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INVESTMENT OPPORTUNITY PROPOSAL

FOR

REVOLVING FUND

SRI LANKA VENTURE CAPITAL

US$1,000,000 LOAN

TO

SRI LANKA VENTURE CAPITAL LIMITED

OFFICE OF INVESTMENT
BUREAU FOR PRIVATE ENTERPRISE

July 1987

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

Exchange Rate Rs 25 to $US1

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SRI LANKA VENTURE CAPITAL

I. EXECUTIVE SUMMARY

A. The Project

1.01 PRE/AID in collaboration with USAID/Colombo each proposes to loan up to US$1,000,000 to Sri Lanka Venture Capital, (SLVC) Ltd. ("the Company") under organization by a number of well known, established Sri Lankan industrialists, namely, Aiken Spence and Co. and Sri Krisha Corporation. The Company will make equity investments in projects having high anticipated rates of return. Although the Company will give emphasis to investing in projects which entail the commercialization of technology of U.S. origin, investments will also be made in projects featuring indigenous technology. The project is featured in the USAID CDSS, and USAID capital funding of US$1,000,000 will be provided through the USAID project in design entitled, "Private Sector Development Program." It is anticipated that this project will be the first of a number of equity pools established in Sri Lanka as part of the emerging securities industry.

This project is foremost a capital markets project. PRE and USAID both believe that such an initiative is timely in the development of Sri Lanka's capital markets in that it represents the professionalization of equity investment which has heretofore been largely informal and unorganized.

In recent years, the GOSL has moved towards less government involvement in the private sector and has called for an enhanced role for this sector in making allocative decisions regarding additions to the base of productive assets. This change in orientation of the GOSL in favor of private enterprise has generated demand for equity financing organizations to support risk-taking in new venture development. The subject project proposes such an organization.

Sri Lanka is characterized by a financial market with a traditional commercial and development banking orientation. Some limited merchant banking activities and certain specialized finance companies, e.g. leasing, have developed. However, the securities market is relatively inactive with modest level of trading in the 250 securities listed. As a result, new business ventures are obliged to auto-finance equity and seed-capital components. This gap in financing is the niche which the project proposes to fill. Efforts of GOSL to establish an equity financing industry have not, to date, been successful. USAID/PRE believe that collaboration directly with the private business community to launch a venture capital program will contribute to a more active securities market.

B. Capitalization

1.02 Notionally, the VCC for Sri Lanka (SLVC) would be capitalized at Rs 100,000,000 (about US$4 million).

VCC Capitalization

Inner Circle Private Placement	Rs. 25,000,000
Public Offering	Rs. 75,000,000
Total	Rs. 100,000,000

The public offering is intended to be achieved 100% through private underwriting. In the event minor (up to a total of 15%) public sector underwriting is required, strict provisions will be applied on residual shares being taken up by the public-sector underwriters. (See Section 4.08 and loan covenants).

1.03 The Inner Circle Private placement would consist of Class A Shares. The Rs. 75,000,000 public offering would be divided into Class A and Class B shares, as shown below:

Public Offering	
Class A Shares	Rs. 25,000,000
Class B Shares	Rs. 50,000,000
Total Class A & B Shares	Rs. 75,000,000

Thus the VCC would issue Rs. 50,000,000 in Class A Shares (Rs. 25,000,000 through the private placement; Rs. 25,000,000 in the public offering); as well as Rs. 50,000,000 in Class B Shares. The difference between those two stocks certificates is that the Class A shareholders would bear the normal risks and rewards

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associated with their holdings; while Class B shareholders would be securitized by a Dollar 2,000,000 escrow account established by USAID/PRE. The escrow account would be structured to guarantee that Class B shareholders would receive within five years, Rs. 50,000,000 in the form of dividends from the VCC and/or proprietary rights over its accumulated retained earnings and/or trading value. Any shortfalls would be made up by the escrow account. In return for sharing risk with Class B shareholders, USAID/PRE would be entitled over five years to 50% of all dividends paid to Class B shareholders as well as proprietory rights over accumulated retained earnings. <u>USAID has indicated that it is prepared to assign to PRE its share of interest and profit participation.</u>

In structure, the VCC would have to book accumulated minimum earnings of Rs. 200,000,000 (in excess of accumulated losses) over five years for the escrow account to be released. In such case, the entitlements of the various stakeholders would be as follows:

VCC Stakeholder Entitlements

(Assuming Rs. 200,000,000 in Accumulated Earnings)

Class A Shareholders	Rs. 100,000,000	(50%)
Class B Shareholders	Rs. 50,000,000	(25%)
USAID/PRE	Rs. 50,000,000	(25%)
Total	Rs. 200,000,000	(100%)

Continuing with the above example, at the end of the five years, USAID/PRE would recover all of the principal in the escrow account, all the interest earned on it over five years, as well as Rs. 50,000,000 in profit participations.

Once the escrow account is released by the end of year 5, the Class B Shareholders would have the same risk/reward entitlements as the Class A Shareholders. In the event draws are made against the escrow account, USAID/PRE will retain up to Rs 50,000,000 of common B to be sold at a subsequent date at USAID/PRE's convenience.

The <u>same</u> par value would be ascribed to Class A and Class B shares; and they would <u>be linked in the public offering</u>. For example, each share of "A" would be linked with 2 shares of "B" stock. In that way, the investor participating in the public offering is guaranteed two-thirds of his investment by the escrow account. The above may be attractive to private

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underwriters and has the additional advantage of eliminating the cross currency risk of a direct loan from USAID/PRE. This is being discussed in detail with the Mercantile Group and other appropriate parties, such as Forbes and Walkers, which might be called upon to underwrite the offering for a public sale.

In the event minor (no more than a total of 15%) public sector underwriting is required to achieve capitalization targets, the escrow agreement and related guarantee will not apply to any shares which as a result of the underwriting remain in GOSL hands. Effectively, this becomes a disincentive to public sector buyers and holders of Class A/Class B stock placed through the public offering. (See Section 4.08 below on underwriting).

C. Role of USAID and PRE

1.04 To facilitate the creation of the SLVC, USAID/PRE proposes to provide support in three areas:

(1) technical assistance from USAID in the amount of roughly $50,000 for purposes of selecting up to ten projects which could constitute the first investments made by SLVC; matching these to foreign technology proprietors and local operating companies; and evaluating the resulting joint ventures against the desirable characteristics (see investment objectives, chapter II).

(2) a due diligence/training grant of approximately $50,000 from PRE for the SLVC's director(s) to travel to the United States to do "due diligence" on the selected projects; and for the SLVC's general manager to undertake a training course of not more than three months in a U.S. venture capital firm.

