PD-ABE-482

EVALUATION OF THE PRIVATE SECTOR POLICY SUPPORT PROJECT (NO. 383-0100)

December 20, 1991

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Mr. Talbot Penner
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December 13, 1991

Re: PIO/T 383-0100-3-91028

Dear Talbot:

I had a chance to meet with Mike McLindon and Rick Samuelson in Manila and review the team's draft midterm evaluation report. An executive summary has been added and the total report edited to minimize redundancies. This letter transmits the final report (additional copies are being mailed separately).

The team concludes that the project approach is consistent with USAID/GSL strategies and should be continued, albeit with some suggested changes in focus and emphasis. This is particularly true for the privatization and capital markets components. USAID's involvement with EQUILL has only just begun. Although the policy support program is on-track, the University of Maryland -- Policy Support Unit relationship needs a little attention.

The synergy in the project elements comes with the public offering of privatized companies. At this juncture, capital markets development, privatization and venture capital reinforce each other. The team's recommendations provide USAID with ideas on strengthening the synergies between the capital market development and privatization objectives.

I regret that I was unable to come to Colombo before the team's departure. Perhaps that could be arranged after the first of the year or perhaps we could meet when you are next in Washington. We would like to explore additional ways we might participate with you and USAID/Colombo in private sector development.

The team appreciates your support as well as that of Mano Nanayakkara and others.

All the best in the new year.

Sincerely,

Edgar C. Harrell

Evaluation

of

The Private Sector Policy Support Project (No. 383-0100)

Prepared for USAID/Colombo*

Prepared by:

Price Waterhouse

International Privatization Group

December 15, 1991

* This report presents the independent findings and recommendations of the evaluation team. It does not necessarily represent the official views of the Government of Sri Lanka or the Agency for International Development.

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ACRONYMS

ADB	Asian Development Bank
AID	Agency for International Development
BOO	Build-Own-Operate
BOT	Build-Operate-Transfer
CBA	Chamber and Business Association
CDS	Central Depository System
CFA	Chartered Financial Analyst
CMDP	Capital Markets Development Project
COP	Chief of Party
COPED	Commercialisation Division of Public Enterprises
CSE	Colombo Stock Exchange
CPI	Consumer Price Index
DFCC	Development Finance Corporation of Ceylon
ESOP	Employee Stock Ownership Plan
ETF	Employees Trust Fund
FCCISL	Federation of Chambers of Commerce and Industry of Sri Lanka
GOBU	Government Owned Business Undertaking
GSL	Government of Sri Lanka
ICC	International Chamber of Commerce
IFC	International Finance Corporation
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissioners
IPO	Initial Public Offering
ISTI	International Science & Technology Institute, Inc.
LMRB	Lanka Marketing Research Bureau
NCC	National Chamber of Commerce
NDB	National Development Bank
NYSSA	New York Society of Security Analysts
PER	Price-earnings ratio
PACD	Project Assistance Completion Date
PIMB	Public Investment Management Board
PSSG	Private Sector Support Group
PSU	Policy Support Unit
Rs	Rupees (Sri Lankan currency; 40 Rs per $US)
SOE	State Owned Enterprise
SEC	Securities Exchange Commission
SPA	School of Public Affairs (University of Maryland)
TA	Technical Assistance
UM	United Motors
USAID	United States Agency for International Development
WCIC	Women's Chamber of Industries and Commerce

EXECUTIVE SUMMARY

I. BACKGROUND

In July 1988, USAID authorized $15 million for the Private Sector Policy Support (PSPS) project. This grant was authorized on July 20, 1988, and has a project assistance completion date (PACD) of July 31, 1993.

The project involves the following components:

(1) To promote capital market development, AID will provide approximately $2.3 million to help (a) the Securities and Exchange Commission (SEC) create the environment necessary to expand the private capital market and (b) the Colombo Securities Exchange (CSE) to improve its operations. The International Science and Technology Institute (ISTI) was contracted to start this activity in the summer of 1989.

(2) To establish a privately owned venture capital company, AID will provide up to approximately $.4 million to help with the start-up costs of a new enterprise utilizing equity funds and professional management. (Since this is a relatively small project component and has just come on stream, it is treated in this report with the first project component under "Capital Markets"). Equity Investment Lanka, Ltd (Equill) began implementing this under a cooperative agreement signed in December 1990.

(3) To support the privatization effort, AID will provide approximately $9 million in technical and financial assistance to the Commercialisation Division of Public Enterprises (COPED). Ernst and Young started this activity under a contract in December 1989.

(4) To strengthen the private sector's contribution to market-oriented economic policies, AID will provide approximately $2.9 million to assist representative private sector organizations in building their capability to advocate policy positions important to their memberships. This program was started in June 1990 under a cooperative agreement with the University of Maryland.

II. OBJECTIVES

The primary objective of this first report to USAID/Colombo and the Government of Sri Lanka (GSL) is to assess progress in project implementation and to recommend any necessary changes to better achieve project objectives.

A secondary purpose is to examine original project assumptions in light of recent political and economic changes in Sri Lanka and, on this basis, to recommend alternative or additional activities which should be considered for project support.

III. OVERALL ASSESSMENT

The chart below provides a financial summary of the project as of September 30, 1991.

1991 PROJECTED COMPONENT BREAKDOWN AS OF SEPTEMBER 30, 1991
(in $US thousands)

COMPONENT	OBLIGATION	EXPENDITURES	PIPELINE
Privatization	9,066	5,344	3,722
Capital Markets	2,264	1,790	474
Venture Capital	444	75	369
Policy Support Unit	2,946	1,169	1,777
Other	280	100	180
TOTAL	15,000	8,478	6,522

Source: see Appendix II

In addition, the GSL, which planned to complement the $15 million AID funding with $17,943,000, has actually contributed $52 million to date.

In terms of its activities, the project has already accomplished a number of its objectives, is on track to realize the remaining ones, and has demonstrated by progress to date that the activities supported will continue even after this project is completed. The project rationale is consistent with USAID's objective (as outlined in its "Strategic Framework: FY 1992-1996") of "expanding opportunities through a new private-public partnership". The capital market is booming in Sri Lanka and USAID's assistance has helped in improving the operations of the stock exchange, bolstering the position and efficiency of the securities exchange, raising the public's awareness of the capital market and funding the central depository system. AID is also providing the GSL with assistance in its privatization program and, through its contractor, is assisting with company profiles and valuations and with company restructuring and privatization strategies. Finally, AID's assistance to chambers and associations through its contractor is helping to improve public sector/private sector dialogue in Sri Lanka. Hurdles do remain as the project goes forward. The operations of the CSE and SEC need to be strengthened and additional training is needed to ensure that financial and management skills keep pace with the growth of the market. As privatizations continue, USAID needs to work with the GSL in improving the process of those transactions and in finding a greater role for its contractor and for itself in assisting privatization activities in the future. Finally, AID needs to work with its policy sector contractor to ensure that gains realized to date are strengthened by continued progress in the future.

Below is a summary of our findings and conclusions with respect to each project component's activities as well as general market trends. Our recommendations for improved project and market performance are highlighted.

IV. CAPITAL MARKETS/VENTURE CAPITAL

SUMMARY: In terms of market performance, technological improvement, regulatory development and investments that have been stimulated in the private sector, the capital markets component of the project has already accomplished a number of project objectives and is well on track for others. USAID has shown that this is a project area where it can clearly add value and that it should therefore follow up on the initial successes. In order for the momentum to be sustained, USAID should work towards such follow-on activities as increasing the supply of and demand for shares.

A. FINDINGS & CONCLUSIONS - SRI LANKA

- During the last year, there has been more than a 25% increase in share trading activity and the number of share holders has almost doubled (from 24,000 in 1990 to 41,000 in September of 1991) mostly as a result of privatization share offers. Nevertheless, these numbers are still low in absolute terms. One constraint is that many listed companies are closely held and therefore do not trade their stock publicly. Another problem is that the potential of privatization to supply shares has only been lightly tapped. Though the number of shareholders has doubled, the percentage of the population owning shares remains minuscule

- **The Sri Lankan public's awareness of the possibilities and potential benefits of investing in shares has grown. Evidence of this is shown in the receipt of thousands of requests made in the last few months for further information on how the stockmarket works. Publicity has been limited however to newsprint, and steps have not yet been taken to expand from this base**

- The Securities Exchange Commission (SEC) has been strengthened through the passage of important legislation (e.g., insider trading laws, takeover and mergers code). There is however a lack of well-paid staff and a need for increased enforcement of the stock exchange. These are the two most important issues facing the SEC and must be tackled soon while the market is booming and in transition

- The Central Depository System (CDS) came on stream in September and its operations are being constantly improved. This has helped speed up operations at the CSE and thus contribute to increased efficiency and activity in the stock market.

B. FINDINGS AND CONCLUSIONS - PROJECT

- The Project played a large role in building up public awareness of the stock market. The TA contractor wrote a study from which the Public Awareness Program was devised. The TA contractor played a large role in determining content for the stock market promotional campaign

- The TA contractor developed an overall structure for the SEC and laid out staffing requirements, placing emphasis on surveillance and enforcement. The TA contractor also completed a two volume study on improving CSE operations which should represent the CSE's blueprint for the future. Further studies and assistance in implementing changes in the SEC are important as the market develops

- USAID funded the Central Depository System at a very minimal cost (about $ 135,000) which is now in operation. The system does have its operational hurdles to overcome however.

The venture capital firm, Equill, has made investments in four companies and will shortly include a fifth. At this point it is too early to assess Equill's investment performance, but it has nevertheless fulfilled USAID's major objective of being up and running and actively searching for investment opportunities.

C. RECOMMENDATIONS

We specifically recommend that the appropriate parties:

1. <u>Improve the supply of and demand for shares.</u>

   a. <u>Supply</u> (1) Initiate policy dialogue within the GSL to remedy debt/equity imbalances (while recognizing that equity is the highest cost source of finance.) (2) Carry out measures outlined in Chapter 4 of this report to strengthen the privatization program and speed up privatization share offers. (3) Provide technical assistance to members of the CSE and to the public to develop the level of technological and financial skills required to enable companies to offer public shares. (4) As a related measure, implement recommendations of the IMF and the Banking Commission for the listing of government securities on the CSE.

b. Demand (1) Through policy dialogue, encourage domestic institutional investors to change investment policies of state controlled financial institutions to permit greater equity holdings, and relieve similar restrictions on private institutions. (2) Provide legal assistance to implement such changes. (3) Sponsor a Chartered Financial Analyst (CFA) program to develop investment research and management skills. (4) Provide technical assistance to work with institutional investors to improve their financial skills and expand their role in the stockmarket.

2. Continue the Public Awareness program.

The program has had its successes so far; it is now important to undertake planned training programs in financial reporting and coverage of the stock market.

3. Continue to provide technical assistance to the SEC.

The SEC needs increased assistance as vital pieces of securities legislation are developed. The ADB's program with the SEC should be closely followed by USAID in order to effect a reasonable division of effort. Accounting standards should be improved and auditors' opinions should be made mandatory in annual reports for listed companies.

4. Continue to strengthen and expand the role of the Colombo Stock Exchange.

USAID and its contractor should encourage and support enactment of needed organizational and structural changes in the area of broker licensing, reporting requirements, exchange surveillance and the creation of a second tier exchange once the SEC structure is in place.

5. Maintain and expand the Central Depository System.

While it is off to a good start, the CDS still has operational (e.g., processing delays) and staffing (lack of programers) problems.

V. PRIVATIZATION

SUMMARY: Despite several concerns, most notably the lack of transparency, the limited role of the Technical Assistance (TA) team, insufficient staffing at COPED, problems with the structuring of privatization transactions and the lack of marketing for upcoming divestitures, the Sri Lankan privatization program has led to some important divestments to date. By addressing these concerns, the privatization process will be strengthened, while the value of assets privatized and the supply of much needed shares of privatized companies to the market will be increased.

A. FINDINGS & CONCLUSIONS - SRI LANKA

- After nearly a decade in which little was accomplished in privatization, the last two years have seen a significant movement in preparing companies for divestiture and in privatizing these companies
- The "60-30-10" privatization strategy evolved by the GSL during its first few privatizations has worked well and merits consideration by other countries initiating privatization programs
- Efforts to privatize have encountered two major issues. The first relates to a lack of public awareness of the privatization process. The second is operational in nature, and includes the role of the technical assistance team, COPED staffing, the structuring of privatization transactions, and marketing
- Due to COPED staffing problems and insufficient use of the technical assistance contractor, there has been a lack of advertising privatizations to corporate investors, and a lack of evaluating offers received.

B. FINDINGS AND CONCLUSIONS - PROJECT

- The original Project target of companies to privatize has grown from 24 to 43, with more to be added shortly. Of the 43 companies to be privatized by COPED and assisted by USAID, 9 have been divested (i.e., 50 percent or more of net assets transferred to the private sector). Of these, 3 (United Motors, Ceylon Oxygen, and Pugoda Textile Mills) have completed the public share offer

- The TA contractor has prepared investment profiles and valuations and brought in short term valuation experts for the GSL. The TA contractor has also assisted in the formation of limited liability companies, has provided company restructuring advice and has undertaken several studies of divestiture strategies for selected companies. The contractor has not played as great a role as it could have however, especially with the marketing of privatizations to investors and with assistance in the structuring of transactions and public awareness.

C. RECOMMENDATIONS

1. Improve Public Awareness of the Privatization Process.

The GSL would like to make its workable process even better. The most critical element is to improve the public's understanding of the process of the initial sale of majority positions in the public enterprises. The GSL took an important step in this direction in August by publishing a list of companies to be privatized. An important follow-on step would be to publish the regulations which ensure standard procedures for these sales so that the public understands how the process works and to adopt standard international bidding techniques.

2. Address a Number of Operational Issues:

a. The Role of the Technical Assistance Contractor

While the technical assistance team contracted by USAID has provided useful assistance in producing valuations and company profiles and has supplied some short-term consultancy work to COPED, it should play a more active role in the future, most likely in providing more training seminars and workshops and by becoming more involved in the marketing of privatizations (see "d" below).

b. COPED Staffing

We recommend that the GSL allocate more staff resources to help the Director of COPED in what will be a growing burden. A technical unit with legal, financial and accounting skills working under his direction should be created. Technical units are fairly standard in other privatization programs and have worked quite well.

c. Structuring Transactions

With a full time technical unit working in COPED, the structuring of transactions can be more thoroughly prepared and executed than the current crushing workload allows. A 25-step process is outlined in this report which can be used to improve work flow.

Structuring will become increasingly important as the sale of large enterprises such as Milco and Distilleries comes on stream.

d. Marketing of Privatizations

The marketing of the SOEs can be improved by better, more targeted advertising in order to generate a larger number of bids and by giving more lead-time and advance notice of the tendering of the majority shareholding. In particular, USAID, through its technical assistance contractor, can continue to assist in improving the marketing of SOEs by providing information to a network of potential investors and intermediaries.

3. <u>AID should support the above two recommendations.</u>

Through its technical assistance contractor, USAID should provide additional training in support of the first two recommendations. In particular, USAID could:

- Continue to provide valuations as a point of reference for the Ministry of Finance, continue to assist the Valuation Department to develop its valuation skills, and provide specific assistance such as machinery and equipment valuations
- Hold workshops for stockbroking firms on writing prospectuses and on the development of other relevant financial documents
- Hold workshops for local advertising agencies on the advertising and marketing of share offers
- Hold workshops on international tendering, evaluation of tenders, and international negotiations

VI. <u>POLICY SUPPORT UNIT</u>

SUMMARY: The PSU has accomplished many of its objectives to date. Nevertheless, these have been accomplished despite the problems in the relationship between Colombo and College Park. The recommendations outlined below should be followed so that the project can go forward with a clear sense of purpose and accomplishment.

A. FINDINGS & CONCLUSIONS - SRI LANKA

- The institutional base of the CBAs is being strengthened through better research, technical skills and relations between individual CBAs and other institutions, such as universities
- Private sector groups and interests (for example, the National Chamber and the Federation of Chambers of Commerce) have become more aggressive in the last couple

of years in formulating policies and making representations to the public sector on behalf of these interests. Although the strengthening of private sector groups is a goal worth pursuing, it must be stressed that steps should be taken to ensure that the goals of the different private sector groups do not conflict with the goals of economic liberalization

B. FINDINGS & CONCLUSIONS - PROJECT

- The PSU program has achieved impressive results during its first year. It has assisted CBAs in nine major policy research activities. It has sponsored four seminars on relevant international and domestic economic issues and four workshops aimed at developing the skills of CBAs

- Thirteen grants have been approved representing 66 percent of the budgeted amount, 15 percent of which has already been disbursed. The monitoring system of these grants is strict and appropriate

- The program has strengthened the CBAs. Information services are being expanded rapidly, education and training are being bolstered, and the program is fostering the formation of new CBAs in the provinces

- The PSU staff has accomplished many of its objectives. Its strategy has been to help CBA grantees expand and upgrade their services and to prepare well-researched representations on policy issues to the public sector

- These results have been achieved in spite of a serious rift between the PSU and the School of Public Administration (SPA) of the University of Maryland, College Park.

C. RECOMMENDATIONS

1. <u>Identify a new Chief of Party (COP).</u>

   The challenge for the program in the immediate future is to ensure continuity. The considerable gains of the first year have to be consolidated. No major new undertaking should begin until a suitable replacement for the Chief of Party is found. The new Chief of Party (COP) should have the ability to work well with the PSU staff. The new COP must understand the administrative procedures of College Park, and be aware of what College Park can offer to the CBAs in terms of analytical studies and research.

2. Delegate authority to the PSU.

Once the new COP is found, SPA College Park should delegate substantial financial and administrative authority to the PSU in Colombo.

3. More effective communication should be established between College Park and Colombo.

Although the direction of the Program should be determined in College Park, the nature of the PSU's work in Colombo demands the ability to be flexible and make tactical decisions.

4. Provide long term strategic support in College Park.

SPA College Park can contribute by supporting the administration of the program and by devising a long-term program of policy research which may include providing training in the U.S. for Sri Lankans.

VII. LESSONS LEARNED

- The successes of the GSL capital markets program and the project to date suggest that the multi-faceted approach to developing a stock market -- public awareness, training, development of the regulatory structure and stock market operations, the efforts to promote the supply of and demand for shares, and the linkages to the privatization program -- lends itself to consideration by other countries

- Experienced financial professionals (such as those advising the SEC and the Merchant Bank) can help seize opportunities to promote and develop linkages with the international market, which is a critical aspect of capital market development

- A strength of the project has been the synergy created between the capital markets and privatization components. A newly invigorated stock market, reflecting Sri Lanka's improved economic prospects due to liberalization, created a demand for shares which successful privatization transactions has only partly satisfied. The scope exists for more public share offerings of privatized state owned enterprises

- The importance of public awareness of how privatization works and the proper marketing of these transactions can not be underestimated. Both USAID and the GSL should work with the technical assistance team and COPED on improvement in these areas.

INTRODUCTION

In July 1988, USAID authorized $15 million for the Private Sector Policy Support (PSPS) project to assist the Government of Sri Lanka (GSL) in its implementation of policy reforms aimed at revitalizing the economy. This grant was authorized on July 20, 1988, and has a project assistance completion date (PACD) of July 31, 1993.

The primary purpose of this first interim evaluation is to provide USAID/Sri Lanka and the GSL with a detailed assessment of project implementation and progress to date and to recommend any modifications to improve the likelihood of achieving the project's objectives.

A secondary but important purpose of the evaluation is to look at changes in the political and economic environment which have affected the project and the initial project assumptions and to recommend alternative or additional activities which should be considered for support under this project.

The evaluation was carried out in September and October of 1991 under an AID contract to PW/IPG. Members of the team were in Sri Lanka from September 15 - October 28. Extensive interviews with GSL officials, USAID officers, technical assistance contractors, private sector figures in banking, brokerage firms and chambers and associations, and World Bank officials were held, and several documents and other sources were reviewed (see "References" at the end of this report). The team's findings and conclusions make up the body of this report.

I. BACKGROUND AND GENESIS OF THE PROGRAM

Sri Lanka, located off the southern coast of India, was known as Ceylon until it obtained independence from British rule in February 1948. It consists of 65,610 square kilometers with a population estimated at 16.8 million (mid-1989 figures) and an annual real GDP growth rate of 3.1 per cent in the last five years.

The economy is primarily agricultural, a sector which provides about 25 percent of the country's GDP and 45 percent of its labor force. While the three traditional exports (tea, rubber and coconut) are all agricultural in nature, the government has recently tried to strengthen its industrial and service sectors.

