Loan amount: 500,000 Rs Interest rate: 13%

Niki Garments was founded in 1990. In 1991, the company received a 500,000-rupee loan from the Bank of Ceylon. In 1997, the company registered with the Board of Investment. In 1998, with three employees and three electrically-operated sewing machines, the company had monthly earnings of 40,000 rupees.

In 1999, the company received a 500,000-rupee loan under this project and bought five electrically-operated sewing machines. The number of employees increased to seven, and in 2000, the company's earnings rose to 100,000 rupees per month.

Since then, the company has bought four more sewing machines, but this time, with its own fund. This year, there are 15 employees, and monthly earnings increased to 300,000 rupees. The company now has 12 electrically-operated sewing machines, so it now operates under a belt conveyor system. The introduction of this system has made the operation significantly more efficient. Targeting the low-price market in the country, the company has contracts with a string of distributing agencies. It manufactures its sewn products whenever it receives orders from its distributors. The company does not know about the technical transfer loan. (See the photo at the top of this report.)

<u>Name of company:</u> M M Car Sales (Pvt) Ltd (Import and sale of large cars)
<u>Location:</u> Gampaha, Western Province
<u>Loan project:</u>
Objective: Construction of a turbocharger repair plant
PCI: NDB Approval: October 1999 Loan amount: 5 million Rs

In 1983, M M Car Sales (Pvt) Ltd was established and began importing large used cars from Japan and selling them in Sri Lanka. In those days, there was no place in Sri Lanka to repair the turbochargers used in large cars. So when a car developed any problem with its turbocharger, the only recourse was to import the finished product from Japan, which took three months to be shipped from Japan after paying in advance. The repair plant was built so that turbochargers could be repaired in Sri Lanka.

In 1999, the company received a loan of 5 million rupees, which was used to import repairing equipment and spare parts. In 2001, the company's owner took part in a three-week training course in Singapore. Then, two new workers were hired. The company had no knowledge about the technical transfer loan, so the company did not take advantage of it.

Since used finished products are being imported from Japan, the company has to compete fiercely with importers of used finished products. However, the company has a virtual monopoly on European cars. The company's actual performance is not as good as the original plan, but since the import and sale of used cars, the company's core business, is going strong, there is no concern about being able to pay back the loan.

Name of company: Luckyland Biscuits (Biscuit manufacturing) Location: Kyandy, Central Province Loan project: Objective: Revolving funds (Phase I), capital investment (Phase II) PCI: People's Bank Approval: 1998, 2003 Loan amount: 5 million Rs, 7 million Rs

In 1998, Luckyland Biscuits received a loan of 5 million rupees. At that time, it had about 150 employees. Because the existing facilities had sufficient capacity, the company used a revolving fund, and production increased by about 25%. Fifty new workers were hired. At that time, the market interest rate was 20% or higher. So this loan really helped the company. This was the first time that the company received a loan from a bank. By 2003, the company had paid back the loan.

In 2003, the company received a new 7 million loan under this project. The company used the loan to install more efficient equipment, enabling the company to manufacture three new types of products. At present, the company has 250 workers on its payroll.