(3) a guarantee in the amount of up to US$2,000,000 (Rs 50,000,000) equivalently co-financed by USAID and PRE. USAID and PRE would be entitled to a profit participation on all net profits booked by the SLVC, as described above **payable in local currency** and convertible as permitted under well established remittance regulations.

1.05 A key difficulty relates to the USAID portion of the loan. USAID Colombo may not be able to process its exposure quite as rapidly as PRE. PRE, for example, contemplates a late fiscal year 1987 booking; while USAID plans for a FY 88 obligation.

One potential way out of the dilemma is for PRE to execute the total loan guarantee agreement (US $2,000,000 approximately) and participating that "commitment" to USAID as soon as USAID funds become available in FY 88. Alternatively PRE can execute a $1MM guaranty to become effective only upon execution of USAIDs $1MM guaranty.

D. **Next Steps**

1.06 The following would appear to be the most important immediate and near term milestones:

(1) USAID should determine whether it will provide needed technical assistance to further develop the project [See Section 1.04 (1) and 1.04(2)];

(2) USAID should determine, after consultation with Forbes and Walker, a local brokerage firm, the likely range of SLVC shareholding which could fall into public sector hands as a result of the proposed underwriting arrangements--including any defensive measures which can be taken to minimize this result;

(3) USAID and PRE, jointly, should resolve the manner and timing in which they will co-finance (in dollars) the US$2,000,000 (Rs 50,000,000) in SLVC guarantee requirements;

E. **Project Timetable**

1.07	IOP	July 29, 1987
	IP	August 25, 1987
	L/A Negotiation	August 1987
	Authorization	September 1987
	L/A Signing-Obligation	September 1987
	First Disbursement	March 1988

See Annex for detailed implementation plan.

F. **Risk**

1.08 Venture capital by definition is higher risk balanced by higher rewards. The success of SLVC will turn on the strength of management provided by the shareholders and the quality of the subprojects. To optimize prospects for high quality management, USAID/PRE have teamed with proven industralists who will provide management and management oversight. To optimize prospects for investment success, SLVC will invest only in proven technologies which are to be commercialized by established Sri Lankan operating companies. The ability to exit via a public offering stands as the major risk to the rate of return expectations of the investors. Although the securities market is relatively inactive at this point in time, good quality shares are trading at a P/E of 10. Projections below use a P/E of 6.

Additionally, the GOSL is currently considering revisions in securities regulations which would serve to promote further development of the securities market. It is anticipated that within the five-year timeframe for exiting, substantially more positive regulations will be in place. In the event exit through the securities market is not an adequate liquidation strategy, SLVC would rely on private placements, limited public offerings and buy backs by management of invested companies.

G. **A.I.D./PRE Issues**

1. Privatization of Liquidity. This project offers the opportunity to experiment with devices by which credit resources which are concentrated in the public sector (a common situation in LDC economies) can be brought under the control of the private sector and, thereby, subjected to the disciplines of the marketplace and mobilized for private sector growth. In this project, there is the risk that a public share offering could result in minor GOSL ownership. This could arise if it became necessary to invite GOSL participation as a minor (no more than 15%) underwriter.

2. Syndication of PRE Loan to USAID. PRE may negotiate the entire A.I.D. participation to the venture capital company in FY 87. USAID funding is not anticipated before FY 88 in which case PRE would "participate" to USAID 50% of the A.I.D. commitment. Alternatively PRE can obligate its $1MM portion subject to USAIDs obligation.

3. <u>Devaluation Risk.</u> Resistance of sponsors to FX risk has required introduction of the guarantee scheme. Devaluation risk favors the escrow account of PRE because any payment would be made in Rupees at a level established up front.

4. <u>Convertibility Risk</u>. Preliminary discussions with the private sector sponsors of this initiative revealed a strong distaste for assuming convertibility risk. An issue for USAID/PRE will be to decide whether it will accept a profit participation payable in local currency. Historically S.L. has permitted permitted conversion for remittances without interruption. This positive condition is expected to continue beyond the next five years. Remittance regulations and highly positive performance in converting protect against convertibility risk.

5. <u>Impact on Reflows to Revolving Fund.</u> The project is structured as a long term guarantee with substantial grace on reduction. The life of the proposed guarantee, assuming no prepayment, is five years, modestly below the average loan life of the RF portfolio. Mitigating the slowness of reflows is: (1) the profit participation feature which could return to the RF an amount equal to the guarantee prior to the five-year mark; and (2) USAID's willingness to direct interest and profit participation to the PRE Revolving Fund.

6. <u>U.S. Trade Policy.</u> General Counsel has ruled that Lautenberg and Bumpers amendments are not strictly applicable for IFI projects of this variety.

II. THE COMPANY

A. Company Purpose

2.01 The Company will have the following mission:

a) Promote the transfer of demonstrated technologies from the United States to Sri Lanka. (See annex for preliminary list of subprojects). U.S. technology proprietors which would be interested in making their technology available for commercialization in Sri Lanka tend to be motivated by the need to extend the usefulness of their technology by locating in lower cost environments. To the extent such proprietors are reticent in undertaking relocation, they find that markets for their products are either eclipsed by technological innovators and/or eroded by competitors, say from other countries, who deploy the technology in lower cost environments;

b) Organize collaborative ventures between the proprietors of these technologies and indigenous operating companies. In practice, these collaborative relationships would take several forms, for example, joint ventures, licensing agreements, supply contracts, marketing arrangements, etc.;

c) Mobilize the required debt and equity resources to organize each commercial venture; and

d) Take equity, and/or convertible debt positions, in the resulting ventures.

2.02 A proposed venture capital company (VCC) able to execute the above functions would be more than a U.S. style venture capital firm. It would have three very separate activities. First, it would be in investment promotion, involved with the identification and evaluation of offshore technologies suitable to the natural resource base of Sri Lanka. Moreover, once it decides to promote the transfer of a given technology to Sri Lanka, it would introduce the foreign proprietor to an indigenous operating company, thereby laying the base for a joint venture. <u>Second, it would be in investment banking</u> since it would mobilize the debt and equity from principals, as well as third parties, required to implement a given joint venture. <u>Third, it would be in venture capital</u> since it would take equity positions in the enterprises that it helps create.

2.03 Perhaps the most critical design element of the VCC is that it would focus on technology proprietors which have both process "know-how" and verifiable access to world markets. In return for know-how and market access, the VCC would arrange to cede up to 20% of the shareholding to the foreign proprietor which contributed these attributes to a joint venture. (See 2.07 below). The proposed transfer of shares, however, would not take effect until the VCC and other sources of equity capital had recovered 100% of their equity through profit participations.