Sri Lanka was established as a republic in 1972 with a unicameral parliament, a prime minister charged with executive powers, a cabinet and a president as the constitutional head of state. In the 1978 elections, the United National Party (UNP) was voted into office. J.R. Jayewardene became President and Ranasinghe Premadasa Prime Minister. They introduced a presidential system of government in which most powers were transferred from the Prime Minister and his cabinet to the President. In 1989, Mr. Premadasa was elected president.

Sri Lanka has gone through many changes and challenges since it achieved independence. It is a very ethnically and religiously diverse country and while this has contributed to its dynamism and development, it has suffered from several societal conflicts.

II. ECONOMIC RESTRUCTURING SINCE 1977

The economic record of Sri Lanka's first 30 years was markedly mediocre. Policies tended to be highly protectionist in nature and money was channelled to social programs which, while successful, allowed few funds to be directed towards industrialization and modernization of traditional agricultural sectors. The private sector's role in Sri Lanka's development was decidedly limited while the government continued to grow and command increasingly larger proportions of the GDP.

With the election of the Jayewardene administration in 1977, the economy became more open and liberal. Import restrictions and price controls were reduced and foreign investment was actively encouraged. The state's overwhelming presence in the economy was also somewhat reduced.

As a result of these changes, GDP growth from 1978-83 reached an average of 6 per cent. This is quite an achievement when compared to the 2.9 per cent average for 1971-77. While growth in the 1980s continues to be impressive, budgetary difficulties, civil disturbances and looser monetary policy has dampened the economy somewhat.

III. GSL ECONOMIC LIBERALIZATION AND THE USAID PROGRAM

A major objective of the new Premadasa administration has been economic liberalization in the form of privatization and development of the capital markets. More of a role has been promised to the private sector.

Recognition of this increased role led AID in July 1988 to fund the Private Sector Policy Support (PSPS) project, a five-year $15 million grant to (a) develop the capital market and broaden public equity participation, (b) assist the GSL in planning and implementing its medium-term privatization program, and (c) strengthen the capacity of private sector chambers and organizations to conduct policy research, analysis and dialogue on issues of concern to the Sri Lankan private business community.

To achieve these purposes, the project is involved in the following four activities:

(1) To assist capital market development, AID will provide $2.3 million in technical and financial assistance to (1) the Securities Council (since renamed the Securities and Exchange Commission, or SEC) to create the environment necessary to expand the private capital market and (2) the Colombo Securities Exchange (CSE) to assist in improving its operations and preparing for anticipated growth in exchange activity. The International Science and Technology Institute (ISTI) was contracted to start this activity in the summer of 1989.

(2) To stimulate the establishment of a privately owned venture capital company, AID will provide up to $.4 million in technical and financial support to assist in the start-up costs of a new enterprise utilizing equity funds and professional management. EQUILL began implementing this under a cooperative agreement started in December 1990.

(3) To support the privatization effort, AID will provide $9 million in technical and financial assistance to the Presidential Commission on Privatization and its secretariat; $1.9 million of this is for technical assistance in analyzing and preparing for privatization (Ernst and Young started this activity under a contract in December 1989) while $7.1 million will be available to assist in preparations for divestiture and reduce the impact of privatizations' likely reduction in employment. Funds will be used to defray the costs of audits, valuation, promotion, severance payments and some retraining programs.

(4) To strengthen the private sector's contribution to the formulation, appraisal and implementation of market oriented economic policies, AID will provide $ 2.9 million in technical and financial assistance to organizations which are representative of various elements of the private business community in order to build their capability to identify, analyze and advocate policy and regulatory issues of key importance to their memberships. This program was started in June 1990 under a cooperative agreement with the University of Maryland.

The remainder of this report outlines PW/IPG's findings, conclusions and recommendations.

3

CAPITAL MARKETS AND VENTURE CAPITAL

This chapter evaluates the capital markets and venture capital components of the Private Sector Policy Support (PSPS) project. The bulk of this chapter is concerned with the capital markets component; a discussion of the venture capital component appears at the end of this chapter.

CAPITAL MARKETS

I. OBJECTIVES OF PROJECT COMPONENT

One of the goals of the Private Sector Policy Support (PSPS) project is to develop the Sri Lankan capital market in order to broaden equity participation in the economy and increase resources for investment.

The Capital Markets Development Project (CMDP) seeks to improve the operations, regulatory structure, size, distribution, and liquidity of the secondary capital market in Sri Lanka.

In July 1989, the long-term technical assistance team arrived to work with the Securities Exchange Commission (SEC, formerly called the Securities Council) and the Colombo Stock Exchange (CSE).

The planned outputs of the Capital Market Development Project include:

- **The promotion of public awareness on the possibilities and benefits of share ownership**
- **The creation of an operative regulatory unit (the SEC) for the securities market**
- **The development of more modern operations for the CSE in order to handle an increasing volume of transactions, including the installation of a computer-based Central Depository System (CDS) in the Colombo Stock Exchange**
- **A significant increase in share trading activity**
- **An increase in the number of listed companies and a broad-based ownership of companies**

II. FINDINGS

A. BACKGROUND

In 1985, Sri Lanka's stock market was reorganized as the Colombo Securities Exchange. (It is now called the Colombo Stock Exchange, or CSE). In 1987, the Securities Council Act created the first regulatory body charged with ensuring orderly markets and protecting buyers of listed equity and debt securities. The Securities Council (now called the Securities and Exchange Commission or SEC) also advises the Government on the development of the capital markets.

It has long been recognized that the Sri Lankan stock market has the potential to play an important role in channelling domestic savings into investments, productive capacity and growth. The economy has long term promise, the financial system is relatively sophisticated, the savings rate is above average compared with other countries at similar levels of national output and income, basic legislation for private corporations is in place, and accounting standards are above average.

However, there were some imposing constraints. Operations on the Colombo Stock Exchange were slow and cumbersome. The operations of the CSE were manual and paper-based, limiting the efficiency and timeliness of share transfers. Even before the recent rise in trading in 1990 and 1991, the CSE had experienced settlement difficulties. For market trading to continue to grow, an automated Central Depository System (CDS) was necessary to provide all post trade settlement services.

Other problems were of a structural nature. Many companies were unwilling to list, thus limiting the supply of shares on the market and reducing liquidity. Interest rate and tax policies actually encouraged companies to favor debt over equity financing. Most of the companies which did list did not trade actively and there was little float in the market. None of the brokers operated outside of Colombo and the services they provided clients were limited. Investment research and portfolio management skills were virtually non-existent.

The demand for shares was also severely limited. The Sri Lankan public was generally unaware of the possibilities and potential benefits of investing in shares. If aware, it frequently lacked confidence in the market and tended to prefer less risky, albeit lower-yielding, bank deposits. Institutional investors which could be a significant source of demand were typically government owned and used as captives for low yielding (in real terms) government debt. Foreign portfolio investment was effectively eliminated by a 100 percent tax on purchased shares.

1. USAID's Project

With $2.26 million in grant funds for CMDP as a part of its PSPS project, AID provided technical and financial assistance to:

- Help the Securities Council in its capital markets development and oversight functions
- Develop specifications for, and procure, equipment to improve the operations of the Colombo Stock Exchange, and provide training and assistance to modernize exchange operations
- Prepare educational materials, seminars, conferences and other events to improve public awareness of the securities market

To this end, USAID entered into a long term technical assistance contract for $2.247 million with the International Science and Technology Institute (ISTI) in May 1989. The long-term TA team arrived in Sri Lanka in July 1989. This team has been complemented by a number of shorter term consultancies looking at specific issues.

The financial status of CMDP as of September 30, 1991 was:

	($US Thousands)
Obligations	2,264
Commitments	2,264
Expenditure	1,790
Pipeline	474

2. Recent Market Performance

In 1990, the CSE was the second best performer in the world after Venezuela and has continued to appreciate strongly since then (see Appendix III for selected graphs). Both the CSE All Share Index and the CSE Sensitive Shares Index have risen over 70 percent per year to date (as of September 1991). As of last month, the average PER was 18.1 (September 30, 1991) which shows that stocks are no longer as undervalued as in previous years.

This, combined with the currently uncertain political atmosphere, could augur for a flatter performance in the foreseeable future. This is a typical pattern in fledgling markets and is not necessarily a cause for alarm.

Moreover, despite the recent leveling off, the domestic appetite for new equity remains strong as is clear from the over

subscription greeting recent share issues such as that of the DFCC.

Securities firms are expanding rapidly in terms of staff, business volume and number of offices. Asia Securities, for example, has gone form 0 to 6 employees in six months. It now claims to handle 16 to 17 percent of volume on the exchange. Similarly, John Keells is expanding rapidly. It plans to open five offices outside of Colombo by the end of next year in such places as Galle and Kandy. If more brokers follow suit, this would be the ideal way of addressing the problem of distributing shares outside of Colombo and is bound to stimulate more activity in the stock market.

3. Contributory Factors

While the project has played an important role in the performance of the market over the last two years, several GSL decisions have been vital to the market's "takeoff". In June 1990, the GSL liberalized foreign portfolio investment by abolishing the 100 percent tax on share purchases by foreigners, subject to the limitation that their aggregate share holding not exceed 40 percent of the issued holding.

This triggered an almost immediate surge in foreign interest in the market, which captured the attention of the CSE, the brokerage firms and the Sri Lankan investing public, and led to a rise in what had previously been undervalued shares. The GSL has also revised the capital gains tax on listed shares, abolished the ad-valorem stamp duty on shares, withdrawn the withholding tax of 15 percent on dividends, and withdrawn the wealth tax on listed company shares.

Even with this seemingly "exogenous" event, the CMDP played a valuable supporting role. USAID's TA team made presentations to the Securities Council and the President's Commission on Taxation proposing a tax package, including withdrawal of the 100 percent transfer tax. Foreign fund managers and analysts frequently called on the TA team for insights into the market which, when linked to the economy's performance and the strengths of certain listed companies, were often parlayed into "buy" decisions. Officials at the CSE report that there are over fifty foreign funds approved to invest in the market.

The TA team has also provided input into representations by the SEC and the CSE to present various policy positions to the GSL which have resulted in some positive policy changes.

Perhaps the most important reason for the successes realized to date is the high caliber of the Sri Lankans serving in the SEC and the CSE.

B. ACCOMPLISHMENTS TO DATE AND REMAINING TASKS AND ISSUES

1. Public Awareness

a. Accomplishments to Date

The public awareness part of CMDP attempted to overcome a severe limitation on the market's growth. As surveys demonstrated and experience confirmed, the Sri Lankan public was generally unaware of the possibilities and potential benefits of investing in shares. If aware, it frequently lacked confidence in the market.

Following a report by the TA contractor, a Public Awareness Program was devised. Performance is periodically reviewed and the TA contractor continues to advise as the program proceeds.

Phase one of the campaign consisted of four ads in the local newspaper in all three languages which described how the stock market works and how one could invest in shares. To date, there have been over 10,000 responses to this phase of the campaign. Each respondent is being sent a booklet describing how the CSE operates.

The next stage calls for publishing a mix of the ads which appeared during the autumn of 1991. Grant Bozell, the advertising firm which worked on this phase of the campaign, is responsible for analyzing the numbered responses to determine which of the four ads were most successful in terms of getting a response. Grant Bozell received significant assistance from the Chairman of the SEC and the resident advisor in terms of the ads' content.

Twelve articles about the CSE have already appeared in both the Daily News and the Island. The resident advisor assisted in providing much of the content for the articles.

Radio and TV interviews have been conducted.

Teacher training seminars have been given to high school teachers for an A level course in capital markets. An A level textbook, "A Guide to Share Market Investing in Sri Lanka", is overdue but nearing completion. This A level course will be formally introduced in 1992 into the educational system through three A level streams: accountancy, business and commerce, and economics.

Key members from the SEC and CSE have traveled to most of the major exchanges in the region on three different trips accompanied by the resident advisor. They found this and other training they received to be invaluable. Such activities should be continued.

b. Remaining Tasks

1. Television

A "Wall Street Week" style television show about the CSE has been discussed. Because the other public awareness campaign projects have taken longer than originally anticipated, this is on hold at present.

2. Journalist training

Another project for the near future is further journalist training in financial reporting. This could involve both course work and sending journalists to visit the Bangkok Post. At present, the financial page of the Daily News, for example, does not even fill one column (except Tuesday's four page review.) The only information reported on a daily basis for individual stocks is the share price, the volume traded and the net price change. Overall market information is also lacking. The only information shown is the current day's closing and previous closing for the two indices (CSE all share and CSE Sensitive), and daily turnover. In addition, there are notes from time to time concerning such things as offerings or rights issues.

2. <u>The SEC and the Securities Market</u>

a. Accomplishments to Date

Progress on the regulatory front has been substantial during 1991. The key amendments to the Securities Act include the following:

- The SEC was given responsibility for regulating unit trusts
- Insider trading was put under the SEC. Previously, this area was addressed in the Companies Act
- A takeovers and mergers code has been drafted, approved by the MOF and the FTC, and is being reviewed by the Legal Draftsman. It is expected to help reduce instances of "creeping" takeover abuses

The TA contractor developed an overall structure and staffing requirements recommendation for the SEC, with particular emphasis on surveillance and enforcement.

b. Remaining Tasks and Issues

The Companies Act lays out disclosure rules. The main problem is lack of enforcement: there are too few staff to review the documents submitted. A further problem is that it is difficult to staff the SEC, given low government salary scales.

More than one broker considers the rule regarding the sale of large blocks of shares to be a problem. In the instances where the CSE considers a block to be large, this rule stipulates seven days before a transaction is closed. This means that a block originally bid for by one broker could be bid up in the meantime by another broker so that the original broker loses the deal in the interim. Brokers want the period shortened. With input from the TA team, the Takeovers and Mergers Code should result in an improvement on the current system and calls for reporting on 10 percent portions and above.

3. Modernization of the CSE

a. Accomplishments to Date

1. Central Depository System

The Central Depository System (CDS) went into operation on September 2, 1991. Five companies are being added to it every three weeks and there are now 17 in the system. The share prices of all companies can be readily viewed on a terminal. Before the end of 1991, remote access to quotations should be available to all eleven brokers. The system is still undergoing fine tuning and further development. Ultimately, it should be capable of linking banks, brokers and investors. It already provides investors with monthly account statements and information generated by the CDS is sent to individual companies on an as-needed basis, e.g. when dividends need to be paid.

In general, brokers are very happy with the CDS. John Keells, a leading brokerage firm, notes that it has eliminated a lot of paperwork.

USAID and the CSE obtained a powerful system at a very reasonable price of about $ 135,000. Comparable systems in the USA typically cost in excess of a million dollars and require two years to develop. The TA contractor supervised the conceptual design of the system and its installation.

2. CSE Operations

The TA contractor completed a two volume study on improving CSE regulations which should represent the CSE's blueprint for the future. It also completed a study on the implementation of an Investors' Compensation Fund.

The General Manager of the CSE indicates that as a control on price movements on the CSE, bid and quoted prices are not allowed to go up or down more than ten percent. This is monitored carefully by CSE officials.

As of July 1991, the CSE began tracking the financial condition of the brokers on a periodic basis. In fact, new rules were put in place in 1991 requiring brokers to file monthly accounts. These reports pass through the CSE onto the SEC. Because the CDS records the time sequence of trades as well as the identity of the brokers doing the trades, the CSE now has the ability to monitor insider trading.

Finally, the General Manager of the Colombo Stock Exchange (CSE) has recently had discussions with Reuters about making CSE quotations available internationally. The main negotiating point is who should pay whom.

b. Remaining Tasks and Issues.

1. Central Depository System

One issue concerns the amount of time (four minutes) required for inputting each shareowner into the CDS. Some of the large privatizations could require adding 10,000 to 30,000+ new shareholders at a time to the CDS, which would be time consuming. Tentative plans call for having two teams working 12 hours per day for three days each in order to cope with this task. One way around this problem is to explore using an optical scanner to input this information automatically.

Another potential problem is insufficient staffing of the data processing department. The head of data management is leaving, while her assistant has had to put in a lot of overtime. However, a replacement head of the department has been recruited as well as additional systems operations employees.

2. CSE Operations

Historically, the CSE has been poorly funded. Its fee charges are still quite modest. Brokers, for example, pay a flat fee of 7,500 rupees (1$ = 40 Rs) per month to support the CSE. There is also a listing fee for corporations which depends on the capitalization of the company. The maximum is 28,500 rupees while the minimum is 7,500.

The primary source of income for the CDS comes from 10 percent of the brokerage income for a particular company. This suggests that a combination of increased trading volume and an increase in the number of companies registered on the CDS will ensure that CSE income will go up substantially. The General Manager of the CSE notes that even though the CSE lost money last year, he expects it to be profitable by next year because of the rise in CDS income. One key uncertainty is whether income will increase to keep up with both increasing staff requirements and the obvious need that the CSE has for better physical premises.

4. <u>Increase Share Trading Activity and Increase Listed Companies and Broad-base Company Ownership</u>.

These two project outputs are closely related and are therefore treated together.

a. Accomplishments to Date

Data are readily available on share trading activity. Below are figures highlighting the number of shares traded on the CSE, the daily market trading by value and market turnover.

Number of shares traded

1985	1986	1987	
4,776,650	6,086,694	17,323,408	

1988	1989	1990	1991*
13,204,532	12,215,762	41,692,180	53,284,242

*Through September 30

Source: CSE

Daily market trading by value

(in $US):

1985	1986	1987	1988	1989	1990	1991*
12,233	21,513	49,542	50,635	29,404	146,797	414,975

In Rs. Thousands:

1985	1986	1987	1988	1989	1990	1991*
332	603	1,459	1,610	1,075	6,567	16,599

*Through September 30
Source: CSE

Market Turnover: Value Traded as a Percent of Market Capitalization

1985	1986	1987	1988	1989	1990	1991*
0.8%	1.2%	1.8%	2.4%	1.3%	4.2%	4.7%

*Through September 30 (6.3% annualized)
Source: CSE

The indicators for number of shares traded, number of transactions on the CSE, daily market trading by value, and market turnover all point to a dramatic increase in share trading. Market turnover, or the value of shares traded divided by market capitalization, while showing significant improvement still indicates a relatively illiquid market even by emerging market standards.

As the table below shows, the number of companies newly listed on the CSE has increased by 7 over the last three years. However, other companies have decided to delist. As a result, the total number of listed companies has remained relatively constant during the last few years.

The number of New Listings on the Colombo Stock Exchange.

	1985	1986	1987	1988	1989	1990	1991*	Total
New Listings	2	6	4	8	2	1	4	27
Delistings	0	5	9	0	2	2	0	18
Net New Listings	2	1	-5	8	0	-1	4	9
Total No. of Companies Listed	172	173	168	176	176	175	179	

* As of September 30

Source: CSE

It should be noted that in 1990 the government imposed a requirement that in order for a listed company to retain its advantageous tax rate (40 vs. 50 percent), it would have to have a specified percentage of its ownership in the hands of outside investors. There is a two year window within which to restructure.

Some 135 out of 179 currently listed companies would "fail" the broadbasing test and may have an incentive to delist.

A mutually beneficial relationship can exist between privatization and securities market development. A well functioning securities market can greatly facilitate privatization of large companies and enable the government to attain broad based ownership. The listing of the newly privatized companies adds much needed supply to the markets.

Privatization through share offer has accounted for most of the increase in listed companies. It has also helped to broad base share ownership. In July 1990, it was estimated that there were about 24,000 shareholders in Sri Lanka.

In 1991, the number of people subscribing to shares in privatizations has grown steadily:

Privatization Applications

Enterprise	Close of Offer	No. of Applications
United Motors	September 1990	1,605
Merchant Bank of Sri Lanka	November 1990	9,146
Ceylon Oxygen	April 1991	15,049
Pugoda Textiles	June 1991	30,973
DFCC	September 1991	41,033

Source: Merchant Bank of Sri Lanka

As a result, the number of shareholders has roughly doubled within the last year. (Note that because of the problem with multiple applications, the number of applications overstates the number of individual shareholders applying for the share offers.) However, as we shall see in the following chapter, the potential for Sri Lanka's privatization program to supply shares to the market has only been lightly tapped.

The overall growth of the market is captured by the impressive growth in market capitalization:

Market capitalization on the CSE.

1985	1986	1987	1988	1989	1990	1991*
In $ millions:						
363.5	421.6	626.9	493.5	529.5	922.0	1,523.2

in Rs. millions:

1985	1986	1987	1988	1989	1990	1991*
9,874	11,812	18,460	15,694	17,087	36,880	62,451

*Through September 30
Source: CSE

b. Remaining Tasks and Issues

Both of these project outputs are closely related to the need to increase the supply and demand for shares of Sri Lankan companies.

1. Supply of Shares

While the demand for shares has grown under the project, the supply of shares, with the basic exception of privatizations, has lagged. The CSE is attempting to get as many new companies as possible to list. Ernst & Young/Colombo is undertaking a survey among listed and unlisted companies to determine what the impediments to listing are. Unfortunately, this potentially valuable empirical study had not been completed at the time of our evaluation.

Companies, in deciding whether to list or not, have to consider the benefits and costs. There is a direct fiscal incentive to list: the corporate tax rate in Sri Lanka is only 40 percent for listed companies, compared with 50 percent for private companies.

The difficulties in getting companies to list in other emerging markets have been well documented. There is a reluctance to widen the ownership of family owned and run companies for fear of loss of control. This has limited new company listings and the availability for sale of shares held by family members in existing listed companies.

Another significant problem is the relative cost of debt and equity finance. After allowing for inflation, the net-of-tax real cost of debt has often been negative. (The easy availability of debt and poor debt recovery legislation are additional factors favoring debt financing by firms.) Equity financing, on the other hand, can be quite expensive.

As other countries have demonstrated, some of the reasons for reluctance begin to ease once prices on the stock market begin to increase. However, an additional constraint is often that the corporate finance skills needed to take a company public may be poorly developed, and the company may be poorly informed about the process and possibilities.

2. Demand for Shares

Most brokers contend that foreign investors have been the driving force behind the exchange during the last year. They describe their domestic clients as "speculative". That is, they do not invest on the basis of the fundamental value or earnings potential of a firm. Thus, there is little need to undertake any research on the market. The result is that with the exception of John Keells, Forbes and Walker, and the Merchant Bank of Sri Lanka, local research is not available. However, given the strong foreign interest in the market, there is a clear incentive for local brokerage firms to develop these capabilities.

Basically missing from the demand side of shares has been domestic institutional investors. The largest pension funds in the country are the Employees Provident Fund (EPF) and the Employees Trust Fund (ETF). As is widely known, these are captive instruments of government policy. EPF is by far the larger of two. The labor commissioner estimates that the EPF collects roughly 400 million rupees per month. Currently both EPF and ETF invest all their funds in either treasury bills or government owned corporations.

Although technically both could diversify, both funds are subject to directives from the Ministry of Finance which basically determine investment policy. To give an idea of how dependent the government is on the EPF, its director estimates that the EPF funds 60 percent of the government deficit. In that light, it seems unlikely that investment policy will change soon. Unfortunately, both funds earn a negative real return on their investments. Obviously, this does not represent an optimal use of funds, and managers of both funds readily acknowledge this and favor changing the situation.

There are some provident funds that pre-date the ETF and EPF but, compared to the EPF, the private provident funds are very small. It is estimated that there are about 150 accounts in total but the aggregate inflow of funds per month is less than 100 million rupees. Unlike the EPF, these funds can invest in high yield securities but there are caveats to this. Every year, for example, the commissioner must approve the accounts to ensure they are sound investments. He notes that in the past there have been instances where funds have been mismanaged.

Legislation has recently been put in place to permit unit trusts, which are expected to play an important role in generating demand. Several firms, including the DFCC and CDIC, are applying for licenses to set up unit trusts. Incentives include a 5 year tax holiday, no capital gains tax and no withholding tax.

Private insurance companies are just beginning to invest in the CSE but they are still small and subject to limitations on the percentage of paid-in capital they are allowed to commit to equity. Meanwhile, the two largest insurers remain state owned and, like the state pension funds, are captives of government policy with respect to their investment decisions.

Clearly, the low institutional demand for shares found in Sri Lanka needs to be addressed.

III. RECOMMENDATIONS

A. PUBLIC AWARENESS

1. Consider the use of television to broaden awareness of the stock exchange.

There are an estimated 1 million television sets in Sri Lanka and this is a medium that has not yet been tried.

2. Continue training the press to improve financial reporting and coverage of the stock market. Encourage the press to accept submissions from industry experts.

At least two brokers, John Keells and Asia Securities, have already offered to make contributions. It seems expedient that until the brokerage houses have geared up to provide a variety of fundamental research (which may take a while), the most efficient and least expensive way to disseminate basic information concerning the CSE is through the newspapers. At the very least, newspapers should be encouraged to provide (where it is available) financial information in a more complete and internationally accepted format -- as one would find, for example, in the Asian Wall Street Journal or International Herald Tribune. These would include the 52 week high and low, dividend yield and price earnings ratios for particular stocks as well as graphs showing the historical performances of market indices, daily turnover and other indicators. In fact, the CSE already publishes most of this information in its "Stock Market Daily". Likewise, it can readily produce graphs showing the historical performance of a variety of indicators which are attached to this report. The CSE is aware of this need and intends to provide the appropriate information and format to the newspapers.

3. Continue executive training.

Exposure to regional markets and practices is viewed as extremely useful in this regard and it is particularly important that the successor to the out-going Director General at the SEC be trained as quickly as possible.

4. Sponsor a regional capital markets conference.

Foreign brokers are currently interested in Sri Lanka and such an event could only serve to disseminate information on the CSE, which is often lacking, especially in the USA. Special pains should be taken to ensure that US-based investment banks participate because they have largely trailed the British and Hong Kong based firms in penetrating Asian markets such as Sri Lanka.

B. SEC AND REGULATORY DEVELOPMENT

1. Find ways to better fund SEC activity.

The SEC is funded by the GSL and needs a bigger budget allocation if it is to undertake significant enforcement activities. A main concern is that low government salary scales will not permit the SEC to attract high caliber enforcement personnel.

The Asian Development Bank (ADB) has recently completed a comprehensive study of the existing regulatory functions of the SEC, the Registrar of Companies, and the CSE. The study recommends an appropriate regulatory framework, and the design of a plan for organizing the staff of the SEC. The ADB is apparently willing to direct significant resources to assist the SEC in its regulatory role, although the current status of this potential project is not known. At some point, it may make sense for the ADB to work primarily with the SEC, and for USAID to work primarily with the CSE. At present, the SEC is making a number of important regulatory decisions that will affect the performance of the stock market. Given USAID's involvement in financing technical advice to work with the SEC to draft regulations suitable for continued market development, we recommend that USAID continue to finance this position.

2. Work with listed companies in order to get them to move towards using internationally accepted accounting standards. Likewise, make auditors' opinions mandatory for the financial statements of listed companies.

The World Bank has noted these needs also.

3. Shorten the subscription and allotment process.

As the ADB study noted, the time required for the subscription and allotment process in Sri Lanka is too long. The process generally involves distribution of a prospectus, a subscription period during which investors submit checks in payment for the shares, a period for collection of subscriptions and checks and clearance of the checks, input of data from applications so that the subscriptions can be analyzed and, finally, refunding of monies for oversubscriptions and delivery of stock certificates. Thereafter, the shares are listed on the Exchange. In efficient markets, this process takes place more rapidly, provides flexibility in pricing and does not tie up investor funds.

4. Permit consolidated tax returns.

Losses in one subsidiary could then offset gains in other subsidiaries. Also, loss carry forwards should be permitted in order to survive an acquisition. This would make it easier for a stronger entity to take over a weaker one and help in handling over-leveraged situations and bailouts.

5. Consider the feasibility of permitting dividends to be paid out of pre-tax earnings.

Dividends will then be taxed on one level only, in the hands of the recipient. (Intra-group dividends from subsidiary to parent should not be taxed.)

6. Review the need for an investment advisor's act.

This does not currently exist in Sri Lanka, and such an act would discourage unqualified persons from giving poor advice to investors.

C. COLOMBO STOCK EXCHANGE OPERATIONS

1. Follow recommendations of Bishop and Tang reports.

The CSE and SEC have had the benefit of a number of studies such as the Bishop and Tang reports. This information should be periodically reviewed at both the SEC and the CSE to ensure it is not lost and progress on implementing these recommendations is being made.

The Bishop study recommended specific rule changes for the stock exchange and proposed a method for implementation of a compensation fund. Mr. Bishop also compiled all exchange and stock exchange regulations into a book entitled "Consolidated Sri Lanka Securities Regulations".

The Tang study included recommendations for the licensing of brokers, compliance requirements (including reporting requirements for brokers, conduct of business rules and suggestions for inspections of brokers and oversight of exchange surveillance.) Ms. Tang also made preliminary recommendations for the organization of the SEC.

2. <u>The CSE should develop into an effective self-regulatory organization and plans should be continued for setting up a second tier exchange once the SEC structure is in place.</u>

This is essential for fostering the venture capital industry in Sri Lanka and should happen within three years to permit an exit vehicle.

3. <u>The SEC should join IOSCO.</u>

The CSE is already a member of the Federation Internationale des Bourses de Valeur (FIBV).

4. <u>The CSE should continue to strive for timely and accurate submissions of data to the IFC Emerging Market Factbook.</u>

This is often a foreign fund manager's first source of information on the market. At some point, the CSE should be included in the IFC's emerging markets index.

D. THE CENTRAL DEPOSITORY SYSTEM

Given USAID's leading role and investment in the CDS, it would make sense, depending on the availability of funds, to provide for "maintenance" of that investment. Examples of appropriate actions that the mission might wish to consider would include:

- Buying a back up printer for the CDS system
- Purchasing an optical scanner to facilitate registering shareholders in the CDS
- Purchasing an independent back up processor which is both off site and under the control of the CSE

In the future, the CSE could automate the current open outcry system trading system as soon as the rise in trading volume merits it.

E. SHARE TRADING and LISTING COMPANIES/BROAD-BASING OWNERSHIP OF COMPANIES

As we have argued above, both of these objectives call for increasing both the supply of and demand for shares. Trading government securities on the CSE would also be desirable.

1. Supply of shares

There are several ways to increase the supply of shares:

a. By seeking to stimulate the stock market as the GSL has done by permitting foreign portfolio investment, improving the regulatory environment, stock exchange operations and so forth, share prices which were previously undervalued will rise in price. At some point even the most reluctant of family owned businesses will begin to reconsider. USAID, through CMDP, is already playing a role at this level.

b. USAID is already providing assistance to COPED to promote privatization which can be the most important source of supply of shares, especially in an emerging market such as Sri Lanka's. The recommendations made in the following chapter will bolster the privatization program, and thus improve the prospects for increasing the number of privatization share offers.

c. The GSL can continue to redress the policy distortions that tend to favor debt over equity in the capital structure of a company. These include directed credit, artificially low interest rates, the double taxation of dividends, and lax debt recovery policies. This would be an appropriate area for USAID to be engaged in at the level of policy dialogue with the government and would ably complement the project.

d. USAID can continue to provide technical assistance to financial institutions to develop corporate finance skills needed to take companies to an initial public offering. This is a useful and appropriate area for USAID to be engaged in. USAID's experience in providing a merchant banking advisor to the Merchant Bank of Sri Lanka has been a positive one and can serve as a model in this respect.

Brokers and others readily admit that corporate finance is not well developed in Sri Lanka but are interested in exploring its potential further. Essentially, brokerage firms earn all of their revenues from brokerage. This is unsatisfactory over the long run because many will fail as margins erode. The development of local investment banking capability is called for. Moreover, strong local investment banks would help in the privatization process. The Merchant Bank of Sri Lanka already points to the possibilities.

In view of the likely demands for such technical assistance if offered, perhaps USAID could consider providing for, say, two long term corporate finance advisors and compete the provision of services among local private sector finance institutions. Criteria for selection would include the thoroughness of the plan developed to utilize the expertise of the advisors.

e. A related recommendation would be to list government debt instruments. The CSE's charter calls for this. Apparently, much of the preparatory analysis has already been competently done by the IMF. This issue is currently being reviewed by the Banking Commission. It is recommended that these existing recommendations be implemented.

2. Demand for Shares

Current demand comes from highly professional foreign investors and mostly speculative domestic individual investors. It is critical to the long term development of capital markets to promote skilled domestic institutional investors with professional investment skills. This is already being done in part by the creation of unit trusts.

a. Rules governing the investments of private sector insurance companies need to be adjusted to allow more equity investment. Public insurance companies can be privatized and the investment policies can also be changed to permit greater equity in their portfolio. The ETF and the EPF similarly need to adjust their investment policies. USAID can pursue most of these goals in their policy dialogue with the GSL.

b. USAID should also be prepared to follow up with legal advisors to work with the GSL to effect necessary changes.

c. One practical and cost effective way to promote needed investment research and management skills would be for USAID to sponsor a Chartered Financial Analysts (CFA) program in Sri Lanka. Virtually all of the institutional participants with whom we visited are interested in having their staff participate in the CFA program.

This program is aimed at training securities analysts and portfolio managers in both the brokerage firms and institutional investors. The CFA program focuses on equity, fixed income securities analysis and portfolio management. It involves three years of self-directed study, with one examination per year. As a result, it is very cost effective: the approximate cost for registration, fees, exam and books would be $2,000 per person over three years. The CFA designation is a widely known credential in the investment research and management field. The Institute of Chartered Financial Analysts is located in Charlottesville, Virginia, with an international division to work with countries interested in setting up programs.

The New York Society of Securities Analysts (NYSSA) has expressed interest in assisting Sri Lanka's development in terms of study tour presentations. Perhaps a link with the NYSSA could complement a CFA program.

d. There are many miscellaneous items where USAID could provide technical assistance to help develop domestic institutional investors.

For example, it seems to be taken for granted that the state banks will succeed in acting as agents for distributing unit trust shares outside of Colombo. A concern, however, is whether bank personnel are sufficiently trained to do that. The DFCC is strongly interested in having a resident foreign expert for one to two years to help them set up and market their unit trust and in fact has approached USAID already about funding this position.

VENTURE CAPITAL

I. OBJECTIVES OF PROJECT COMPONENT

To further assist capital market development in Sri Lanka, USAID provided a grant of $500,000 ($444,000 obligated to date) to set up a venture capital company, called Equity Investment Lanka Ltd, or Equill. Equill, through the assistance of several local investors, will seek, when fully capitalized, to make equity investments in fifteen to twenty ventures.

The $500,000 grant was to help:

- Defray capital equipment costs (about $80,000);
- Defray operating costs over the first four years of operation ($160,000);
- Defray costs associated with hiring short-term expatriate and local technical assistance in its management and research activities ($180,000); and,
- Defray costs associated with promotion and training exercises for Equill management and for the Sri Lankan investment community at large ($80,000).

II. FINDINGS AND CONCLUSIONS

Equill is fulfilling a financial role in capital market development in Sri Lanka.

Both the DFCC and CDIC have been engaged in equity investment in private firms for several years, though they have not called it venture capital. The two firms are also in the process of starting venture capital funds to take advantage of the government's tax incentives.

Other firms are reportedly also in the process of getting venture capital funds started. The DFCC is getting assistance from the ADB. An ADB official is in fact recommending that USAID fund an in-house venture capital consultant for the DFCC. (the general manager of the DFCC perceives this as a less pressing priority than getting an in-house consultant to help them in setting up and marketing a unit trust.)

The managing director of Equill, draws a distinction between the DFCC/CDIC investment approach and his own by noting that to date they have been passive investors. There is little question that Equill is breaking new ground in Sri Lanka:

- Unlike DFCC and CDIC, it is investing in a new niche: namely, small and medium-sized businesses
- Unlike DFCC and CDIC, Equill is set up and run much as one would find in a classic venture capital company in the USA -- small, lean and headed up by a managing director whose primary experience is at the line level, that is, actually running businesses as opposed to managing a finance department

With minor exceptions, Equill's investment policies, outlined below, are in line with what one would expect from a venture capital company in the USA. Equill has sensibly chosen to focus on bringing foreign technology into existing businesses. In keeping with a pro-active policy, the managing director visits his portfolio of companies at least once per month and more if necessary. Equill plans to go public within three years.

Equill Investment Policies

- Always takes a minority stake (25-49 percent)
- No interest in seed financing; will only consider mezzanine and buy-out financing
- A guideline from USAID limits Equill to investing less than 15 percent of their equity in any one investment, but this is not stringent
- Equill may not invest in the textile industry because it would compete with US businesses. This is another condition of the USAID grant
- Normally tries to exit in 4-5 years
- Invests in either manufacturing of new products, manufacturing involving new processes or exports (manufacturing, trading or services). This is stipulated by the government in order to qualify for tax incentives

Equill has made four investments to date and has committed funds to a fifth. Investments are all in the 3 million rupee ($ 73,000) range.

Equill Investment Portfolio

Company	Equill ownership	Amount invested	Exit mechanism	Foreign interest
Dimo bus co	15%	na	CSE (3 yrs)	Mercedes*
Nikko towels	42%	3 mil R	na	no
Enamel copper wire	30%	2 mil R	na	no
Industrial Sew thread	na	3.5 mil R	na	yes
Plants	na	3.25 mil R	na	no

* Limited to technical assistance

Source: Equill

In making his first five investments, the managing director initially reviewed nine business proposals. Our only comment is that this is a surprisingly high acceptance rate compared to what one would find in the USA. Normally a venture capitalist rejects the vast majority of plans he reviews. In any case, he is currently reviewing sixteen business plans and expects to invest in 15 companies by December of 1992. He notes that deal flow has been so good that he is not using his advertising budget.

At this point, it is too early to assess Equill's investment performance. The main objective from USAID's point of view has been achieved, namely, that the firm is up and running.

The financial status of EQUILL as of September 30, 1991 was:

	($US Thousands)
Obligations	474
Commitments	474
Expenditure	75
Pipeline	369

The AID grant agreement calls for $US444,000 on a reimbursement basis but Equill's rate of usage has been low so Equill has only used up ten percent to date. It therefore would like an extension by one year of the grant. This is a reasonable request.

PRIVATIZATION

I. OBJECTIVES OF PROJECT COMPONENT

The objectives of this component of the Private Sector Policy Support (PSPS) project are to assist the Commercialisation Division of Public Enterprises (COPED) in the Ministry of Finance to plan and implement the GSL's medium-term privatization program. USAID plans to spend approximately $9 million (of a PSPS total of $15 million) in technical assistance, expenses for COPED, and actual costs of divestiture.

Expected project outputs by the end of the project (July 1993) are that the equivalent of the original project list of twenty-four enterprises will have been divested and that the GSL will have the institutional capability to carry out privatization activities.

II. FINDINGS

A. BACKGROUND

USAID's contribution to the GSL's privatization program was preceded by nearly a decade of effort by Sri Lanka to transfer state-owned assets to the private sector. During this time, however, virtually no state owned assets were transferred to the private sector. This is largely a reflection of the fact that the techniques for privatization, first developed as a serious program of national policy in Great Britain in the early 1980s, were not disseminated to other countries until the mid to late 1980s.

As discussed in the introduction, Sri Lanka has relied heavily on the state as the engine of growth. The GSL's involvement in directing the national economy started soon after independence, when industrial policy was marked by import barriers erected to protect and develop local industry.

In 1957, the government passed the State Industrial Corporations Act which set up state-owned enterprises in mining, agriculture, textiles and other sectors. In addition to creating these "corporations", the GSL nationalized companies that were previously run by the private sector through the Business Undertakings (Acquisition) Act of 1971 during the government's nationalization program of 1970-77. Such companies are referred to as "GOBUs" (Government Owned Business Undertakings).

As a result of these policies, as Tissa Jayasinghe, the Director of COPED, noted at a privatization conference:

> Sri Lanka has proportionately one of the largest public sectors outside the centrally planned economies. State-owned enterprises (SOEs) account for about 40 percent of the gross output in manufacturing, 38 percent of manufacturing value added and over 40 percent of employment in manufacturing.

The liberalization process which began in 1977 spawned the current interest in privatization. During the 1980s, it became increasingly clear that Sri Lanka's public enterprise sector could not compete with the liberalized external sector and the increasingly dynamic domestic private sector. Worse, public enterprises were a serious drain on the Treasury.

However, privatization of public enterprises has only recently come on-stream. Between 1977 and 1987, almost no assets were transferred to the private sector. The major achievement of this period was passage of the "Conversion of Public Corporations or GOBUs into Public Companies Act, no. 23 of 1987", which provided the legal framework for the "commercialisation" of public enterprises.

In August 1987, the Presidential Commission on Privatization was established. It laid out the criteria for choosing candidates for privatization: they should be profitable and obviously commercial, small enough to be divested in the domestic market and not politically or security sensitive.