2.04 In discussing the design of the VCC with the Sri Lanka business community, that area which elicited the most interest was the proposed focus by the VCC on "export-oriented" projects. As might be expected, those areas eliciting the most discussion touched on the Company's project origination effort, initial and on-going, as well as its modality of ceding up to 20% of the shares of a given joint venture to the foreign partner who has contributed technology and market access.

With regard to the above point, it was generally understood that a successful project origination effort, involving the recruitment of proprietors and their technologies, was dependent, in part, upon being able to conclude more attractive business arrangements than those available in other countries.

B. **Sponsors**

2.05 The lead sponsors of Sri Lanka Venture Capital Limited are as follows: Mr. Charlie de Silva, Chairman of Aiken and Spence Co.; and Mr. Mano Selvanathan, Director Sri Krisha Corporation. (Expand with background data on corporations)

2.06 Mr. de Silva together with Mr. Sevanathan will take the lead in promoting and incorporating the Company in Sri Lanka. All sponsors (some 10-15 who have responded with interest) will participate in the equity of the Company and also assist in providing for the Company's management.

2.07 The sponsors will subscribe to 25% of the shares of the Company amounting to US$1.0MM equivalent as follows:

Subscriber	percentage of shares subscribed	number of shares
(See potential shareholder list below)		
	100%	

B. Investment Objectives and Policies

2.08 The Company's primary investment objective is to seek long term capital appreciation by making debt and equity investments in new and existing companies believed to be engaged in the processing of products which feature innovative agroindustrial technology (hereinafter referred to as "Subprojects"). These particular subprojects will, generally, have the following characteristics:

(a) Are commercially viable, offering potentially significant returns to the VCC, with a target of at least 40% p.a., using discounted cash flow analysis;

(b) Incorporate product, process or management technologies imported from the United States which can be applied to the exploitation of Sri Lanka's natural resource base;

(c) Involve a product, process or management technology which has a demonstrable track record in implementation elsewhere suggesting that the technical and managerial risks involved are well understood and manageable;

(d) Are eligible for generally available fiscal and economic incentives awarded by the government; and

(e) Generate exportable products.

To achieve the desired rates of return specified above, each of the projects should have the following economic profile:

POTENTIAL SHAREHOLDERS OF THE VCC --
A REPRESENTATIVE LIST
(IN ALPHABETICAL ORDER)

-- Aiken Spence & Company, Ltd.

-- Ceylon Tobacco Ltd

-- Ceylinco Ltd

-- Finco Group of Companies

-- Forbes and Walker Ltd

-- Hayleys Ltd

-- Huejaj International Ltd

-- Lankan Developments Ltd

-- Maharaja Organization Ltd

-- Mercantile Credit Group

-- Sri Krisha Corporation Ltd

(a) A construction period of less than one year;

(b) Are projecting profits, after direct and indirect expenses, by the end of the second year; and

(c) Are capable of operating at full capacity by the end of the third year.

The chances for a successful funding are diminished considerably if the projects are not identified in advance. To keep costs down, a subproject origination program will be undertaken in the pre-organization phase which focuses on ten projects is suggested of which,

(a) Four would be start-ups

(b) Three, would be borrowed from work already completed under the Thailand venture capital project and adapted to Sri Lanka,

(c) Three, would be expansions of existing enterprises;

2.09 The Company may also make investments identified as follows:

(a) the Company may invest in financially troubled companies in bankruptcy or under reorganization if the Company determines that an infusion of capital or additional managerial expertise will enable such companies to operate profitably. Investments in these special situations will be made only in those cases where management has defined or identified a specific strategy for improving operating performance;

(b) investments will be made in situations in which a reasonable opportunity for liquidity is apparent such as the fact that a prospective subproject or portfolio company would likely be the subject of a later acquisition and/or public offering.

(c) the Company intends to invest in companies that can employ relatively small amounts of capital productively. Capital intensive projects will generally be avoided.

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(d) the Company may invest in projects which exhibit potential for high rates of return but which do not rely on U.S. technology and/or are not export oriented.

However, the above are not fundamental policies of the Company and may be changed at any time by the company's Board of Directors. They will remain flexible so that the Company may adapt to continuously changing investment environments.

2.06 In general, for each Subproject organized by the Company, funding and ownership could look as follows:

	Funding	Ownership
The SLVC Company	50%	50%
Agroindustrial Firm	50%	30%
Technology Proprietor	NIL	20%

Although the domestic agroindustrial firm suffers the dilution of its investment to accommodate the technology proprietor, it remains a majority owner and principal beneficiary of the Subproject.

In addition, the Company would mobilize required debt for each Subproject, in local or foreign currency as needed, either from third party domestic financial institutions, e.g. NDB, EDB and DFCC, or foreign financial institutions, e.g. ADB and IFC. Commissions earned in this activity would be a source of revenue to the Company.

2.07 Technology proprietors and brokers, who in assisting in implementing a given subproject shall be eligible for an equity position as described above in addition to a general or technical services contract to be provided on mutually agreeable terms over the first 1-3 years of the Subproject.

C. Exit through Listing Subprojects on SESL

2.08 The Company intends to recommend all approved Subprojects to make application to the Securities Exchange of Sri Lanka (SESL) for the Subproject to become a registered company or an authorized company, if qualified as such.

In the event exit via the SESL is not the optimum avenue available to maximize capital gains, SLVC will give consideration to private offerings, limited public offerings and buy-backs as exit strategies.

D. **Organization of the Company**

2.09 Board of Directors

(a) Unless otherwise agreed, the Company shall have directors, and so long as the parties thereto maintain beneficial ownership of the share capital of the Company as below stated they shall be entitled to designate the number of directors indicated and the parties shall ensure that such designated persons are so appointed as directors:

	Percentage of Shares beneficially owned	Number of directors to be designated
Total	100%	100%

(b) The Chairman of the Board of Directors of the Company shall at all times be a nominee of .... and shall be entitled to a casting vote.

(c) The Board of Directors of the Company may designate a director to be managing director of the Company.

(d) The quorum for a meeting of the Board of Directors of the Company shall be ....(........) of the directors in office, present in person or represented by proxies.

(e) At the Meeting of the Board of Directors a resolution shall be effective if it shall have been passed by a majority vote of the directors present and entitled to vote.