The Presidential Commission was disbanded in January 1990. Its tasks are now handled by the Commercialization Division of Public Enterprises (COPED) of the Ministry of Finance. More precisely, the functions of the Presidential Commission are now carried out by tender boards created for each company to be privatized. COPED oversees many (but not all--some are handled by line ministries, such as the Ministry of Industries, with support from the World Bank) of the privatization activities for selected companies.

1. The Privatization Process in Sri Lanka

The privatization process has evolved out of the lessons learned from the first few privatization transactions. The first step in privatization in Sri Lanka is called "commercialisation" and is fairly straightforward. The next steps, which can be quite time consuming, are referred to as "people-isation". The resulting "60-30-10" divestiture strategy is an important contribution to the state of the art in privatization.

Commercialization involves the following specific steps:

- The "corporation" or "GOBU" must first be converted into a limited liability company. As mentioned above, the legal basis for this was created by Parliament in 1987

- Upon conversion, these public companies are registered with the Registry of Companies. All shares of these companies are held by the Secretary of Treasury. Supervision of these individual companies is done by the Ministry responsible for the sector in which the company operates

The second step is referred to as "people-isation", where, in chronological order, 60 percent of the converted company's shares are sold by a tender process to an investor (often foreign) who can bring the resources and technology to make the enterprise more competitive. 30 percent is then offered to the public and 10 percent is given to the company employees. The actual percentages can vary depending on the enterprise but in practice most privatizations have followed this "60-30-10" formula.

(For public enterprises that are already listed on the Colombo Stock Exchange--Lanka Milk Foods, Asian Hotels Corporation and TransAsia Hotels--the GSL has used a different strategy: sell a block of 51 percent of the shares through a sharebroker to a corporate investor. The remainder of shares will be disposed of in small blocks of shares through the secondary market, to the general public, and by transfer to the employees. It should be noticed that the 51 percent divestiture of Lanka Milk makes this the largest transaction in the history of the Colombo Stock Exchange, as of the completion of this evaluation.)

The strategy has several notable features that merit consideration by other countries. Selling 60 percent to a foreign investor helps provide new management, technology, access to markets and financing and the majority shareholding ensures that the investor will have sufficient interest to make the company work. Selling 30 percent to the Sri Lankan public helps to supply much needed shares on the market, a key constraint in the development of Sri Lanka's capital markets as we have seen in the previous chapter. A 30 percent local holding also serves as a check and balance on the foreign investor by requiring that the company issue annual reports and hold public stockholder meetings. Finally, since 10 percent of the shares are given to the employees, it also helps to turn what is normally a group opposed to privatization into supporting it.

2. USAID's support for GSL's Privatization Program under the Project.

On July 29, 1988, AID and the GSL signed the Private Sector Policy Support Agreement, of which privatization was a significant component ($9.066 million.) These funds were made available to help:

- Analyze privatization possibilities and methods

- Defray expenses incurred in the preparation of companies for divestiture. Such expenses include independent financial audits, legal costs associated with company restructuring, advertising of the public offering and using the advice of share brokers (though not for paying commissions or other fees)

- Defray post-privatization expenses. Such expenses include severance payments for redundant workers (only after successful divestiture of an SOE), management services to newly-divested firms and worker training programs for the new company

- Defray costs associated with public education and publicity for the Commission, office equipment and furniture for the Commission and one vehicle for the project

Project goals included privatizing a total of 24 SOEs, two of which were to be done in 1988, and helping the GSL develop the institutional capability to carry out privatization activities.

As part of the project, USAID entered into a three year contract (due for completion in late 1992) with Ernst & Young (USA) to work directly with COPED to identify appropriate short-term specialists (expatriates and locals) for the tasks, guide their work and report on the use of contract funds.

Through August 1991, obligations and disbursements by major element for the privatization component of the project were as follows:

Privatization Component: Projections Through September 30, 1991

(in $US 000)

Total Planned Obligations: 9,066

	Planned Commitments	Actual Expenditures
Redundancy Fund	4,550	3,000
Technical Assistance	1,900	1,064
COPED Secretariat	1,776	711
MBSL, PMI, IESC, Banking Commission	840	569
Total	9,066	5,344

Source: USAID/Private Sector

Items that have been funded by USAID include preliminary studies for four textile mills; registration of shares for United Motors, Ceylon Oxygen and Pugoda; legal fees for Hotel de Buhari and Ceylon Cold Stores; profiles of tire, rubber and plywood companies for the Ministry of Industries; surveying for Milco Land; post-privatization technical assistance for United Motors through the IESC; and promotion and advertising for United Motors, Ceylon Oxygen, Pugoda, Nylon 6, Oils & Fats and Hunas Falls.

B. ACCOMPLISHMENTS TO DATE & REMAINING TASKS AND ISSUES

After nearly a decade in which little was accomplished in privatization, things have moved quickly in the last two years and especially within the last year.

Of the two enterprises originally planned for immediate privatization in 1988, one (United Motors) was privatized in 1989 and the second (State Distilleries Corporation) will probably be advertised before the end of 1991. It has been reported that 40 percent of Distilleries shares will be sold to a corporate investor, though the actual divestiture strategy is not clear. Its targeted divestiture date is 1992.

1. USAID-Assisted Privatizations

Of the 24 SOEs originally identified by USAID and the GSL in the project paper as candidates, 14 are still under active consideration by the government.

To this list of 14 corporations from the original list, another 29 companies have been selected for privatization and added to the COPED list, bringing the total to 43 (see Exhibits A and B). According to discussions with GSL officials, another 5 public enterprises will be shortly added to the list.

Of the 43 companies, 9 companies discussed below have been divested (50 percent or more of net assets transferred to the private sector) to a corporate investor. Of these 9, 3 have included a public share offer (United Motors, Ceylon Oxygen and Pugoda Textile Mills.)

Evaluation of offers for the 60 percent portion of privatizations is currently underway for an additional 6 companies. In all, investor profiles have been produced for 27 companies and valuations have been competed for a total of 36 companies.

The universe of privatizations transacted by COPED is still small. It is worthwhile to review briefly these transactions in order to get an understanding for the state of the art of privatization, its development over the last two years and the challenges that face the current process. Completed USAID-assisted privatizations which fall under this particular grant are summarized in the following table while descriptions of each (and other USAID and World Bank assisted projects) are found in appendix IV:

Value of Assets Sold to Private Sector*

Enterprise	Rs. Million	No. of Employees
1. United Motors	95	535
2. Thulhiriya Textile Mill	206	3,000
3. Hotel de Buhari	7.5	108
4. Dankotuwa Porcelain	115	500
5. Ceylon Oxygen	81	419
6. Pugoda Textile Mills	90	3,000
7. Mattegama Textile Mills	NA	956
8. Hunas Falls Hotel	6	39
9. Lanka Milk Foods	528	423
Total	1128.5	8,980
Total $US @ Rs. 41 per $	$27.5	

*Does not include value of shares gifted to employees.

Source: COPED

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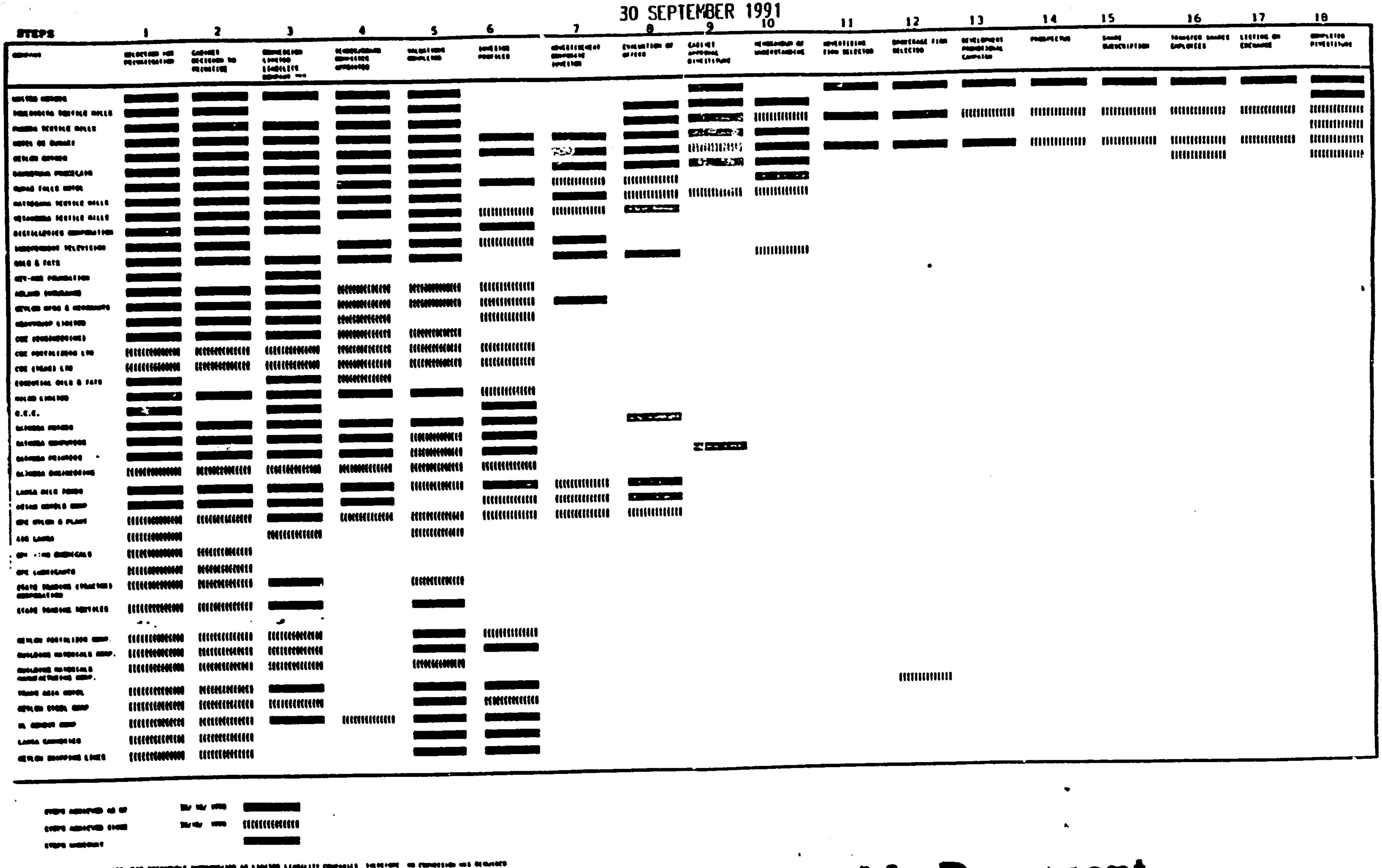
2. The GSL's New Privatization Timetable

The planned outputs under COPED's privatization activities have now been assigned a specific timetable for privatization (i.e. sale of a majority shareholding) in conjunction with the IMF's Enhanced Structural Adjustment Facility (ESAF), which will make US$ 455 million in loans available over the next three years. The following two charts list the companies selected for divestment by December 1991 and March 1992.

TO BE PRIVATIZED BY COPED

30 SEPTEMBER 1991



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Companies Targeted for December 1991 Divestiture

Company	Steps Completed as of Sept. 30
Acland Insurance	1-6
CCC Engineering	1-5
CCC Fertilizer	1-6
CCC Teas	1-6
Ceylon Manufacturers and Merchants	1-7
Heavyequip	1-4, 6
ITN	1-7
Oils and Fats	1-5, 7-8, 10
Sathosa Computers	To be liquidated
Sathosa Engineering	1-6
Sathosa Printers	1-6
Sathosa Motors	1-7
Paranthan Chemical	N.A.

Companies Targeted for March 1992 Divestiture

Company

Ceylon Plywoods Corporation
Leather Products Corporation
Mattegama Textile Mills
State Hardware Corporation
Tyre Corporation
Veyangoda Textile Mills
Asian Hotels Corporation
CPC Nylon Plant
Lanka Milk Foods
Transasia Hotels Group

The Central Transport Board has been selected for June 1992 and the Paper Corporation has also been targeted for 1992, though no particular month is specified. (Note: this list includes some companies which are receiving World Bank assistance in privatizing and which are not on COPED's list.)

The program is certainly ambitious but how realistic is it? The chart above on the "Status of Individual Companies to be Privatized by COPED" plots the progress of the 43 companies selected for privatization against the 18 steps involved. Steps 1-10 cover the divestment of the majority shareholding in the enterprise, typically the 60 percent discussed earlier. Steps 11-15 involve the public share offer and Step 16 involves the gifting of 10 percent of the shares to the employees.

It is evident that a crunch will occur in trying to meet the December targets. Of the 12 companies on the list, 7 as of September 30 had not yet been advertised. Only 4 had advertising underway and only 1 has actually reached a memorandum of understanding, although the cabinet has not approved its divestiture. One company (Sathosa Computers) was recently found to be insolvent and is to be liquidated. One is being held off the market until November to update the financial statements. Another (Paranthan Chemical) is not on the COPED list. (The mention of steps "completed" often overstates the case for some companies because the profiles are often prepared ahead of time and when the companies are brought to sale, the financial data is often out of date, which reduces the number of serious bidders participating.)

In discussing ways of improving the current process in the following section, we point to the need to advertise the companies more widely and to allow investors more time to put together serious bids. Three months is recommended as a reasonable period of time for international investors to be sought. Assuming that all of the advertisements have been made by the time this report was being completed, then perhaps the potential investors would have the required amount of time to put together bids. However, this would not permit enough time for the evaluation of offers, selection and conclusion of the memorandum of understanding, which typically takes several months.

Thus, there are several problems with the current targets. The timetable for December 1991 is not practical because it ignores the way that serious investors make decisions. Not enough time is allowed for the investors to made a solid offer and for the GSL to evaluate and conclude an award. To carry it out could result in lower returns to the government. To force the process to make the December targets risks weakening, rather than improving and solidifying, the current process.

The March 1992 list appears to be more reasonable, although 4 of the 10 companies are not on the COPED list, and so we are less certain of where matters stand in their privatization. One of these, Leather Corporation, has been sold (90 percent) to a local investor. Tyre Corporation and Hardware Corporation are reported to be in process. CPC Nylon 6 has reportedly been sold. The GSL may have already found a buyer for 60 percent of Mattegama's shares, as noted above. Asian Hotels, Lanka Milk Foods and TransAsia Hotels, already listed on the Colombo Stock Exchange, are individually being divested by selling 51 percent through a stockbroker, a process which can occur quite quickly depending on the price the government is willing to accept, although the first offer period for Asian Hotels and Lanka Milk Foods was unsuccessful. On October 25, 51 percent of Lanka Milk Foods was sold through the Colombo Stock Exchange.

In summary, the December 1991 list of companies to privatize seems to be at variance with improving the privatization process. The March 1992 list seems to be more reasonable. We believe that a more realistic target would be about half the number of enterprises (say, 12) by July 1992 in the GSL timetable. More importantly, the targets should include improvements to the process outlined below under "Recommendations". Doing so would ultimately lead to a more rapid pace of privatizations in the final year of the project (July 1992-July 1993.)

3. Challenges Facing the Privatization Program

While the progress of the GSL's privatization program to date is noteworthy, Sri Lankans in both the public and private sectors who we interviewed tend to believe that the program has not yet hit full stride and that the accomplishments to date are not yet fully commensurate with the growing vigor of the economy or talent emerging in the financial sector. Indeed, discussions with a wide variety of participants in the privatization program have revealed a number of different challenges facing the program.

These challenges fall into two basic categories. The first concerns the public's awareness of how the privatization process works. The second group of issues are operational in nature and include staffing, the structuring of privatization transactions and marketing.

a. Public Awareness

While the mechanics of selling the 30 percent portion on the capital market and granting 10 percent to the employees are relatively straightforward, our discussions with a wide range of people familiar with privatization indicate that the public does not fully understand how the 60 percent portion is sold. As we understand it, the following are the main steps:

- As a part of the process, the Cabinet writes a memorandum listing the companies to be privatized and appoints a Tender Board which handles the privatization. A Tender Board usually consists of 3 or 4 people, including the secretary from the line ministry and the Director of the Commercialization Division at the Ministry of Finance

- The valuation of the company is determined by the Chief Valuer of the GSL, with an independent valuation by Ernst & Young/Colombo often used as a reference point. Ernst &

Young/Colombo also prepares an investment profile. The company is then advertized, usually in the Financial Times and the mid-Atlantic edition of the Wall Street Journal if foreign investors are desired and bids are solicited from investors who wish to purchase majority ownership in the company. (The GSL has also recently sent profiles to Sri Lanka embassies worldwide, though the usefulness of this is not well established.) The advertisements stipulate a certain date by which all bids must be received, generally 6 weeks from the date of advertisement. Tender documents available through the line ministry specify the relevant offer requirements (price, restructuring plans, financial position of potential investor, etc.) However, no formal weighting of these criteria is indicated

- Investors are, in theory, free to visit the companies and management as part of preparing their bid documents. In practice though, according to some investors, gaining such access has often been difficult

- On the appointed date, the bids are reviewed by the tender board and it makes its recommendation. This recommendation is sent to the Minister, within whose portfolio the company is found, who approves the winning bid. The recommendation is then sent to Cabinet and copied to the Ministry of Finance, which sends its comments to the Cabinet. The Cabinet approves the bid and contacts the winning bidder

- Following negotiations, which have frequently been complex and protracted, the GSL and the winning bidder draw up and sign a "Memorandum of Understanding" outlining the terms and conditions

- The Secretary of Treasury authorizes the transaction and executes the transfer of shares to the successful bidder

- The price arrived at in the bidding process then becomes the price at which shares are sold to the public in the public share offer (usually 30 percent of the company)

While the above seems fairly straightforward, both the public and potential investors have little understanding of the procedures governing the bidding and selection techniques, and we some ideas in the "Recommendations" section that might help make the process more transparent.

b. Operational Issues

There is not necessarily a clear line between these two challenges. Once some of the operational issues have been addressed, the public's awareness of the process can simultaneously be improved. The review of the current process and the experience with the 9 privatizations to date brought to light several specific operational issues:

- The timing and scheduling of privatizations is not well known in advance, giving the relevant actors insufficient time to respond

- The valuations employed and prices negotiated with the buyers have, on occasion, been poor indicators of what the stock market has been willing to pay for shares

- In the tendering process for the 60 percent ownership, the invitations are not widely advertised (often limited to the Financial Times or the mid-Atlantic edition of the Wall Street Journal when foreign investors are desired)

- There is not enough time for serious investors to respond (often six weeks or less)

- Not enough information is available: profiles have occasionally been inadequate (though quality has improved greatly, dated or unavailable; it is difficult to visit facilities and meet with management; procedures for bidding are often not clear

- Weighting of evaluation criteria is unclear

In public share offers:

- Quality of advertising and marketing campaign needs to be better targeted and improved

- Selection criteria of underwriters is not clear

- Institutional investors have been precluded from participating in the share offers, thus limiting their development as important sources of demand. The previous chapter of this report identified the development of institutional investors as critical for further capital market development

- Multiple applications for shares are reportedly fairly widespread

- Application forms need to be reduced to one single-sided page

- Collection and processing of applications by brokerage firms and the two state owned banks needs to be improved

- The management of share offers has been limited to only three sharebroking firms

We believe that most of these challenges can be met by instituting changes in the size and nature of COPED's staff, by structuring privatizations differently and by increasing marketing efforts: all three issues are looked at in our section on "Recommendations".

4. Performance of the technical assistance contractor

a. Background

The long term advisor under the Ernst & Young (USA) contract arrived in December 1989. The role of the technical assistance was first and foremost to work on the nuts and bolts of implementing the privatization program. A subcontract between Ernst & Young (USA) and Ernst & Young (Colombo) assisted the staff in producing on-going valuations and company profiles of public enterprises selected for privatization. A subcontract with Equity Expansion International was executed to provide services in connection with employee share ownership plans (ESOPs).

As matters developed, the government required that the Chief Valuer participate in the valuation process. The Chief Valuer's valuation became the "official" valuation for the purposes of privatization. There were several problems encountered with this approach, however. First, the Valuation Office was primarily experienced in the valuation of land and property, rather than enterprises subject to privatization. Second, its approach was totally an asset based, rather than a going-concern, valuation.

The contractor provided several initial valuations and then trained the staff of Ernst & Young/Colombo which had little previous experience in undertaking privatization-related valuations or in producing profiles which would meet the often exacting demands for information from foreign investors. Subsequently, the contractor arranged for the training of two senior members of the Valuation Department and presented a seminar to all key department officials, Ernst & Young (Colombo) staff, local sharebrokers and bankers.

Valuation exercises and seminars undertaken by Ernst & Young (USA) have received praise from the concerned parties we interviewed. The Director of COPED cited it as a valuable example of the transfer of needed financial technology to Sri Lanka. Through assistance and quality control from Ernst & Young (USA), the quality of the investment profiles by Ernst & Young/Colombo has shown steady improvement. The most recently produced ones are of high quality.

At the request of the GSL, the contractors prepared, in collaboration with Simat, Helliesen & Eicher Inc. of New York, a preliminary study of the privatization of Air Lanka. This report was of particularly high quality. The recommendations were not implemented but Air Lanka is now proposed for privatization and the recommendations concerning its privatization should prove useful.

In general, the bulk of the technical assistance effort provided under the project has been the preparation of investment profiles and valuations but Ernst & Young has also:

- Assisted in the formation of limited liability companies in a number of cases

- Provided restructuring advice concerning individual companies

- Recommended clauses to be incorporated into the memorandum of understanding executed with the corporate investor

- Distributed investor profiles directly to prospective investors, brokers, intermediaries and other interested parties and contacted intermediaries and investors concerning the sale of individual companies

- Reviewed the prospectuses for the public share offers and provided technical input

- Reviewed the advertising campaigns for the public share offers

- Provided transport engineering assistance and developed a series of studies containing divestiture strategies for three Central Transport Board workshops

- Through its subcontractor, Equity Expansion International, reviewed a possible ESOP (Sathosa Computers) which actually resulted in a recommendation to liquidate the company that was accepted by the government

b. Assessment of Performance

On balance, PW/IPG believes that the TA contractor has performed its duties conscientiously and at a high professional level. This conclusion is based on a number of conversations with the present chief of party and a review of a wide range of documents prepared by the contractor.

While its contributions have been valuable, one senses disappointment by the contractor that the technical assistance supplied has not been utilized in some of the "higher order" steps in the privatizations, such as input into the structuring of the transactions, or advice for improving the privatization process.

This reflects in part the sensitive political nature of privatization and the desire by the GSL to keep technical assistance at "arms length". This was perhaps reflected in the project paper when it was decided that the technical assistance group would be located in a different office than the COPED team.

Another possible factor was that an earlier chief of party for the project, according to sources interviewed, did not actively try to market, or create a demand for, additional services (such as structuring transactions) potentially available under the contract. Ernst & Young (Colombo) has performed well as a subcontractor and has provided the bulk of the person-months under the TA contract. As a result, COPED directed its requests more and more to Ernst & Young (Colombo).

While one can never be certain that the resident advisor would have been consulted for more substantive inputs, or on a more ongoing basis, the opportunity to do so seems to have been lost early in the project. The opportunity has not presented itself again. As GSL officials gained increasing experience from actual hand-on operations in privatization transactions, they seemed to view themselves as more knowledgeable about the process and operational issues than the consultants.

The original chief of party was replaced in March 1991 by a career Ernst & Young employee, who is widely known and respected among practitioners of privatization. However, his efforts to play a more activist role than his predecessor and try to add value "upstream" in the privatization process have been rebuffed. By this point, the GSL had the experience of several privatization transactions to draw on and felt that the contractor had already successfully completed its main mission through its efforts in valuation and investment profiles.

The fact that a rapport has not been established has presented USAID with certain managerial dilemmas. Because the TA team does not work closely with its GSL counterparts, it is often a recipient of requests for discrete assignments. This naturally makes it difficult for the contractor to engage in much forward planning in anything other that a generic sense of providing assistance. This complicates USAID's oversight role vis-a-vis its contractor and in fulfilling its stewardsnip function on the use of US government funds, since it then becomes difficult, in the absence of specific workplans, to monitor contractor performance against various benchmarks.

III. RECOMMENDATIONS

A. IMPROVE PUBLIC AWARENESS OF THE PRIVATIZATION PROCESS

The GSL would like to make its workable process even better. The US Mission asked the evaluation team to provide suggestions on how the public's understanding and awareness of how the privatization process works could be improved.

The most critical element in the public's understanding of the process is the initial sale of majority positions in the public enterprises. The GSL made an important step in improving transparency when it published in August a list of companies to be privatized. An important follow-on step would be to publish the regulations which ensure standard procedures for these sales so that the public understands how the process works. This could be accompanied by a flow chart which captures the main steps in the process.

Additional measures would include adopting standard international bidding techniques. Sealed bids should be opened in a public setting where the bidders may attend. In fact, this was done in the last two privatizations. A next step would be to institutionalize this as a standard operating procedure for each privatization of this nature. Additional steps would include photocopying the bids, with the originals locked in a safe. The mechanics of re-bidding awards, when necessary, need to be worked out.

Although USAID plays no direct role in the tendering process and indeed is convinced that it would be an inappropriate area for donor involvement, USAID is acutely aware that the success of the program depends on these endeavors. Therefore, USAID should be prepared to follow up on these requested recommendations and assist the GSL in improving the process along these recommended lines.

B. ADDRESS SEVERAL KEY OPERATIONAL ISSUES

1. COPED Staffing

Most of the challenges facing the program arise from the fact that the individuals working on privatization issues do not have adequate staff to support their efforts. The fact that so much has been achieved within the last two years is a testimony to the hard work and perseverance of the Commercialisation Division, especially its director and the work of the tender boards and line ministries. Not only have these individuals had to set policy regarding privatization but they have also had to get involved in much of the details of individual transactions.

Recently, two of three staff members have left COPED, which will create an even greater workload for the director, who already sits on over 30 committees dealing with individual company privatizations. Line ministries are similarly understaffed and overworked for the role that they play in privatizations, especially in the marketing of the SOEs to investors.

We recommend the development of a technical unit with legal, financial and accounting skills, working under the director of COPED. Such a technical unit would enable COPED to improve the structuring of privatization transactions and learn how the privatization of approved enterprises may be achieved in accordance with policy objectives.

The technical unit would be a core group which would be supplemented as required by outside specialists. The essence of the technical unit's work would be to identify candidates for privatization, gather information about the public enterprises to be privatized, identify practical means to overcome barriers to completing the transaction, work with the valuators, finalize recommendations on the appropriate modality for privatization, oversee the preparation of the profile for investors and work with the tender boards to screen applications, negotiate with applicants and other parties and then present recommendations.

In order to maximize the value of transactions for the GSL, the technical unit should attempt to solicit a large number of competitive offers from applicants. To negotiate effectively, the team must have, among other things, sufficient knowledge of the enterprise and the industry in which it operates. Technical units designed along the lines recommended have worked well in other countries.

An appropriate staffing pattern would follow the following lines:

a. Chief Executive

The Director of COPED would be the Chief Executive of the technical unit. He would have policy and administrative oversight of the technical unit.

b. Manager(s)

There should be a full-time Manager and possibly several in the future, in the technical unit. The manager (s) would report to the Chief Executive. Experienced in the management of contracts, the manager(s) would have a broad range of experience in investment banking and transaction development and in presentations to potential investors and government officials. He/she would possess strong negotiating skills and could represent COPED on some of the Tender Board meetings, reporting back to the Chief Executive. This would relieve the Chief Executive of a current time-consuming duty.

c. Legal Adviser

In view of the multiple privatizations that may be carried on by the unit at any time, there should be a full-time commercial attorney available and qualified to practice in Sri Lanka to be the Legal Adviser to the technical team. His work objectives would be set by the Chief Executive.

d. Financial Analysts/Accountants

Since the program would be of long duration, a core of experienced financial analysts and/or qualified accountants would be needed to gather information about the enterprises and compile projections on the potential of the enterprises. Much of this work is being undertaken by Ernst & Young/Colombo but it would be useful to have full time talent working within the technical unit.

These persons must be capable of utilizing word-processing and spreadsheet packages. They should be organized into enterprise teams with a leader or assigned individually to deal with enterprises, depending on the complexity of the transactions. In the first year, it is recommended that six people possessing skills comparable to the above be recruited for the technical unit.

The staff members should also receive training and should acquire valuable on-the-job training from working under the Chief Executive. A short term foreign consultant may be chosen to provide initial on-site training. The financial analysts should be encouraged to enroll in the Chartered Financial Analyst program.

Part of the effort of the technical unit will require ad-hoc consultants. These will include industry specialists, marketing experts and appraisers. Where this talent is not available in Sri Lanka, it can be provided by the TA contractor (Ernst & Young/USA.)

2. <u>Structuring Transactions</u>

A technical unit designed along the lines suggested above could play an important technical role in the initial structuring of privatization transactions.

The following work method could be used by the COPED technical unit, as it would fit well into the current tender board process, while providing needed, ongoing technical input into the process. Such a work method has worked well in other countries.

a. Arrange for the preparation of the memorandum and articles of association or any special incorporating statute for the public enterprise to be privatized. (Lawyer)

b. Obtain copies of all important agreements, including loan agreements, encumbrances of assets, leases, clear title to land, confiscation orders, construction contracts in progress, union agreements, licenses, authorization for incentives and any special legislation applicable to the enterprise. (Lawyer)

c. Summarize important or unusual features and exposure to litigation for any of the above for the enterprise and its business operations. (Lawyer)

d. Oversee the preparation of audited financial statements for the last three years for the enterprise and to within three months of the sale in accordance with Sri Lankan and international accounting standards and with an auditor's opinion. (Accountant)

e. Comment on operating history, capacity utilization, problems facing the enterprise and the industry in which it operates and any relevant events subsequent to the latest accounts that may affect the sale of the company. (Accountant)

f. Define preliminary data requirements for preparation of financial forecast. (Accountant)

g. Prepare preliminary SWOT (Strengths, Weaknesses, Opportunities and Threats) for the enterprise. Begin investor profile. (Manager with TA contractor.)

h. Assemble file of the above using standard index corresponding to the step numbers above. (Accountant)

i. Submit to Chief Executive for review. (Manager)

j. Follow up review points raised and finalize data requirements. (Manager)

k. Obtain data requirements. (Accountant, Lawyer, Industry Specialist and Valuation Specialist, as required)

l. Determine if any financial or legal restructuring required. (Chief Executive)

m. Follow up review points raised. (Relevant persons)

n. Prepare computerized financial forecast and submit entire file and forecasting diskette to Chief Executive. (Accountant)

o. Make final selection of recommended divestiture option and negotiating parameters in connection with the tender board. (Chief Executive with Manager)

p. Approve divestiture modality and negotiating parameters. (Cabinet)

q. Complete investor profile. (Manager overseeing TA contractors)

r. Advertise enterprise internationally and/or locally as required, with wide distribution of the investor profile to intermediaries and prospective buyers. (Technical unit with significant input by TA contractors)

s. Meet with and assist prospective buyers as required with visits to enterprise and management. (Manager with line ministries)

t. Accumulate sealed offers in a sealed tender box located in a central location. (Chief Executive with tender board)

u. Review financial offers after public opening of the offers. (Members of tender board, Chief Executive)

v. Tender board presents recommendations to Cabinet. Cabinet must approve the acceptance of the offer. (Chief Executive, GSL tender board representatives)

w. Negotiate with offeror after approval by Cabinet. (Chief Executive with GSL tender board representatives)

x. Formulate memorandum of understanding with buyer. (Chief Executive and lawyer)

y. Forward memorandum of understanding to Cabinet for its approval and prepare final legal documents. (Chief Executive and Lawyer with specialized legal assistance)

3. Marketing of Privatizations

The marketing of the SOEs is part and parcel of this process. Marketing can be specifically improved by advertising more widely in order to generate a larger number of bids and by giving more lead-time and advance notice of the tendering of the majority shareholding.

This would enable both prospective intermediaries and the technical assistance contractor to provide advance notice to prospective buyers. Foreign investors must have more time to put together serious bids based on the information in the company profiles, company visits and interviews, due diligence activities and professional consultation. The GSL needs to ensure that better and more up-to-date financial information is provided to potential investors. Access to companies and contact with current management needs to be improved. Evaluation criteria should be specified in the tender document and the relative importance of these criteria indicated.

We have noted that the present TA contractor has played a valuable, though circumscribed, role in the current process. We believe that the TA contractor could provide a useful role in the marketing of privatization transactions, especially internationally. In particular, the TA contractor could continue to assist in improving the marketing of SOEs by providing information to a network of potential investors and intermediaries. For example, the TA team could identify newspapers, trade magazines and journals appropriate for the advertisement of the sale of these companies. It could also distribute company profiles widely through investor networks.

C. PROVIDE ADDITIONAL TRAINING IN SUPPORT OF THE FIRST TWO RECOMMENDATIONS

Training in the following areas has frequently been cited by the GSL as examples of how USAID, through its TA contractor, could provide more assistance:

- Continue to provide valuations as a reference point for the Ministry of Finance, assist the Valuation Department in developing its valuation skills and provide specific assistance such as machinery and equipment valuations

- Hold workshops for stockbroking firms on writing prospectuses and on the development of other relevant financial documents

- Hold workshops for local advertising agencies on the advertising and marketing of share offers

- Hold workshops on international tendering and evaluation of tenders and international negotiations

If the recommendations above are adopted, then the process should become more sustainable. This should increasingly enable the GSL to meet retrenchment payments from privatization proceeds and reduce the need for USAID to assume this burden.

Through working closely with COPED, USAID will continue to be in a position to respond should additional but as yet unarticulated, requests for relevant services be made as privatization comes into full stride and transactions become more complex. This would be helpful not only in furthering the cause of privatization but also in advancing the objectives of the capital markets component of the project.

For example, USAID has the opportunity to take the lead and initiative in working with the GSL in promoting Build-Operate-Transfer (BOT) and Build-Own-Operate (BOO) privatizations. USAID has already held a workshop for senior government officials which was well received.

Another potential area down the road for USAID's involvement would be the utilities sector, notably the telephone and electricity sectors. The US has a wide range of experience in the private sector operation of these sectors and the related regulatory structure needed to oversee them. Airlines and railways are also possible areas where the special skills available from the U.S. can be useful.

D. CONTINUE USING THE TECHNICAL ADVISOR

The current view of COPED is that Ernst & Young can play a valuable role in providing short-term specialized services for transactions in privatizations where current experience is lacking in Sri Lanka. COPED also looks to the contractor to provide some additional training courses. The GSL believes that this role can be undertaken from the United States, with the savings from running a local office being used to assist the government in its redundancy payments.

USAID's view is that such savings would be minimal compared to the amounts required. USAID has indeed generated a significant level of project resources towards reimbursing the GSL for its redundancy payments ($US 3 million with another $US 1.5 million planned.) These resources have played a critical role in serving as a catalyst for what could have been a bottleneck in getting the privatization process up and running. Once the program is fully on track, redundancy payments can be met increasingly from sales proceeds generated by privatizations as the remainder of USAID's resources directed for this purpose are drawn down.

USAID also notes at a minimum that a resident advisor is needed to play an important coordinating and quality control function. The importance of this can only grow as new training seminars and workshops are planned (as detailed above). And to play an expanded role in the marketing of privatizations will also benefit considerably from a resident advisor to coordinate matters.

E. CONTINUE USAID SUPPORT FOR GSL PRIVATIZATION

Given the circumscribed nature of the contractor's role in the privatization process, the dilemma for USAID is whether it should be content with a situation which often precludes its usual oversight role, when the effect of its participation is to contribute to a process that has realized some success to date and has the potential for much greater success in the future. As development practitioners know only too well, the obverse of the present case is much more frequent: micro-management of inputs into a process that is not producing the desired outputs.

The deeper issue is one of the spirit of partnership between US assistance and the GSL's development program. By all accounts, the partnership is strong. We believe that it is appropriate for USAID to participate in a project such as the present privatization program but that for the next major effort, a closer partnership will be required.

We believe that a focus on the outputs of the process (SOEs privatized) rather than the inputs (workplans for technical assistance) is the more relevant oversight benchmark for USAID in this project. By the same token, the spirit of partnership could include a greater appreciation by the GSL for USAID's internal management requirements over the funds it brings to the project and a concomitant effort to work with USAID in this area.

There will come a point when the desired outputs can be attained even without USAID inputs. When this point has been reached, the project will have achieved sustainability and USAID will be able to shift resources elsewhere, for example, in further developing the capital market. Assuming their reasonable concerns are met, however, we believe that USAID should work with the government to consolidate and fine-tune the accomplishments to date.

EXHIBIT B

Public Enterprises in the Process of Divestiture

	Number of employees	Estimated value of gross assets Rs. Millions	Target divestiture
Public Enterprises Designated by the GSL for Divestiture			
Acland Insurance	27	31	Dec 1991
Asian Hotels Corporation	706	1,800	March 1992
Building Materials Corporation	1,521	135	
Building Materials Manufacaturing Co	119	6	
CCC Engineering	1,481	122	Dec 1991
CCC (Fertilizer) Limited	502	459	Dec 1991
CCC (Teas) Limited	278	92	Dec 1991
Central Transport Board	23,000		June 1992
Ceylon Fertiliser Corporation	690	1,250	
Ceylon Manufacturers and Merchants	166	49	Dec 1991
Ceylon Oxygen	419	309	1991
Ceylon Steel Corporation	1,543	812	
Consolidated Exports and Trading Cro	446	144	
Cooperative Wholesale Enterprise	6,114	1,662	
CPC Nylon Plant	504	1,200	March 1992
Dankuotuwa Porcelain	500	230	1990
Distilleries Corporation	1,966	448	1992
Heavyquip Limited	30	6	Dec 1991
Hotel de Buhari	103	13	1991
Hunas Falls Hotel	39	8	1992
Independent Television Network	135	56	Dec 1991
Lanka Canneries	375	42	
Lanka Milk Foods	423	541	March 1992
Milco Limited	600	156	1992
Oils and Fats Corporation	1,116	305	Dec 1991
Sathosa Cpmputers	57	3	Dec 1991
Sathosa Engineering			Dec 1991
Sathosa Motors Company	184	88	Dec 1991
Sathosa Printers	187	20	Dec 1991
Sri Lanka Cement Corp.	3,512	1,811	
Sri Lanka State Trade Corp.	555	210	
State Trading (Textiles) Corp.	1,527	345	
State Trading (Tractor) Corp.	440	126	
TransAsia Hotels Group	647		March 1992
Public Manufacturing Enterprises			
Ceramic Corporation			
Ceylon Plywoods Corporation	2,300		March 1992
Leather Products Corporation	1,054		March 1992
Mattegama Textile Mills	956	149	March 1992
Mineral Sands Corporation			
Mining and Mineral Corporation			
Paper Corporation			1992
Paranthan Chemicals Corporation			Dec 1991
Pugoda Textile Mills	3,000	426	1991
Salt Corporation			
State Hardware Corporation	537		March 1992
Thulhiriya Textile Mills	3,000	206	1991
Tyre Corporation	2,000		March 1992
Veyangoda Textile Mills	2,074	309	March 1992

Source: COPED, IMF

5

THE POLICY SUPPORT UNIT (PSU)

I. OBJECTIVES OF PROJECT COMPONENT

The objectives of this component of the Private Sector Policy Support (PSPS) project are to strengthen the private sector institutions in appraising, formulating and implementing market-oriented economic policies. USAID obligated $ 2.9 million, of which $ 1.0 million is for grants to CBAs and $ 0.8 million is for administrative and indirect costs. The rest, $ 1.1 million, is allocated to technical assistance sub-grants.

By the end of the project (June 1993), it is expected that there will have been fifteen to twenty subgrantees (private sector organizations) which will be in a better position to participate effectively in influencing business and economic policy and that there will have been between five and ten workshops held to develop the skills of groups of PSOs with similar interests and to provide a basis for effective collaboration.

II. FINDINGS

A. BACKGROUND

As one of the four components of the Private Sector Support Project, the Policy Support Unit (PSU) program aims at strengthening the private sector institutions in appraising, formulating and implementing market-oriented economic policies.

The program recognizes the critical role of the private sector as the vanguard of economic development in Sri Lanka. The private sector must respond dynamically to new policies conducive to a more stable, predictable and efficient environment for production and investment.

The program recognizes the Chambers and Business Associations (CBAs) as the appropriate vehicles for analyzing economic issues and making well-researched representations to the government and for developing dialogue between the public and private sector in Sri Lanka.

The PSU program was launched during momentous times. Since 1977, successive governments in Sri Lanka have made great strides in enacting major economic policy reforms in the direction of market-oriented policies, a trend that has greatly accelerated in the last three years.