(f) The Company's management, operation and all business investment and transaction shall be under the control of the Board of Directors. In making any decision under the authority conferred to it, the Board of directors may consult any persons, juristic or natural with compensation as the Board of Directors considered appropriate

(g) A party desiring to change or replace any of its designated directors of the Company shall notify the other parties hereto of such desire and such other parties shall ensure cooperation in facilitating the desired change or replacement.

E. Call and Transfer of Shares

2.10 The shareholders will pay the initial subscription amount and the subsequent calls in Rs to the credit of such account of the Company and at such bank in Sri Lanka as the Company shall notify to the parties.

2.11 The shareholders shall not transfer or otherwise dispose of their shares in the Company to any person who either is not of Sri Lanka nationality or considered to be of Sri Lanka nationality for purposes of holding shares if this would cause the ownership of shares in the Company held by persons who are not of Sri Lanka nationality to exceed 60%, or such lesser percentage as may from time to time be amended by the Board of Directors.

2.12 Unless and until the Company shall become a public company or the shares of the Company shall be listed on The Securities Exchange of Sri Lanka, none of the shareholders shall transfer its shares in the Company to a third party without first offering those shares to other shareholders in proportion to their respective shareholdings in the Company on the same and identical terms which the transferring shareholder certifies in writing to each that a third party, who shall be named, has offered and which offer is acceptable to the transferring shareholder.

F. Non-Competing

2.13 The shareholders of the Company will not without the consent of the Board of Directors of the Company, undertake commercial transactions of the same nature as and competing with that of the Company, either on their/his own account or that of a third person, nor may he be a partner with unlimited liability or make investment in term of shareholding more than .... in a commercial concern carrying on a business of the same natures as and competing with that of the Company.

G. **Future Funding of Investments**

2.14 Although the Company intends to schedule its investment activities in order to ensure the availability of sufficient cash for working capital purposes, it is possible that the Company may require additional capital in order to continue its operations. The working capital needs of the the Company may be met either through borrowings, through a later private or public offering of debt or equity securities, or a combination of debt and equity securities, through exchanges of its securities for the stock of portfolio companies or realized proceeds from the sale of its assets.

H. **Portfolio Valuation**

2.15 At least annually the Board of Directors will value the Company's investments. The Board of Directors will also value the Company's securities at such other times as circumstances warrant. The investments shall be valued at either market value or in good faith at fair value, whichever is appropriate under the circumstances. The Board of Directors will use standard methods for valuing securities held by the Company.

I. **SESL Listing for Transformation to Public Company**

2.17 The shareholders recognize that it may become desirable and in the best interests of the Company and the parties hereto for the shares of the Company to be listed on the Securities Exchange of Sri Lanka and/or for the Company to be transformed into a public company. Should either or both such actions appear desirable the shareholders shall consult among themselves with a view to amending the terms of this Agreement in a fair and equitable manner so as to cause or permit the Company to take such action(s).

2.18 In the event the Company, due to increasing number of shareholders, shall be required by laws to transform into a public company, the shareholders shall set up a meeting to decide whether the Company should be transformed into a public company in accordance with the provisions of the governing laws or the Company should reduce the number of its shareholders in order to maintain its entity as a private Company.

III. CREATION OF A VENTURE CAPITAL FIRM AND ITS RELEVANCE TO SRI LANKA DEVELOPMENT AND SRI LANKA CAPITAL MARKETS

3.01 The creation of a venture capital firm (the "Company") to promote the development of capital markets and which focuses on the commercialization of technologies (especially though not exclusively agroindustrial technologies) is consistent with Sri Lanka's development objectives. The discussion below highlights the status of Sri Lanka's capital markets and the business objectives of the Government of Sri Lanka as well as those of the U.S. Agency for International Development. (Descriptive material below on the Sri Lanka capital markets has been freely borrowed from a recent study conducted by Ernest and Whinney for the Asian Development Bank on the prospects for venture capital in Sri Lanka).

A. Sri Lanka Capital Markets

3.02 Overview. The securities market, i.e., the new issues and secondary markets, is relatively inactive. Prior to 1970, the securities market dealt mainly in plantation companies. Shares quoted by the Colombo Brokers Association were those of old, established Sri Lankan companies enjoying sound financial backing. The nationalization of many public quoted companies and the vesting of the assets of plantation companies with the state, resulted in a decline in the activities of the share market during the period 1970-1977. Between 1977 and 1980, trading in quoted shares were limited to three or four transactions per day, mainly speculative trading in shares of plantation companies.

Investors in the securities market are either institutional investors or private individuals. The various GOSL institutional investors are the development finance institutions (DFIS), the Employees Trust Fund, the National Savings Bank and the Capital Development and Investors Company Limited. The non-GOSL institutional investors are the few unit trusts.

3.03 Current Status of the Securities Market. The composition of the securities market over the period 1981-1985 is detailed in the following table. For the period, growth has been moderate but not dramatic. The total number of companies listed increased 31% for the

SECTORAL DISTRIBUTION OF LOCAL COMPANIES AND THEIR TRADING ACTIVITY

	No. of Listed Companies					1 9 8 4 No. of Shares		1 9 8 5 No. of Shares	
	1981	1982	1983	1984	1985	Traded ('000)	Value (Rs. Billion)	Traded ('000)	Value (Rs. Billion)
Beverages Food & Tobacco	8	k9	14	15	15	405.1	3.32	2256.76	9.538
Engineering & Motor Ind	37	44	55	56	56	1281.4	9.69	1227.22	23.024
Finance & Land	11	13	17	20	20	617.3	8.76	661.88	18.663
Stores & Supplies	7	7	7	7	7	187.3	1.40	1531.38	10.380
Hotels & Travels	16	24	34	37	37	88.4	0.76	269.57	2.070
Miscellaneous	21	23	29	30	30	381.4	7.27	436.61	12.814
Plantation	102	102	102	102	102	1174.5	1.67	4.8	2.472
	202	222	258	266	265	4135.4	32.87	6388.22	78.971

Source : Colombo Securities Exchange (Gte) Ltd period from 202 in 1981 to 265 in 1985, with growth concentrated in the hotel and travel industry. Share trading activity appears to be limited with few companies having high growth potential and a steady dividend record. Volume indicators stood at 6,388,220 shares traded in 1985 for a total traded value of about US$3 Billion. Profitable companies are traded at a price to earnings ratio of 10.

3.04 Historical Factors Affecting the Development of the Securities Market. The factors affecting development of the market are as follow:

a. GOSL has not, until recently, encouraged private sector business activity. The establishment of the National Development Bank in 1979 and the increased activity of the Development Finance Corporation of Ceylon has led to a corresponding increase in the level of private sector activity over the last five years;

b. Fear of takeovers has encouraged firms to seek alternatives to flotation to finance themselves;

c. Until recently, the Companies Act served to create public suspicion of companies. The new Companies Act (Companies Act No. 17 of 1982) has served to reverse many of the deficiencies of its predecessor;

d. The merger of the Colombo Brokers Association with the Colombo Stock Exchange has brought about a common trading floor with increased public interest;

e. Disincentives in the tax code have encouraged purchase of securities to obtain investment relief rather than to achieve rate of return objectives;

f. Participation in the trading of shares is restricted to the Colombo area (population 1.5 million) with no access to the stock market available to the rural population.

The GOSL has recently undertaken to develop a more positive environment for the develop of the securities market including the creation of more conducive tax legislation and the enactment of a new securities law. The legislation is currently before Parliament. USAID is tracking this change.

3.05 Regulatory Features Conducive to a Venture Capital Company. The overall regulatory environment for a venture capital company is positive. Provisions are conducive in the following areas:

- -Investment protection agreements
- -Constitutional safeguards
- -Equity Participation for foreigners
- -Remittance of profits and dividends
- -Repatriation of capital
- -Transfer of shares
- -Payment of royalties, technical service fees and management fees
- -Employment of foreign personnel.

Local tax council states that a company established as a public limited company and which eventually seeks a public listing is the most suitable organizational form for a venture capital company in Sri Lanka. This form will allow the SLVC to enjoy all the reliefs applicable to public companies.

3.06 Regulatory Impediments to Venture Capital. The impediments to venture capital turn essentially on issues pertaining to divestment or exit. First of all, as stated above, the securities market is thin. Secondly, investment relief provisions can be lost if securities are sold before 5 years. This condition serves to diminish trading and, accordingly, the liquidity of securities. In addition, there is no unlisted securities market for investee companies which do not meet listing standards.

New legislation under consideration will mitigate the above in part. Ongoing policy dialogue by USAID in this area is a logical dimension to this venture capital project.

3.07 Competition to a Private Venture Capital Initiative. The existing competition is all in the public sector The entities providing risk capital are as follow:

Capital Development and Investment Company Limited (CDIC). CDIC was established as a public limited company in 1983 to provide equity financing to enterprises where the majority of shares would be privately held. CDIC has not been functioning as expected and had its staff completely replaced in 1986. The ability of CDIC to operate as a venture capital company remains to be demonstrated. The portfolio of CDIC is largely the result of transfers from GOSL.

Export Development Board (EDB). EDB assists ventures in product development and export marketing and invests in pioneer export oriented projects for up to 49% of equity. The level of operations of EDB have been low due to weak project origination capability and resistance from entrepreneurs who see EDB support as a first step towards GOSL participation in the management of their company.

Development Finance Institutions. The DFIS, namely the National Development Bank and the Development Finance Corporation of Ceylon, have not been active in equity investments.

The only other venture capital initiative is that sponsored by the GOSL Mahaweli Authority. This company, the Mahaweli Venture Capital Company (Private) Limited, is a joint venture between the Mahaweli Authority and Appropriate Technology International (ATI) of the U.S. Notwithstanding the word private in the name, this VCC is a joint venture between a parastal and a non-profit which receives its funding from A.I.D. The company is in organization. It has not been able to attract private sector interest.

B. Developmental Objectives of the Government of Sri Lanka

3.08 The focus by the Company on new starts and expansions, especially agro-enterprise activities, has the potential for increasing rural incomes because of powerful backward linkages to agricultural employment and forward linkages to transport and rural service sectors. This focus is consistent with the development objectives of GOSL.

The contribution of the project to the development of Sri Lanka capital markets is also complementary to the efforts of GOSL to stimulate broader participation by the private sector in investment generally, and capital markets development specifically.

C. Relevance of USAID Activities to the Company

3.09 The SLVC proposed here is a reflection of USAID activities in both the capital markets area and that of industrial development. The project has been co-designed with staff of USAID and is featured in the CDSS.

IV. FINANCIAL PLAN AND PROFITABILITY

A. Project Capitalization

4.01 The VCC will derive its Rs. 100,000,000 capitalization from two sources:

VCC Capitalization

Inner Circle Private Placement	**Rs**	**25,000,000**
Public Offering	**Rs**	**75,000,000**
Total	**Rs**	**100,000,000**

Two classes of shares would be issued, "A" and "B". To simplify matters, the **same par value** would be ascribed to each.

The inner circle private placement would consist of Class A shares, exclusively, while the public offering would be divided into Class A and Class B shares, as is shown below:

Summary of the Private and Public Placements

Inner Circle Private Placement		
Class A Shares	**Rs.**	**25,000,000**
Public Offering		
Class A Shares	**Rs.**	**25,000,000**
Class B Shares	**Rs.**	**50,000,000**
Total	**Rs.**	**100,000,000**

4.02 Under this plan, the VCC would issue Rs. 50,000,000 in Class A shares and Rs. 50,000,000 in Class B shares. The difference between these two stock certificates is that the Class A shareholders would have the normal risk and reward entitlements associated with common stock holdings; while Class B shareholders would be securitized by a $2,000,000 escrow account established by USAID/PRE.

The objective of the escrow account is to guarantee Class B shareholders the full recovery of their Rs. 50,000,000 investment within a certain time frame. Under normal circumstances Class A and Class B shareholders would recover their full investment through one of the following four means of "entitlement":

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(1) the sale of their shares in the open market particularly if price of sale is higher than that of purchase;

(2) cumulative dividends received over a period of years;

(3) proprietary rights on retained earnings, which have not yet been paid out, but which presence affects the book value of Class B shares;

(4) a combination of all of the above.

In this particular instance, the escrow account could be established for **five** years. Its purpose would be to make up any deficiencies existing, **exactly five years after the public offering,** between the amount originally invested by the Class B shareholders (Rs. 50,000,000) and the amount that **has been, or could be,** recovered through the entitlements described above.

4.03 Mechanically, the escrow account could be structured in the form of a "loan" from USAID/PRE to the VCC, The $2,000,000 in loan proceeds would be deposited in a "limited access" account held half locally and half offshore by the VCC with the bank of its choice. Interest earned from the escrow account would be assigned by the VCC to A.I.D. The bank holding the deposit, on instructions from the VCC, would issue a stand-by letter of credit. Through the stand-by, the bank would pay the Class B shareholders in one lump sum any deficiency that might arise, **five years from the date of the public offering,** between their original investment and (actual or potential) entitlements that may have been realized by then.

Under the terms of the loan agreement, the VCC would have the obligation of returning to USAID/PRE any amounts remaining in the escrow account after the five year stand-by letter of credit is triggered--no more, no less.