Real gains from opening up the economy are increasingly evident: the more rapid pace of privatization, the growth of the stock market and, most importantly, the high rate of economic growth in 1990 (6.2 percent). With political and policy stability, prospects in Sri Lanka are good.

Under a Cooperative Agreement, the PSU program was awarded to the School of Public Affairs (SPA) of the University of Maryland, College Park, in March 1991 and is scheduled to end on July 31, 1993. Administrative functions related to the PSU office were supported by the Sri Lanka projects management unit at the International Science and Technology Institute (ISTI), which was expected to maintain a role only as a facilitator of the PSU and as a provider of technical assistance when requested. The budgeted amount of the Agreement is \$ 2.9 million of which \$ 1.0 million is for grants to CBAs and \$ 0.8 million is for administrative and indirect costs. The rest, \$ 1.1 million, is allocated to technical assistance sub-grants.

The financial status of the PSU as of September 30, 1991 was:

($US Thousands)

Obligations	2,946
Commitments	2,946
Expenditure	1,169
Pipeline	1,777

B. ACCOMPLISHMENTS TO DATE AND REMAINING TASKS AND ISSUES

The institutional base of the CBAs is being strengthened. The installation of the equipment, e.g. fax machines, office furniture and computers, through the program, demonstrates this in part. More important, the chambers interviewed stated that they were working towards improving their knowledge and technical skills in order to better serve their members.

Networking with universities, an idea suggested by the PSU, is an interesting indicator of this awareness. More concrete evidence of institution building is offered by the fact that some CBAs are now rapidly computerizing their information systems (CCC), that hiring of competent, skilled staff is taking place, that newsletters are being upgraded (WCIC) and that new journals (NCC) are being published. In addition to this, insight into the issue of future sustainability of CBAs is provided by the fact that some chambers, such as the NCC, are now conducting fee-paying seminars and workshops.

It should be emphasized that the PSU was praised in meetings with the CBAs. Both the monies awarded and the high quality of the technical assistance of the Installation Teams were cited as critical factors contributing to the strengthening of the institutional base of the CBAs. At this point, it is fair to conclude that the grantees will soon be in a position to improve and expand their services to their members.

Assessing the impact from activities aimed at fostering a productive and constructive dialogue between the public and the private sector as the foundation for the effective implementation of market-oriented policies is very difficult. In this regard, it should be noted that with the technical assistance of the PSU, chambers from the banking and tea industries made representations to the GSL (see Appendix I-B). Also, the PSU program is playing a very important role in defining the policy agenda for the fruits and vegetables and the gems and jewellery sectors. But, it must be added, these activities are not easy to evaluate because they are affected by the interactive relationships between the public and private sectors, characterized either by shared or diverging goals and commitments embodied in the development strategy and economic policy of the government.

Nonetheless, it is still possible to offer judgement with regard to the likelihood of achieving the program's ultimate purpose. Rather than search for quantifiable indicators of success in public/private dialogue, one should instead focus on the activities that have been undertaken, i.e., on the program's outputs and by assessing how they are contributing to the promotion of a productive partnership between the public and private sectors. In this regard, we should note that the results achieved so far have been substantial and impressive.

The PSU has offered valuable assistance in the undertaking of analytical activities by CBAs on taxation, national budget, debt recovery laws, exchange controls, etc., as it has promoted and sponsored seminars and workshops (for a detailed description of these activities, see Appendix I-B). It is also worth noting an interesting fact. In all of our meetings with the CBAs, a common denominator was revealed: that the private sector in general supports the economic liberalization process that is being conducted by the government. Yet, the larger question remains whether or not the new relationship that is evolving between the public and private sectors is conducive to the adoption of broad-based development policies.

1. The PSU in Operation

Running the program has tested the resilience and creativity of the PSU. The program's environment is challenging. Unlike some developing countries, Sri Lanka has not had mechanisms for dialogue between the public and private sectors. In particular, the ability of CBAs to present high quality representations to the public sector on economic policy does not exist at present.

These circumstances forced the PSU to adopt a strategy grounded on a "trial and error" or "learning by doing" method, which -- it should be stated firmly -- never departed from the original goals and ultimate purpose of the program.

The main problem was that the Team Planning Meeting set guidelines within which the PSU would act as the recipient of grant proposals from the CBAs which would be screened and "filtered" by SPA College Park for assessment and final approval. In this meeting, it was decided that the criteria used to select the second round of grant recipients was to be developed based on the experiences of the first round.

Reality dictated a more activist, aggressive approach from the PSU, which required intellectual, marketing and operational acumen. This unusual ability explains the noteworthy gains of the first year. Nagging operational hurdles had to be overcome. Among these, it is worth noting that the facilitation that the SPA was supposed to have provided to expedite a range of operational needs was inadequate. The local disbursement capability, a local bank account, was not set up in time.

The PSU developed a strategy to:

- Strengthen the CBAs' capacity in the generation and use of information

- Strengthen the institutional base of the CBAs

- Research the constraints on and potential economic benefits from, specific business sectors with a view to improving their economic efficiency

- Develop the capacity to prepare well-researched papers on economic issues for representation and dialogue with the government

The PSU staff quickly recognized that its top priority was to upgrade the skill level of CBAs. The PSU has helped to strengthen the institutional base of the CBAs through the development of information services, education and training and through the development of new chambers in the provinces.

There has been a development of information services useful to CBAs. For example, the PSU commissioned Survey Research Lanka, a market research firm, to survey business costs and business and consumer confidence indicators in Colombo and in the main towns of the Southern Province, information which is not available to private firms.

The Fruit and Vegetable Producers and Exporters Association and the Gem Traders Association were involved in an interesting example of information dissemination. They prepared newsletters with the assistance of information centers which have the capacity to access and process information from journals and magazines specific to these trades.

The evaluation team reviewed a sample of these newsletters, which dealt with new technologies, debt recovery laws, transportation, exchange rate analysis, vegetable and rice price analysis and recent developments in agricultural research. In addition to this, we also reviewed samples of newsletters which detail information on, inter alia, new markets, prospective importers and upcoming seminars. The information that was gathered and imparted to the chambers' members has, in the view of these members, been very useful to the objectives of these chambers.

The rationale and implementation of this "exercise" deserves praise. These newsletters try to identify potential economic benefits for the CBAs' members. The newsletters are well-prepared and provide rich information. Ultimately, however, the usefulness of this activity will depend on the capacity of the CBAs to print and produce high quality newsletters which can be made available to their members.

The PSU's most ambitious initiative in this area is a proposal to develop an integrated business information system which strongly resembles the system in Hong Kong. The Institute of Computer Technology at the University of Colombo has been enlisted to advise on the hardware and implementation needs of information systems.

The COP told the team that this project was well underway and that the major technical difficulties had been resolved. It would represent a major breakthrough in information: CBAs could have access to updated domestic and international business and economic data.

Education and training are two critical components of institution building that the PSU has addressed and managed well. Workshops, seminars and training sessions have been conducted regularly, including discussions on topics such as AID standard provisions and procurement regulations, desk-top publishing, computer networking and strategic planning.

Workshops on the costs and benefits of forming CBAs have also been conducted. Also, the credibility of the PSU program was enhanced with the preparation, on very short notice, of two seminars on the Gulf Crisis.

On its own initiative, the PSU is fostering a closer collaboration between CBAs and the academic community. Valuable synergetic activities can be expected. Universities are well-positioned to offer analytical inputs and will in turn benefit from student internship programs in the CBAs. The CBAs will be actively participating in improving the quality of human capital.

Another important activity has been the development of new chambers in the provinces, which broadens the participation of the private sector in Sri Lanka.

The PSU has identified and advertised the existence of many small and medium sized CBAs in rural areas. This is important since about 26 percent of GDP is generated by the agricultural sector, which employs approximately 50 percent of the economically-active population. Moreover, the promotion of CBAs in the provinces will make headway in the integration of the informal sector -- where an estimated 40 percent of GDP is generated -- into the modern economy.

The PSU has assisted in the formation of new chambers and in the formalization of existing CBAs. Seven workshops have been conducted on the formalization of business organizations in the Central and Southern Provinces, which ultimately facilitates their legal registration. Also, two workshops were undertaken on the development of investor associations in the Mahaweli area. As we write this report, the Central Province Chamber of Commerce has been registered and is now in operation.

2. Other PSU Activities

An example of activities aimed at strengthening the public/private sector dialogue is a $ 143,592 grant awarded to the Federation of Chambers of Commerce and Industry of Sri Lanka (FCCISL) for the purpose of establishing a Private Sector Support Group (PSSG) for the Advisory Council set up under the Industrial Promotion Bill.

In essence, this grant seeks to take advantage of a good opportunity to promote a constructive private sector/public sector dialogue, arising from the installation by the government in late 1990 of an Industrialization Commission and an Advisory Council for Industry, bodies that oversee the implementation of industrialization strategy.

The PSSG is charged with providing documentation for representations and for research and analysis of issues of particular concern to the membership. The recruitment of staff for the PSSG has begun and a workshop on computer networking and discussions on the procurement of equipment has been conducted. In our opinion, this grant has the potential to strengthen significantly the relationship between the public and private sector.

3. Grants Awarded to Date

As of today, the PSU program has awarded 13 grants. The first, for $ 9,741, was awarded to the Sri Lanka National Council of the International Chamber of Commerce (ICC) with the purpose of "increas(ing) awareness among (Sri Lanka) businessmen about the international documentation requirements for credit operations".

The second grant, for $ 200,000, to the Ceylon Chamber of Commerce (CCC), will have a broader impact. This grant aims at "strengthening the contribution of the CCC to private sector development by establishing an economic intelligence unit, improving business informational services, promoting public-private sector dialogue and conducting seminars".

The CCC is well-positioned to undertake these ambitious tasks since it is the largest, oldest (it was founded in 1839) and most prestigious of the Sri Lankan chambers. The PSU is assisting in the implementation of this grant. It has brokered a cooperative arrangement between the Economics Department of the University of Colombo and the CCC and is assisting both in the computerization of CCC's information system and in the development of equipment by obtaining duty-free certificates for the purchase of computers.

Among other grants, it is worth highlighting the following: a US$ 109,000 grant was awarded to the Women's Chamber of Industries and Commerce to strengthen the its policy function. The program contemplates the hiring of competent staff and the procurement of computer equipment to develop new services such as consultancy, the preparation of feasibility reports for proposed firms, the establishment of a trade information center and the development of workshops and seminars. In our opinion, the selection of this chamber for a grant has been prescient since there are a fair number of small and medium size firms that are owned and run by women.

The National Chamber of Commerce (NCC) was the recipient of a grant for $ 37,500 which will be used for developing systems for information processing and dissemination and which should culminate in upgrading the quality of the chamber's journal.

Grants have been directed towards activities that are conducive to the strengthening of the export capabilities and competitiveness of the private sector. For example, grants have been awarded to the Sri Lanka Gem Traders Association in order to strengthen the international competitiveness of this sector through the development of an industry agenda and the promotion of trade seminars and exhibitions.

Similarly, both the National Exporters Association and the Ceylon Chamber of Commerce--Export Section were recently awarded small grants. The former, an association of small and medium size exporters, will benefit from a $ 27,000 grant that is destined to improve the administrative capabilities of the chamber. It includes the setting up of an office, the hiring of staff and the purchasing of faxes and computers. The $ 16,000 awarded to the Ceylon Chamber of Commerce - Export Section will be used in the design of marketing and advertising strategies appropriate for export promotion in Sri Lanka.

4. PSU Management

As suggested above, the program has clearly benefitted from the skills and professionalism of the PSU staff. The first Chief of Project provided valuable leadership, earning the respect and admiration of the business and academic communities of Sri Lanka, a fact corroborated in numerous interviews.

The PSU policy adviser is very knowledgeable and understanding of the complex interaction between the public and private sector and of the institutional milieu in which they operate. This knowledge is supported by a mastery of the issues of economic development.

Other managers of PSU Colombo have provided not just managerial and strict accounting support but also financial advice to CBAs. Their contribution is valuable and ensures the smooth administration of the program.

It is worth stating that we found documentary evidence which points to strict scrutiny and administration of the grants. Each grant has a file that contains the proposal, agreement, approval for installments, quarterly reports on the CBA's activities, etc. Credit is due to PSU management.

5. Installation Teams

To expedite assistance to the CBAs, the PSU devised the concept of Installation Teams. Highly-skilled, university-educated young professionals were hired to assist institution building and to develop public/private dialogue.

The contribution of these teams has been extremely valuable. For example, given the limited analytical capacity of most CBAs, a research assistant was given the task of preparing the proposals for grant applications.

Useful assistance from these teams also included:

- Development of membership profiles and updating membership lists in the selected CBAs
- Technical assistance in the procurement of the equipment required by the CBAs (see Appendix I-A)

- Assistance in computer networking

- Assistance in the preparation of newsletters used for information dissemination

- Assistance in the preparation of well-researched documentation for representations

6. Relations with the University of Maryland

Remarkably, these impressive results have been obtained under less than ideal conditions. We refer to the unfortunate breakdown in communications between PSU in Colombo and SPA College Park which occasioned a serious rift that ultimately led to the resignation of the Chief of Party.

The conflict revolved around procedural issues such as the delays in the disbursement of funds for grants, owing to the cumbersome mechanisms and procedures for releasing the monies. In essence, these functions were approved and carried out not in Colombo but in Maryland. The PSU calculated that the average processing time per grant, from the time in which the proposal was submitted for approval to SPA College Park to the delivery of the first installment, was 82 working days.

Setting these procedural, albeit important, points aside however, there were some larger issues that played a more critical role in this discord. Two are worth mentioning. The first is how much decision-making powers should be invested in the PSU. In our opinion, these should be substantial. The PSU staff stated that the structure of the program gave SPA College Park too many administrative decisions that in the end made administration in Colombo difficult and frustrating.

The second issue is related to the analytical contribution offered by SPA College Park. Once again, the PSU staff thought that this activity was not very relevant to the specific needs of the CBAs in Sri Lanka.

It is worth underscoring, once again, that the success obtained in this first year is greatly explained by the skills of the PSU management, especially through its ability to respond rapidly and effectively to methodological and financial constraints. As stated above, the program was hindered by the fact that the SPA could not process the requests for approval of funds as quickly as needed. Adjustments in the operation of the Program, therefore, were desperately needed. ISTI has stated to us that they were able to facilitate the accommodation of these adjustments by offering funding from ISTI's sub-contract budget. As such, for example, ISTI claims that the seminar on the gulf crisis, all the Installation Teams and additional transport and communication costs have been funded by the ISTI budget. The contribution of this subcontractor is also expressed in the hiring of consultants who were used to develop strategies for business and economic intelligence for the CBAs. Overall, it is safe to state that the sub-contractor's role in enabling the PSU to access additional capacities and services has been an important contribution to the achievements of the PSU.

III. RECOMMENDATIONS

A. ENSURE CONTINUITY IN THE PROGRAM

The challenge for the program now is to ensure continuity. It is the task of the new management to build on the considerable gains obtained during the first year. Fortunately, the activist, aggressive approach that has characterized the program during the first year seems to be no longer necessary since the PSU staff greatly succeeded in establishing the credibility and prestige of the program.

This fact, as suggested before, has been a great accomplishment, underlined by the overwhelming demand for PSU's assistance from local CBAs. The present situation calls not only for sustaining the momentum of the program but for actually being more selective given the additional demand for PSU's services. Under this criteria, the PSU management should focus on the following activities during the next nine months:

- monitoring each grant to ensure compliance by grantees and assessing the progress of grant implementation in connection with the achievements of the program's objectives

- finalizing the work schedule of the Second Year Work Plan ending June 30, 1992 and

- processing the grants that are still in the pipeline or pending for approval and ensuring that their implementation closely follow the criteria spelled out by Second Generation Grants

Above all, it is imperative that the PSU demonstrate that its inputs are conducive to attaining the ultimate purpose of the Program, i.e., to enhance the capacity of the public/private sector partnership to produce open market policies. As a purpose-level indicator, we propose that the PSU conduct at least two major analytical policy research studies on issues that are relevant to CBAs and which can be utilized as the foundation for effective policy representations.

B. DELEGATE MORE AUTHORITY TO THE PSU

It is extremely important that SPA College Park delegate authority to the PSU so as to enable it to:

- ensure the smooth development and administration of each grant and

- develop a strategy that can be used to select new grantees

SPA College Park can concentrate on the long-run, larger issues of strengthening the research analytical capabilities of the CBAs in close consultation with the PSU in Colombo.

With respect to the decision-making powers invested in the PSU staff in Colombo, they should include:

- Monitoring of the implementation of existing grants and discretionary powers to terminate grants in case of lack of compliance

- Identification of new technical assistance opportunities corresponding to criteria spelled out by Second Generation Grants

- Should the program be extended, the PSU staff should actively participate in the definition of new criteria for program development and offer suggestions for change as implementation proceeds

- Personnel policies, e.g., supervision, appointment and dismissal of staff at the PSU, should be carried out by COP/Colombo

- Fast-track approval of all new grants under $ 10,000 should be under the discretionary power of PSU/Colombo

- Administration of the bank account opened in Colombo, with the provision for adequate expenditure limits, should be handled in Colombo

C. ENSURE GREATER COOPERATION BETWEEN SPA COLLEGE PARK AND THE PSU

This last recommendation is really the most important. For a variety of reasons, there was a serious communication gap between College Park and the PSU which fortunately did not affect significantly the outputs of the PSU. All parties agree that in the future the PSU COP should be selected carefully by College Park and that once this selection is satisfactory to College Park, the new COP should be provided with the flexibility and delegation critically needed in such a fluid setting. SPA College Park can contribute greatly by supporting the administration of the program and by devising a long-term program of policy research which may include such things as providing training in the U.S. for Sri

Lankans. Care should be taken that the new COP be able to work well with the PSU staff, which is highly qualified and motivated.

We took up these issues with the appropriate officials in College Park. They attributed these problems to a lack of proper communication with COP in Colombo and, equally important, to the existence of the many regulations that exist at a state university. It took a great effort on their part to make the administration of grant disbursement more flexible and expedient.

It was refreshing to get their agreement that the program should be run basically from Colombo. They stressed that the new COP should have great discretionary powers. On the issue of SPA College Park's technical input in the program, they stated their firm conviction that this area should improve once PSU Colombo adequately conveys their specific technical assistance needs. Given the successes to date and the agreement on the future direction of this component, all parties involved stressed optimism that the future would promise even more progress.

APPENDICES

Information on Project Components

APPENDIX I-A

P.S.U. SUBGRANT PORTFOLIO (AS OF OCTOBER 1, 1991)

NAME OF INSTITUTION	TITLE OF PROPOSAL	Agreement Status		Amount ($)		
		Starting	Ending	Agreement	Received	Status
Subgrants Completed						
1.Sri Lanka National Council of the International Chamber of Commerce	Business Document Development Program	28-09-90	24-11-90	$9,741	$9,741	ICC
2.National Chamber of Commerce	Seminar on the Gulf Crisis:Short & Long term perspectives	19-09-90	19-09-90	$1,580	$1,580	NCC
3.Ceylon Chamber of Commerce	Seminar on the Gulf Crisis Impact on Business & the Economy	22-08-90	22-08-90	$558	$558	CCC
4.Maharagama Three Wheelers Association	Arranging Common facility use parking space	16-10-90	31-01-91	$179	$179	TWA
Sub Total of Subgrants Completed				$12,058	$12,058	
Subgrants in Progress						
5.Ceylon Chamber of Commerce	Strengthening Policy Representations	01-09-90	01-09-93	$200,000	$30,000	CCC
6.National Chamber of Commerce	Developing systems for information proce sing & Dissemination	12-04-91	30-10-92	$37,500	$17,500	NCC
7.Women's Chamber of Industries & Commerce	Program Development for the Women's Chamber of Industry	09-04-91	30-07-93	$109,000	$19,000	WCIC
8.Institute of Chartered Accountants of Sri Lanka	Developing Information Services for Management Education	09-04-91	30-04-93	$35,344	$10,344	ICA
9.Federation of Chambers of Commerce & Industry of Sri Lanka.	Establishing a Private Sector Support Group	12-04-91	30-07-93	$143,592	$23,592	FCCI
10.Sri Lanka Fruit & Vegetable Producers, Processors & Exporters Association	Towards an Industry Agenda	12-04-91	30-04-93	$44,500	$14,500	FVPA
11.Sri Lanka Gem Traders Association	Enhancing Industry's International Competitiveness	12-04-91	30-04-93	$35,400	$15,400	GTA
12.National Exporters Association	Developing the Small & Medium Scale Export Sector	01-09-91	01-07-93	$27,277	$7,277	NEA
13.Ceylon Chamber of Commerce-Export Section	Identifications of Marketing Strategies for Export Promotion	01-09-91	30-11-91	$16,136	$8,135	CCX
Sub Total of Subgrants in Progress				$648,748	$145,748	
Total Subgrants Awarded				$660,806	$157,806	

P.S.U. SUBGRANT PORTFOLIO (AS OF OCTOBER 1, 1991)

NAME OF INSTITUTION	TITLE OF PROPOSAL	Agreement Status		Amount ($)		
Proposals submitted to PSU		Starting	Ending	Agreement	Received	Status
14.Federation of Exporters	Development of the Export Sector			$38,800		
15.The Ceylon National Chamber of Industries	Development of the Industrial Sector			$106,140		
16.Sri Lanka Chamber of Small Industries	Improvement of member services			$109,750		
17.Galle Trade and Industries Association	Strengthening Provincial Level Business Associations			$41,000		
18.Central Province Chamber of Industry & Commerce	Strengthening Chamber Activities			$94,440		
Total				$351,330		

Check List for Small Grants

1.Object clause of the Organization.
2.Organizational Chart & strength of the membership.
3.Organization profile.
4.Legal status of the Organization.
5 Financial Reports for previous three years.
6 Source of Finance.
7.Procedure of disbursement of expenditure.