4.04 In return for providing this guarantee to the Class B shareholders, USAID/PRE would claim, for itself, 50 percent of the entitlements to be realized by the former

From one perspective, entitlements should be shared half and half between the Class B shareholders and USAID/PRE because the former are putting up 100% of the money but have no principal at risk; while the latter put up 0% of the money, but absorb 100% of the risk. Using this common sensical approach, the investment community accepted the reasonableness of the formula below.

Allocation of Entitlements

	Percentage of Total Entitlements
Class A Shares (50% of all shares issued)	**50%**
Class B Shares (50% of all shares issued)	**25%**
USAID/PRE	**25%**
Total	**100%**

4.05 The above structure has the advantage of eliminating the cross currency risk for the VCC entirely. If the VCC is successful, the stand-by is **never** triggered and the escrow account is returned to USAID/PRE intact along with accumulated interest earnings. Any, and all other, entitlements arising from the deal with the Class B shareholders are paid in local currency.

If the VCC is unsuccessful, the stand-by is triggered, a disbursement takes place but the VCC is not required to repay it. USAID/PRE have agreed to assume this risk and to seek recovery through their rights to entitlements.

4.06 Now, how does USAID/PRE ensure that it gets full entitlements, particularly since **they are not actual owners of shares**. What has been described up to now is an agreement between USAID/PRE and the Class B shareholders to **share** entitlements. But in order to participate fully on the upside, USAID/PRE must have **control** over shares, if not ownership.

To perfect control, the following features, additionally, must characterize the public offering and/or the relationship between USAID/PRE and the Class B shareholders.

First, the Rs. 25,000,000 in Class A shares should be linked with the Rs. 50,000,000 in Class B shares in the public offering. For example, each share of "A" should be linked with 2 shares of "B". Since the "A" and "B" shares have the same par value, any investor participating in the public offering is guaranteed the return of two-thirds of his investment. Hopefully, the proposed linkage will make the shares more attractive to small investors, thereby broadbasing ownership of the VCC.

Second, after purchasing each troika of shares (1 "A" linked with 2 "B"), the investor would be required to "leave behind" one of his two B shares under certain terms and conditions designed to compensate USAID/PRE for guaranteeing the "B" issue. Eventually, Rs. 25,000,000 in "B" shares (one-half of the total "B"-share issue) would be left behind in a collateral account, lodged with the VCC, and indirectly under the control of USAID/PRE. This collateral account permits USAID/PRE to control 50% of all dividends, proprietary rights to retained earnings and/or the value placed by the market on the issue. Holders of B shares would be able to get their collateralized shares back, after **the escrow account is liquidated in five years,** and **then** only if the investors pay to USAID/PRE a price which is equivalent to the full appreciation the shares have enjoyed during the time they have been in the account. (In this context, "appreciation" is the difference between current market price and the original par value of the "B" stock, if that was the purchase price);

Third, the "A" shares and the "B" shares could be allowed to freely trade unlinked on the stock exchange. In practice each of the two types of shares would find its own price based on the market's perception of their inherent value.

4.07 At any time of its choosing, during the three years **subsequent** to liquidation of the escrow account, USAID/PRE would have the option to return the shares to the Class "B' shareholders for the payment described earlier. They would reserve the additional right to sell any unclaimed B-shares on the open stock exchange.

Underwriting

4.08 According to Forbes and Walker, a local brokerage house, a Rs 75,000,000 public offering is quite large by Sri Lanka standards for private underwriters, particularly for a start-up such as the proposed SLVC. One tactic to improve the probability of a successful issue is the above discussed guarantee from USAID/PRE to facilitate placement of the Common B. Recent underwriting by the local private sector has exceeded these amounts, but only for the businesses whose dynamics are well understood by the investing public.

4.09 An event which could improve the attractiveness of the remaining Rs. 25,000,000 Common A offering would be a joint, underwriting commitment from the Bank of Ceylon or the Export Development Board (both GOSL-owned) to purchase for their own account a total of up to, say, the final 15% of shares should all, or a portion, of these remain unsold. The balance of the shares would be spoken for by the private (lead) underwriter.

4.10 The underwriting mechanism proposed above may broaden the appeal of the offering. In other words, more money may be raised from the public with the presence of the guarantee and underwriters than without them. The downside for USAID and PRE is that an undefined minority of the SLVC's shares may fall into the hands of the government.

4.11 To act as a disincentive, the escrow account would not guarantee Class B stockholders that are government-owned; nor would shares subscribed to in the public offering by government entities be accepted for inclusion in the collateral pool.

4.12 An underwriting strategy, such as is outlined above, would both, maximize the broadbasing of VCC ownership and minimize the incentives for the public sector to participate in the process.

4.13 Further, prior to issuing their underwriting commitment, both the Bank of Ceylon and the Export Development Board, would be required to agree to no role in the management of the VCC; no voting rights on the board of directors; and a sunset provision requiring the sell-off of their shares within a three to five year period on a basis satisfactory to all parties.

B. Sources and Uses

4.14 Sources and applications of funds, Sri Lanka Venture Capital Ltd. for first year of operation.

(In U.S. dollars)

Sources

Corporate Sir Lanka	$1,000,000	Equity
Public Sri Lanka (no guarantee)	$1,000,000	Equity
Public Sri Lanka (A.I.D. guarantee)	$2,000,000	Equity
Deposit interest (@5% minimum)	$ 200,000	
Debt Placement (2%)	$ 160,000	
Total	$4,360,000	

Applications

Operating Cost, yearly	$ 250,000
Available for investment	$4,110,000
Total	$4,360,000

C. Profitability

4.15 The Company will generate revenues from investment banking fees associated with its project developer role, dividends and, more significantly, from capital gains. The fees to be collected from Subprojects by the Company may consist of:

-- Origination.

-- Documentation.

-- 1-2% of equity raised from the Sri Lanka joint venture partner.

-- .5-1% of debt raised from the Sri Lanka banking system.

-- Trading fees.

The total fees collected may be up to 5% of subproject capitalization.

4.16 The SLVC Company will be capitalized at US$4.0MM equivalent in equity and placed as equity and equity-like investments in subprojects. An average of US$500,000 would be invested in 8 subprojects accounting for 25%-50% of the subproject equity. Total equity mobilization at the subproject level would be, therefore, up to US$16.0MM.

TABLE --
SRI LANKA VENTURE CAPITAL
INCOME STATEMENT, 1988-1992
($'000)

	1988	1989	1990	1991	1992
Revenue					
Debt Placement	160.00	0.00	0.00	0.00	0.00
Dividends	25.00	760.00	1900.00	2100.00	2180.00
Capital Gains	0.00	0.00	0.00	0.00	13080.00
Interest Income @5%	200.00				
Gross Revenue	385.00	760.00	1900.00	2100.00	15260.00
Operating Expenses	250.00	250.00	250.00	250.00	250.00
Gross Margin	135.00	510.00	1650.00	1850.00	15010.00
Interest Expense					
Net Income B/T	135.00	510.00	1650.00	1850.00	15010.00
Profit Participation					
Common A @50%	67.50	255.00	825.00	925.00	7505.00
Common B @50%					
To Common B (@25%)	33.75	127.50	412.50	462.50	3752.50
To AID (@25%)	33.75	127.50	412.50	462.50	3752.50
Investor At Risk Position ($4MM Invested)	-3865.00	-3355.00	-1705.00	145.00	15155.00

SENSITIVITY

A. Planned Performance

IRR Stream at 6x earnings	-3865.00	510.00	1650.00	1850.00	15010.00
IRR at 6x earnings	58%				
IRR Stream at 5x earnings	-3865.00	510.00	1650.00	1850.00	12830
IRR at 5x earnings	53%				
IRR Stream at 4x earnings	-3865.00	510.00	1650.00	1850.00	10650
IRR at 4x earnings	48%				
IRR Stream at 3x earnings	-3865.00	510.00	1650.00	1850.00	8470
IRR at 3x earnings	42%				

B. 1 Yr Lag in Performance

IRR Stream at 6x earnings	-4000	135	510	1650	1850	15010
IRR at 6x earnings	42%					
IRR Stream at 5x earnings	-4000	135	510	1650	1850	12830
IRR at 5x earnings	39%					
IRR Stream at 4x earnings	-4000	135	510	1650	1850	10650
IRR at 4x earnings	35%					
IRR Stream at 3x earnings	-4000	135	510	1650	1850	8470
IRR at 3x earnings	31%					

VENTURE CAPITAL COMPANY
ASSUMPTIONS FOR PRO FORMA STATEMENTS

Simplified Model

Equity:	Equity disbursements of up to $4,000,000 based on financial performance of a representative five subprojects described below in Table I "Equity and Debt Disbursements for Five Subprojects."
Timing of Disbursements:	All disbursement are assumed to occur on January 1 of each year. See Table I, "Equity on Debt Disbursements for Five Subprojects, 1988-92."
Cumulative Profit Five Subprojects, 1988-93:	Table II "Cumulative Profit Five Subprojects, 1988-93" provides rough estimates of net profit before tax for each subproject. No taxes are payable on any of the subproject earnings.
Debt Placement Fees:	"Venture Capital Company Income Statement" assumes debt placement fees amount to 2% of the total debt identified in Table I which would be organized by the VCC in each of 1988, 89 and 90.
Dividends:	All earnings are paid out in dividends in the year earned.
Capital:	Assumes sale of securities at the end of the fifth year at a multiple of 6x earnings.
Operating Expenses:	$250,000 annually in operating expenses which the VCC would be assumed to have for a $4,000,000 portfolio.
Profit Participation:	Assumes USAID/PRE receives profit participations equal to 25% of Net Income B/Tax.

TABLE I
EQUITY AND DEBT DISBURSEMENTS
FOR FIVE SUBPROJECTS, 1988-92
(US$ 000)

	1988	1989	1990	1991	1992
Floriculture	2 Ha	2 Ha	2 Ha		
Equity	120	120	120		
Debt	180	180	180		
Ornamental Folliage	2 Ha	2 Ha	2 Ha		
Equity	120	120	120		
Debt	180	180	180		
Integrated Hog Production					
Equity	1,400				
Debt	2,100				
Activated Carbons					
Equity	500				
Debt	700				
Tea Bagging					
Equity	400				
Debt	600				
TOTAL					
EQUITY	2,540	240	240		
DEBT	3,760	360	360		
of which Venture Capital Company provides 50% Equity:	1,290	120	120		

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TABLE II

CUMULATIVE PROFIT
FIVE SUBPROJECTS, 1988-93
(US$ 000)

	1988	1989	1990	1991	1992	1993
Floriculture	0	20	60	120	180	240
Ornamental Foliage	20	60	120	180	180	180
Integrated Hog Prod.	0	200	500	500	500	500
Activated Carbons	0	100	600	600	600	600
Tea Bagging	0	200	200	200	200	200
Total	20	580	1480	1600	1660	1720
Disbribution of Dividends:						
-- To Local Op. Co	10	290	240	800	830	860
-- To Venture Capital	10	290	740	800	830	860

4.18 Exit from investments to capture Capital gains will be through those strategies which are most likely to yield maximum appreciation. The projections above assume exit through public offerings of the stock of the subprojects. Exit may also be attempted through public trading of SLVC itself. Alternative exit strategies include private placements, limited public offerings and buy backs. Costs of registration and placement and perceptions of market acceptance will govern the choice of exit strategy.

4.19 It is likely that USAID will permit all payment due for its participation as co-guarantor to the PRE Revolving Fund, thereby doubling PRE's anticipated return.

4.20 Internal rate of return runs on three additional (and more conservative) scenarios when the equity only doubles, indicate the following returns to A.I.D. including interest earnings on the escrow account:

	IRR
(1) $8.0MM in SLVC distributions by year 5	25%
(2) $8.0MM in SLVC distributions by year 6	20%
(3) $8.0MM in SLVC distributions by year 7	15%

The actual rates to PRE double with assignment of USAID's returns to PRE. The actual rates diminish on a percentage basis as distributions are decreased.

V. Transaction Summary for PRE Portion (Indicative Only)

Borrower:	Sri Lanka Venture Capital Company Limited, SLVC, a wholly Sri Lanka-owned corporation.
Amount:	$1.0 million loan to effect a guarantee form and held in a collateral account.
Term of Loan:	5 years from disbursement.
Disbursement Period	2 years from loan execution.
Purpose:	Provide seed money for the start-up or expansion of small and medium-sized agribusiness and other enterprises in Sri Lanka.
Grace Period:	5 years (60 months) from disbursement, on principal only.
Interest:	Interest earned on collateral account to effect guarantee payable to A.I.D. in dollars.
Principal Repayment Schedule:	Bullet payment five-years from disbursement payable in dollars.
Use of Funds:	Loan proceeds will be used to guarantee Class B Common Share purchase value issued by SLVC in public offering.

Profit Participation:

A.I.D. (specifically PRE) will receive in profit participation 50 percent of net profits and/or proprietary rights paid to Class B common shareholders as long as the guarantee is in effect.