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APPENDIX I-B

Analytical activities undertaken by Associations and Chambers following discussions and/or assistance from the PSU.

The Ceylon Chamber.

1. Commissioned a paper by the Economics department of the University of Colombo on "**Economic Consequences of the total removal of Exchange Controls**".

   This followed discussions the PSU held with the head of the economics department on co-operation between the chambers., a meeting was arranged between the CCC and the economics department. This is the first of a set of planned activities that enhance the analytical capacity of the CCC through networking.

2. **Submission to the Finance and Banking Commission**. Prepared by a CCC committee with PSU research assistance.

3. **Submission to the Taxation Commission**, Paper on Fiscal Incentives for the Export Sector. Prepared by a committee of the Export Section, PSU research assistance and discussions with the COP.

4. **Review of the Budget Proposals for 1991.** An annual event of the CCC a report is prepared and submitted to the council, the PSU had discussions with the CCC, assisted with a document.

The Ceylon Tea Traders Association.

5. **Document on the Disincentive Effects on the Withdrawal of the Export Packaging Refinance Scheme** submitted to the Tea Board. PSU prepared a paper after discussions with the CTTA, and industry persons.

6. **Short paper on the Need for a Strategy for the Tea Industry**. Prepared by the PSU.

The National Chamber.

7. **Document to be submitted to the government on the impact of removing the Export Incentive Schemes**. PSU provided research assistance.

The Federation of Chambers of Commerce.

8. **Submission to the Finance Ministry on the Debt Recovery Laws**. Prepared by the National Council of the International Chamber of Commerce. PSU participated with a small advisory role.

The Gem Traders Association

9. Short paper on a "**Strategy for the Gem and Jewellery Sector**" for the president of the association to be presented at a meeting of the export related associations. Prepared by the PSU.

In addition to the above, the chambers and associations submit regular documents to state authorities on incentive schemes, state assistance and regulations; especially when concessions are withdrawn and after the annual budget proposals are presented.

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APPENDIX II

Private Sector Policy Support (PSPS 383-0100)

/FY	88	89	90	91	92	93	Total
Obligations							
Privatization Support	1,288	0	5 042		2,680	56	9 066
Capital Market Development	1,000	1 264					2.264
Policy Support	750	2,146	(1 096)		1 146		2,946
Venture Capital Company	200	(64)	264		44		444
Monitoring and Evaluation	12	288	(150)		130		280
Contingency and Inflation	0	260	(260)				[illegible]
Total Obligations	3,250	3,894	3 800	0	4 000	56	15 000
Cumulative Obligations	3 250	7 144	10 944	10 944	14 944	15 000	
Commitments							
- PCP TA			800	300	800		1 900
- PCP Secretariat		443	400	400	300	233	1,776
- PCP Redundancy				3,000	1,550		4 550
- Merchant Bank				240			240
- Private Management Institute			100				100
- IESC Volunteer Executives			250				250
- Banking Commission				250			250
Privatization Support	0	443	1,550	4,190	2,650	233	9,066
Capital Market Development		2,264					2,254
Policy Support			1,500		1,446		2,946
Venture Capital Company				400	44		444
Monitoring and Evaluation				130		150	280
Total Commitments	0	2,707	3,050	4,720	4,140	383	15,000
Cumulative Commitments	0	2,707	5,757	10,477	14 617	15 000	
Expenditure							
- PCP TA			418	646	700	136	1,900
- PCP Secretariat		253	173	285	500	565	1,776
- PCP Redundancy				3,000	1,550		4,550
- Merchant Bank				124	116		240
- Private Management Institute			75	25			100
- IESC Volunteer Executives			20	200	30		250
- Banking Commission				125	125		250
Privatization Support	0	253	686	4,405	3,021	701	9,066
Capital Market Development		162	670	958	474		2,264
Policy Support			245	924	945	832	2,946
Venture Capital Company				75	170	199	444
Monitoring and Evaluation				100	25	155	[illegible]
Total Expenditure	0	415	1,601	6,462	4,635	1,887	15,000
Cumulative Expenditure	0	415	2,016	8,478	13,113	15,000	
Obligations less Commitments							
Privatization Support	1,288	845	4,337	147	177	0	
Capital Market Development	1,000	0	0	0	0	0	
Policy Support	750	2,896	300	300	0	0	
Venture Capital Company	200	136	400	0	0	0	
Monitoring and Evaluation	12	300	150	20	150	0	
Contingency	0	260	0	0	0	0	
Total	3,250	4 437	5,187	467	327	0	
Commitment less Expenditure							
- PCP TA		0	382	36	136	0	
- PCP Secretariat		190	417	532	332	0	
- PCP Redundancy		0	0	0	0	0	
- Merchant Bank		0	0	116	0	0	
- Private Management Institute		0	25	0	0	0	
- IESC Volunteer Executives		0	230	30	0	0	
- Banking Commission		0	0	125	0	0	
Privatization Support		190	1,054	839	468	0	
Capital Market Development		2,102	1,432	474	0	0	
Policy Support		0	1,255	331	832	0	
Venture Capital Company		0	0	325	199	0	
Monitoring and Evaluation		0	0	30	5	0	
Total		2,292	3,741	1,999	1,504	0	
Pipeline							
Privatization Support	1,288	1,035	5,391	986	645	0	
Capital Market Development	1,000	2,102	1,432	474	0	0	
Policy Support	750	2,896	1,555	631	832	0	
Venture Capital Company	200	136	400	325	199	0	
Monitoring and Evaluation	12	300	150	50	155	0	
Contingency and Inflation	0	260	0	0	0	0	
Total	3,250	6,729	8,928	2,486	1,831	0	
Pipeline / Obligations %	100	94	82	23	12	0	
Months elapsed/project time %	5	25	45	65	85	100	
Expenditure %	0	3	13	57	87	100	

Financial Projections as at 25-Oct-91

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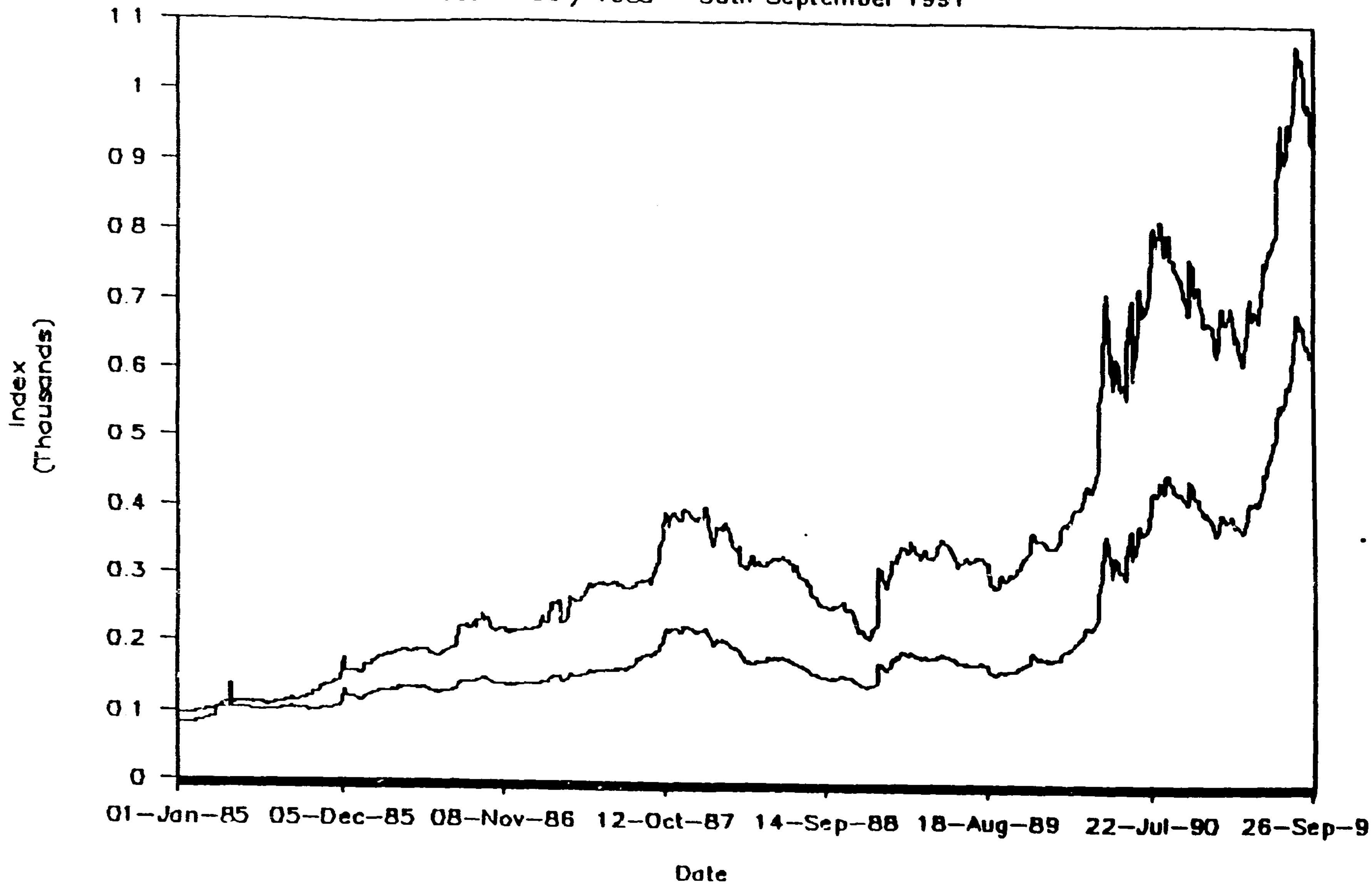
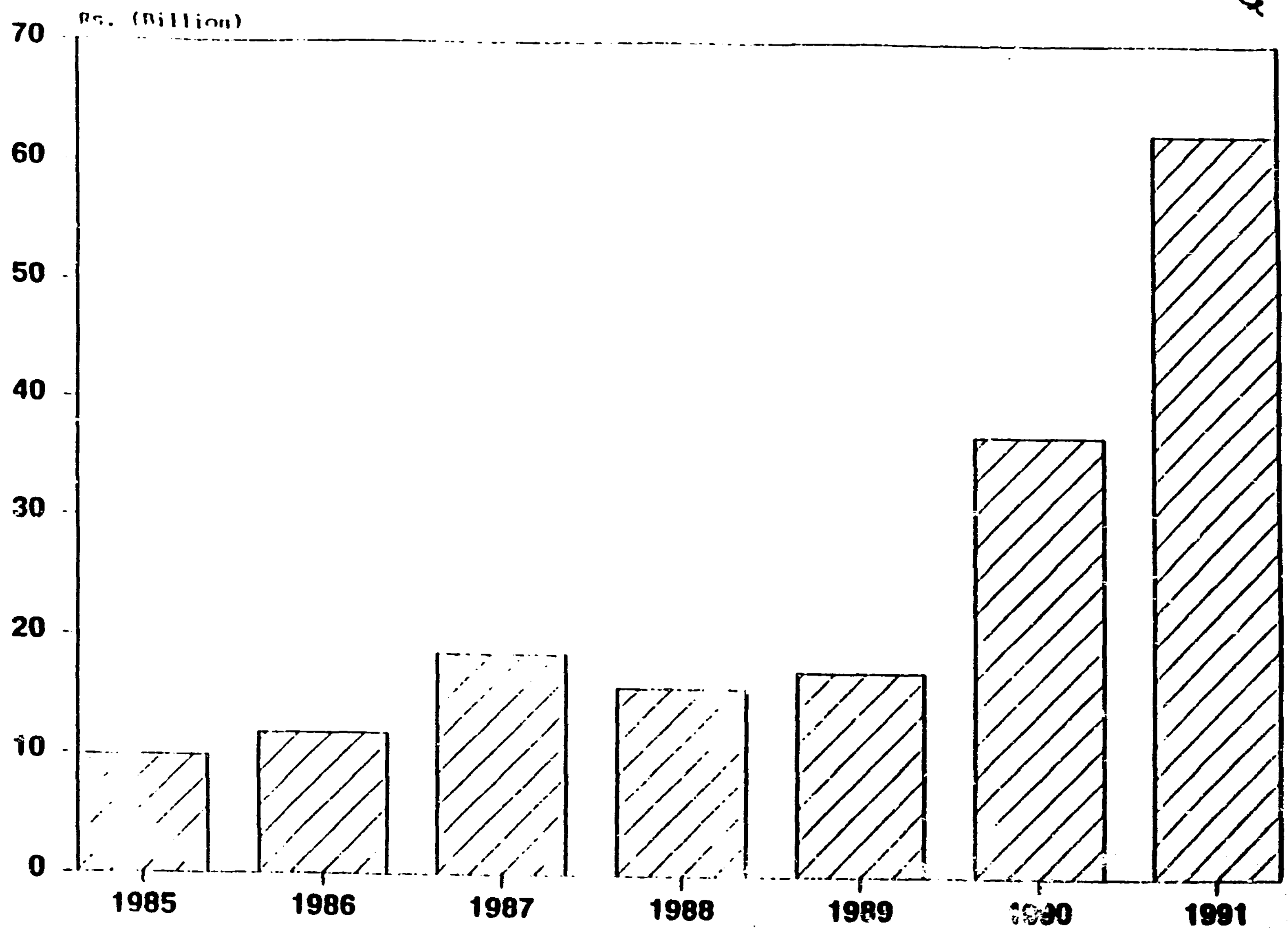
APPENDIX III

Colombo Stock Exchange Indices

1st January 1985 – 30th September 1991

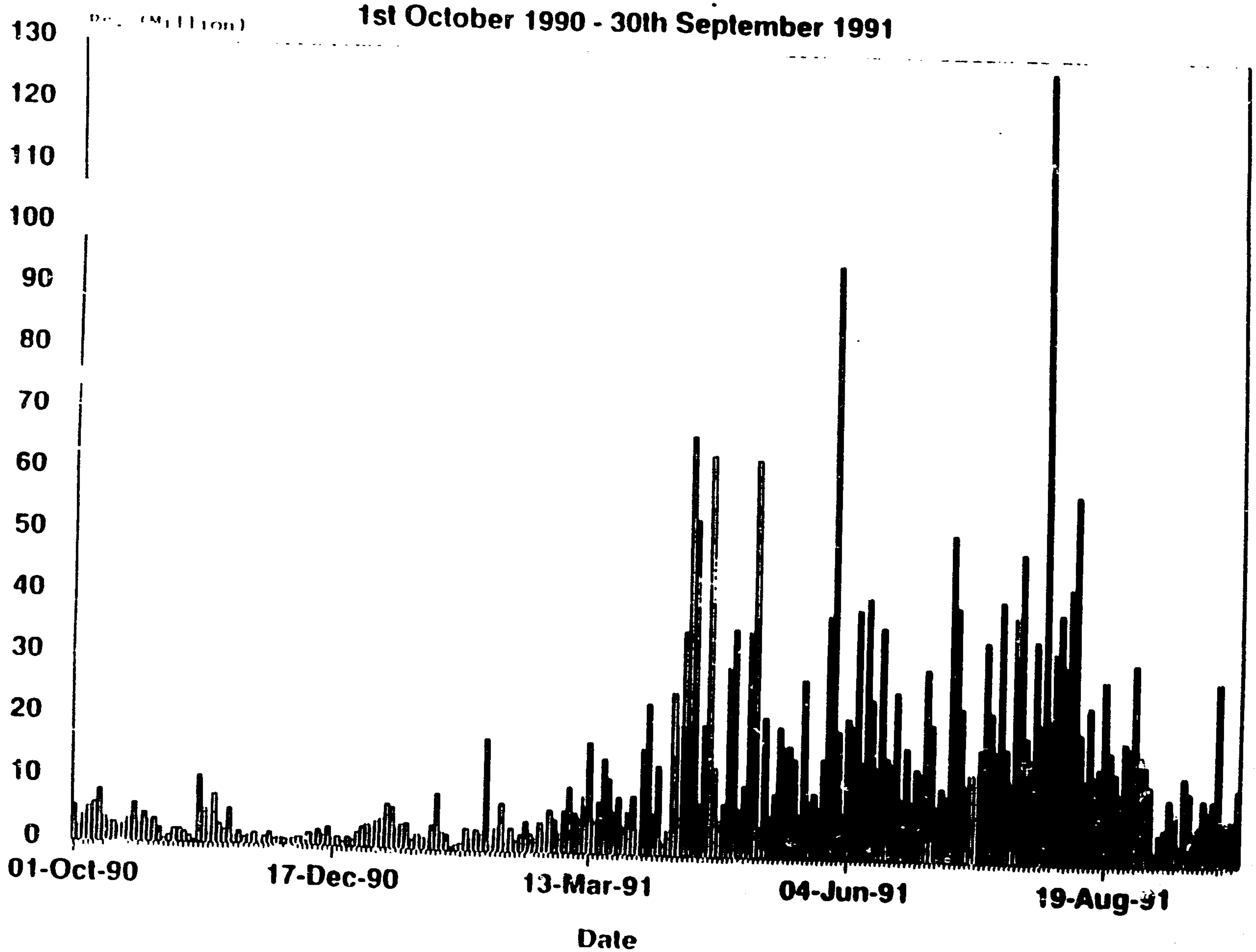


Market Captalization 1985 - 1991 Sep



Daily Turnover

1st October 1990 - 30th September 1991



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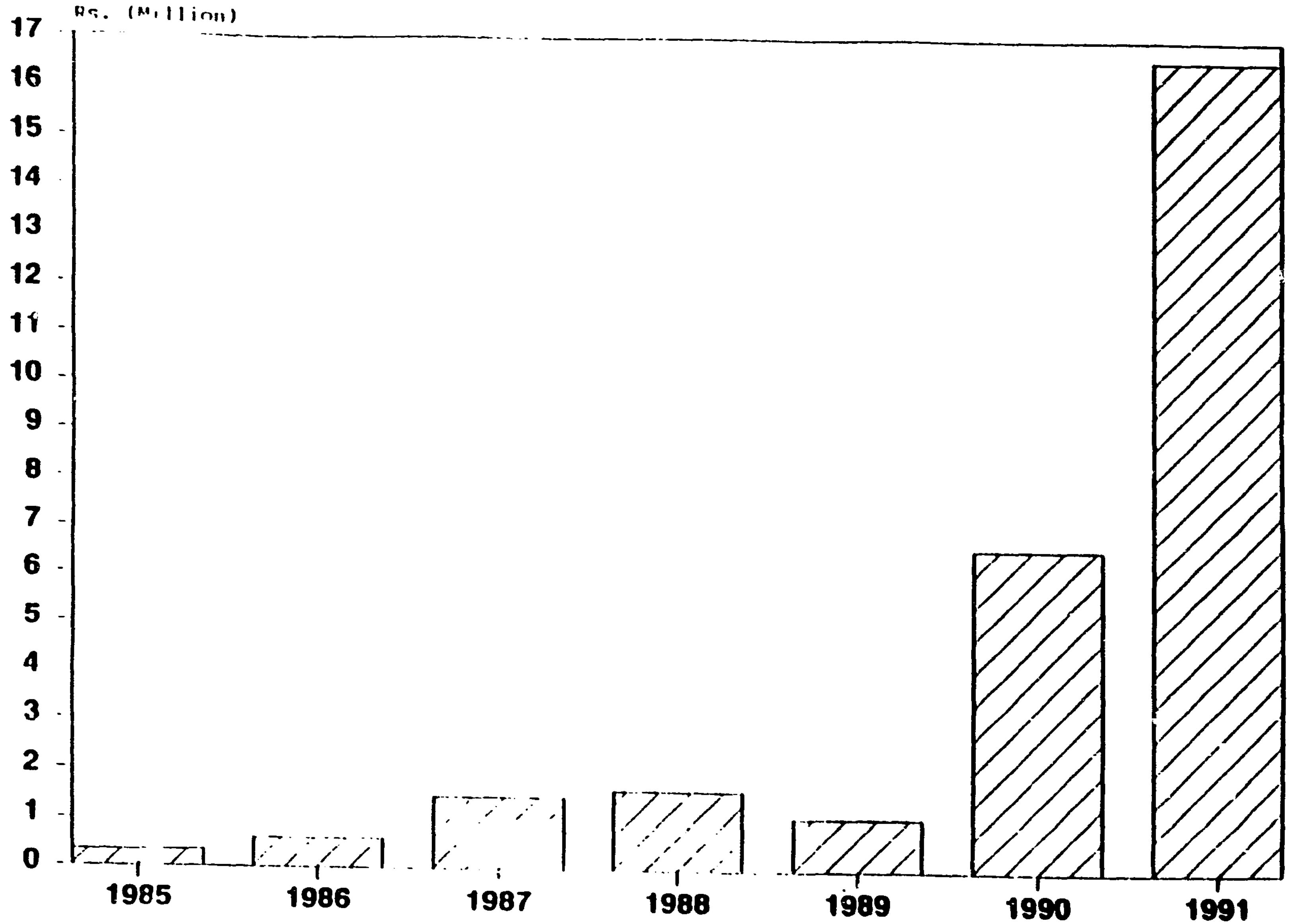
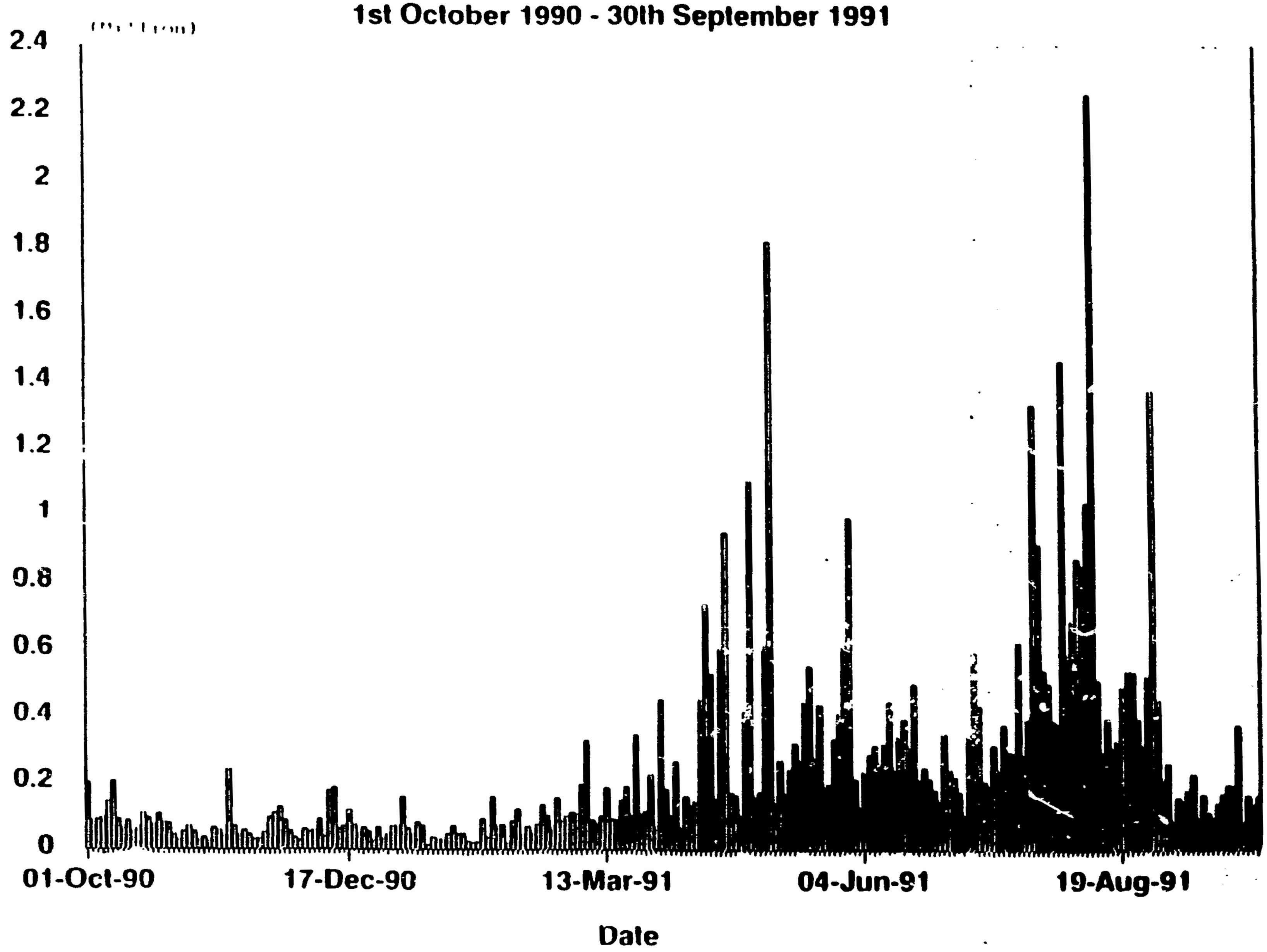
Average Daily Turnover 1985 - 1991 Sep



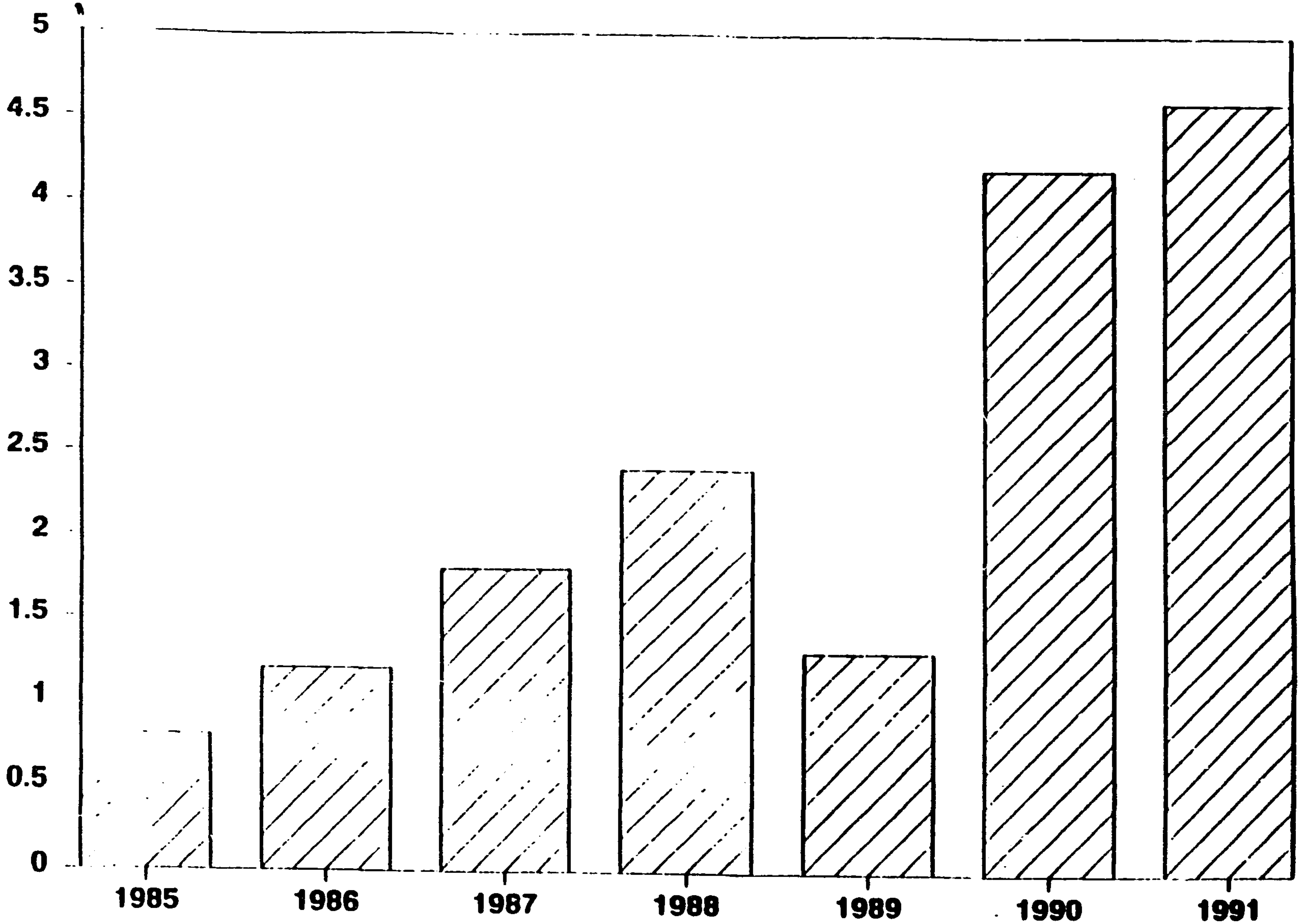
Daily Share Volume

1st October 1990 - 30th September 1991



Sri Lanka : Market Turnover Ratios

AS A % OF MARKET CAPITALISATION



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APPENDIX IV

1. Privatizations Under the USAID Grant

a. United Motors

United Motors was converted into a public company in May 1989 with an authorized share capital of Rs 100 million. Of this, 5 percent was sold to Mitsubishi, a Japanese automobile firm and 5 percent was "gifted" to employees. (This structuring preceded the 60-30-10 strategy.)

Unfortunately, when UM was ready for public share sale of the remaining 90 percent in early summer 1989, the country was at the height of a security problem. The Government, however, went ahead with the sale in July. Only Rs 33 million was taken up by the public (75 percent of which was taken up by the two state-owned insurance companies.) The underwriters which were largely government controlled were left with the remaining Rs. 57 million of shares in United Motors.

A World Bank economic memorandum attributed the undersubscription in part to "bad timing but mostly because of the inadequate preparation and sales efforts and insufficient understanding of the capital market". It further noted that "the need to present United Motors to the public with a positive image through strong marketing was not fully recognized -- the prospectus was bland and the marketing was done through the branch network of the state banks without giving the banks any financial incentives to market the offer to their clients".

The United Motors privatization ended satisfactorily, though the route to success was, to say the least, circuitous. The offer price (and par value) of the company was Rs 10 per share. With the revival of the stock market, aided in part by the capital markets component of the project, the price for United Motors climbed to Rs 15 and then to Rs 20 by mid 1990, resulting in attractive profits for the underwriters who had earlier been faced with a large overhang of unwanted shares. (The current price is Rs 40.) The underwriters subsequently sold more than 50 percent of their position to individual investors and thus the company has been privatized.

b. Thulhiriya Textile Mill

Thulhiriya Textile Mill was a 100 percent asset sale of Rs. 206 million to a Korean textile company, Kabul Lanka (Private) Limited in June 1990.

c. Hotel de Buhari

The sale of 80 percent of Hotel de Buhari to a labor union was consummated in November 1990. The value paid was Rs 7.5 million

(US$ 187,500.) The employees received a 10 percent shareholding and 10 percent was retained by the GSL.

d. Dankotuwa Porcelain

Mitsui of Japan purchased a 50 percent share in this company for Rs 115 million in November 1990. The company was originally advertised for sale in May 1990. The GSL has retained a 40 percent share which, it was originally thought, would be divested through a public share issue. The 10 percent shareholding destined for the employees was given in early September 1991. However, the company is not listed and there are no current plans to list. Therefore, employees would have a difficult time in selling their shares.

Otherwise, this has been a successful privatization. No employees were retrenched and the company is expanding its capacity, which could double employment by 1995. One of the apparent reasons for success has been a marketing and technical collaboration arrangement with International Ceramic Inc. of Japan.

e. Ceylon Oxygen

Sixty percent of Ceylon Oxygen, a monopoly supplier of industrial gases, was sold to a Norwegian firm, Norsk Hydro (ranked number 115 on the Fortune 500) in November 1990, at a price per share of 15 Rupees. Negotiations lasted from January 1990 until October 1990.

The 60-30-10 divestiture strategy emerged out of this transaction. The share offer opened on March 18, 1991 and was scheduled to close on April 16. However, because of an early oversubscription of shares, the subscription period was closed on April 1, 1991. The offer resulted in 15,049 applications and 12,758 subscribers were ultimately sold shares. With a share offer price of Rs 15, the P-E ratio of the Ceylon Oxygen was 3.6, while the CSE market P-E was about 17. Once the shares were listed, the share price rose to Rs 125 per share but later fell to around 80 per share. (At the time of this evaluation, it was trading at 91.)

While a slight undervaluation is usually helpful in making a transaction succeed and creating a healthy aftermarket, an undervaluation of this magnitude can be counterproductive to the long-term prospects of the privatization process as it feeds into the usual criticisms from those opposed to privatization for reasons of ideology or vested interest. This points to the importance of marketing and the need to continue to secure a reasonable number of serious bidders when the first 60 percent of an enterprise is sold in order to obtain a fair market price (which then becomes the price for the public share offer.)

Mercantile Stock Brokers was chosen as the sponsoring brokers for the Ceylon Oxygen share offer. Major delays occurred during the share offer as a result of Mercantile's difficulties in handling a large number of applications, clearing the checks, issuing the refunds and issuing the share certificates. Refunds were finally sent out around the middle of June and share certificates were mailed near the end of June. The Ceylon Oxygen share offer was not underwritten.

f. Pugoda Textile Mills

An Indian textile investor, Lakshmi Textile Exporters, acquired 60 percent of Pugoda Textile Mills in February 1990. Lakshmi had been the management contractor at Pugoda during the previous 10 years. Lakshmi acquired a 60 percent shareholding in the company for Rs 60 million, financing this through a Rs 160 million it obtained.

McKinnon and Keells Financial Services was selected as managing brokers and began to develop the prospectus in May 1991. Grant Bozell developed the promotional campaign. The share offer opened in the second week in June and was handled well. Keells mounted a coordinated campaign, handled the computerized subscriber lists well and early and mailed the refunds and stock certificates as scheduled. There were a then-record 31,000 subscribers for the shares. Pugoda was oversubscribed several times. Sold at Rs 10 a share, Pugoda subsequently rose to 33 Rs a share.

g. Mattegama Textile Mills

Mattegama Textile Mills was originally advertised in August 1990. It has been reported that the GSL has negotiated the sale of 60 percent of this company to Gherzi Ltd., which is believed to be a Swiss firm with offices in Hong Kong.

h. Hunas Falls Hotel

A 60 percent shareholding in this 29 room hotel has been sold to Hayley's, a leading local company. The total value of the hotel is Rs. 20 million. The GSL apparently tends to sell this under the "60-30-10" strategy. The public share offer would amount to only Rs. 6 million or US$ 150,000. This is one instance where the desire to broad base ownership may not be advisable. The small value of the company and the cost of undertaking a share offer and maintaining shareholder relations indicate that in this instance a share offer would not be cost effective.

i. Lanka Milk Foods

As this evaluation was nearing completion, 51 percent of Lanka Milk Foods was sold through the Colombo Stock Exchange. On October 26, 1991, the 15.3 million shares sold at a price Rs 34.5, for a total of Rs 528 million, or about $US 12.6 million. This represented the largest transaction in the history of the Colombo Stock Exchange.

2. <u>Other USAID - Assisted Projects</u>

In addition to the above, USAID has occasionally provided assistance for the privatization of enterprises not on the COPED list.

a. Central Transport Board

In 1989, the GSL decided to privatize the road passenger transport operations of the Sri Lankan Central Transport Board (SLCTB). The main assets of the SLCTB are bus depots, buses and workshops. The bus depot operations of the SLCTB have been converted into public companies with 50 percent of the shareholding given to the employees of the depots. The remaining 50 percent is expected to be disposed of to private sector buyers. The GSL also proposes to privatize the workshops. The USAID TA team provided transport engineering assistance and developed a series of studies containing divestiture strategies for three Central Transport Board workshops.

b. The Merchant Bank of Sri Lanka

The Merchant Bank of Sri Lanka (MBSL), which had been fully-owned by the Bank of Ceylon, a government-owned commercial bank, directed its own privatization. It conducted negotiations with possible partners and Citibank and the Asian Development Bank became shareholders with a 10 percent stake each. In November 1990, MBSL went to the public market with an initial public offering of 31 percent of the stock. Within an hour of opening, the issue was four times oversubscribed. Its prospectus was of high quality. The Merchant Bank also pioneered an employees share ownership plan (ESOP) using a specially dedicated trust as part of the privatization plan. The Bank of Ceylon now holds only 49 percent of the shares.

USAID provided a merchant bank advisor to assist in developing corporate finance activities and particularly to help package privatization transactions. MBSL has completed one GSL privatization, the State Hardware Corporation, for Rs 40 million. The corporation, makers of farm hardware, was sold to an MBSL client and MBSL mobilized the debt with an innovative debenture placed by its money brokering subsidiary.

The MBSL has been retained as underwriter and financial advisor to NOVA Lanka Limited in its privatization bid for the state-owned Kelani Tyre Corporation. This will be one on the largest GSL privatizations, estimated at Rs 400 million. As part of the package, it was proposed for the first time that a Sri Lankan company will not only issue equity securities for capitalization but also a subordinated debenture. This subordinated debenture will be listed on the CSE. The latter will offer additional investment opportunities to domestic and foreign investors. This creation of new financial instruments points again to the synergy between the privatization and capital markets components of the project.

c. The Development Finance Corporation of Ceylon (DFCC)

The share issue of DFCC in September 1991 represented a partial privatization. The issue consisted of 366,667 new shares, in addition to the 1,333,333 existing issued shares. Before the share issue, the DFCC was broadly held by domestic institutions (61.9 percent), with the two state owned banks, Bank of Ceylon and People's Bank, each holding 19.52 percent of the shares. Foreign institutions held 32.4 percent and individual investors the remaining 5.7 percent. Existing shareholders were favored, with the stipulation that no single shareholder own more than 15 percent of the final issued share capital of the DFCC. Thus, the effect was to dilute shareholding by the two government owned banks.

While the privatization impact was admittedly limited, the more interesting aspect of the share issue was that it continued the trend, mentioned in the previous chapter, of a growing number of applications for privatization-related share offers:

Enterprise	Close of Offer	No. of Applications
United Motors	September 1990	1,605
Merchant Bank of Sri Lanka	November 1990	9,146
Ceylon Oxygen	April 1991	15,049
Pugoda Textiles	June 1991	30,973
DFCC	September 1991	41,033

Source: Merchant Bank of Sri Lanka

It was noted that privatization is the most important potential source for supplying needed new shares to the market. While some successes have occurred, the potential for privatization to contribute to capital market development has only been lightly tapped to date.

3. <u>World Bank - Assisted Privatizations</u>

In addition to USAID, the World Bank is also providing assistance in privatizations. The World Bank is working directly with line ministries in the privatization of public enterprises that are not included in the COPED project.

The World Bank is helping the GSL restructure and commercialize (with an eye to eventual privatization) two large state-owned banks: the People's Bank and the Bank of Ceylon.

The World Bank is also helping the GSL privatize the plantation sector through management contracts. This sector is one of the most economically significant in Sri Lanka, accounting for 13 percent of exports and employing over 500,000 people.

Acknowledgements

The evaluation team members would like to express their appreciation to both the GSL and USAID for making it possible to work on this evaluation.

For their hospitality and assistance, the Commercialization Division of Ministry of Finance, the Securities Exchange Commission, the Colombo Stock Exchange, the Policy Support Unit and Equity Investment Lanka Ltd. deserve special thanks. The technical assistance contractors associated with the project components were very cooperative and were generous with their time and insights.

Thanks also to the many people other people in Sri Lanka cited under "Persons Contacted" for meeting with us, often on short notice, and sharing their ideas and concerns.

<u>Persons Contacted</u>

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