SLVC Investments -- General Requirements:

(1) SLVC investments will be made only in Sri Lanka.

(2) SLVC investments will be principally in agribusiness projects that emphasize employment generation, net foreign exchange generation, and/or forward/backward linkages to other local entrepreneurs.

(3) SLVC will invest only in companies having at least 40% local ownership (or higher if prescribed by local law).

(4) SLVC's investment in a subproject shall not constitute more than 25% of the total cash capitalization (equity plus term debt) of the subproject.

(5) SLVC will exercise due diligence to determine that any subproject in which an investment is made will be in compliance with U.S. laws and regulations concerning licensing of U.S. technology for use overseas.

Collateral:

As collateral for the A.I.D. loan, SLVC will assign to A.I.D. a security interest in the Class B common pending retirement of A.I.D. collateral guarantee.

Currency of Repayment:

All payments of interest and principal on the collateral account, will be in U.S. dollars payable, unless otherwise specified in writing, to the U.S. Treasury. Payment of profit participation through dividends and/or proprietary rights will be in local currency and converted as permitted by remittance laws.

Application of Payments:

All payments received by A.I.D. will be applied to the payment of interest, principal, and payment of profit participation in that order.

Payments will be deemed made as of the date received by the authorized payment office.

Termination in Full:

Upon payment in full of all principal, interest, interest, and profit participation due, all obligations of the Borrower and A.I.D. under this agreement will cease.

Conditions Precedent to Disbursement:

The A.I.D. obligation will terminate on _____ unless the conditions precedent to disbursement are met.

(1) Drawdown on the A.I.D. loan is contingent on SLVC or its affiliates: raising at least Rs. 25,000,000 in a private offering.

-- establishing the collateral account.

-- preparation of documentation for raising the Rs. 75,000,000 in a public offering.

-- establishing to AID's satisfaction the collateralization arrangements for A.I.D.'s guarantee.

-- retaining underwriters to A.I.D.'s satisfaction with strict controls and sunset provisions on any public-sector underwriting.

(2) A.I.D. approval is required for the selection of the individuals who will serve as managing director and Chairman of the Board of SLVC.

(3) A.I.D. reserves the right to review and approve the following documents:

1. Shareholder Agreement
2. Statement of Investment and Operating Policies
3. (Other)

(4) Other normal conditions precedent to each disbursement will be included, e.g., disbursements will not be made if Borrower has undergone a material and adverse change in financial conditions, etc.

General Covenants:

There will be general covenants as to:

1. Program evaluation.
2. Consultation.
3. Execution of the program.
4. Reports, records, inspections and audit.
5. Financial reports of the Borrower.
6. Completeness of information
7. Other general covenants to be determined.

Financial Covenants:

1. SLVC will draw down A.I.D. funds for capitalization on the following schedule:

   At least $500,000 by, March 1988, and $1.0 million by September 30, 1988.

2. SLVC will not contract any additional debt (including senior debt) from that contemplated in the initial capitalization without the written approval of A.I.D.

3. SLVC's audited net worth must at all times exceed \$1.5 million.

4. Dividend participations and/or preferred share redemptions permitted subject to the condition that all scheduled payments of interest, principal, and loan fees due to A.I.D. are current.

Negative Pledges:

No portion of the total capitalization of SLVC will be used, unless A.I.D. agrees in writing, to finance enterprises involved in the production, processing, or marketing of sugar, palm oil, cotton or citrus for export; or to finance the procurement, research development, production or distribution of weapons; or to finance the manufacture, importation, distribution or application of pesticides.

Special Covenants for Investments Made:

1. SLVC will adhere strictly to the Statement of Investment and Operating Policies as amended from time to time and approved by A.I.D.

2. By the beginning of the 60th month, at least \$1.0 million of all investments made by SLVC will be joint ventures with U.S. companies or investors.

Events of Default on the A.I.D. Loan:

Standard, including but not necessarily limited to the following (applying to both Borrower and Guarantor):

Representation and warranties.

u\

Failure to report to A.I.D. in a timely manner any material adverse change in the financial condition of the Borrower.

Material failure in reporting compliance.

Failure to comply with Financial Covenants 2,3 or 4; or with Special Covenant 1.

Non-payment.

Governing Law:	The Loan Agreement will be governed by the laws of the District of Columbia of the United States.

VI. **CONTRIBUTION TO DEVELOPMENT**

A. Impact of PRE participation of USAID Policy Areas

6.01 The proposed PRE participation would provide a positive impact in four key USAID policy areas: basic human needs, private sector development, institution building and policy dialogue.

6.02 The project addresses basic human needs (BHN) criteria by focusing on growth in the smaller-scale agribusiness sector which will have a positive impact on rural employment.

The project will promote private sector development, by catalyzing a number of new enterprises through the mobilizing of private risk capital, private technology and private management.

The project has as a central element institution building of Sri Lanka-owned and supported capital markets. This project has been designed in close collaboration with private commercial businesses and would not come about without A.I.D. sponsorship.

Finally, the project clearly complements USAID policy dialogue in that it meshes well with the USAID activities to develop the rural industrial base and Sri Lanka capital markets.

6.03 Specifically, USAID highlights the following:

* Increasing reliance on the private sector as the determinant of sustained growth and development

  The proposed project relies precisely on a private sector delivery mechanism and the disciplines of profit and loss decision making;

* Redirection to agribusiness and rural industrialization

  The project focuses precisely on this redirection and can be expected to support mobilization of new technologies by entrepreneurs making investments in the rural sector;

6.04 This capital markets project, in addition to earlier PRE loans, offers tangible case material and a methodology for replication elsewhere. This project adds to previous financial instruments introduced by PRE and will demonstrate its utility for effective, self-sustaining collaboration with the private sector.

B. Relation To The CDSS

6.05 The project conforms with the priorities established in the USAID CDSS, particularly as concerns the Mission's goal of developing strategies to expand productive self-sustaining, rural employment, and its focus on enterprise development.

C. Relation to PRE Objectives and Policies

6.06 PRE's objective is to meet the Basic Human Needs mandate of the Foreign Assistance Act of 1961 (revised) using self-sustaining private sector vehicles. In addition, PRE utilizes a variety of operating policies for its Revolving Fund investments to ensure high development and secure financial returns. The Sri Lanka Venture Capital satisfies both. The proposed investment is responsive to development priorities by focusing its resources or the agribusiness sector. The rural sector is typically disadvantaged, especially in the area of credit. This project will leverage up to US$16.OMM equivalent in equity alone on a self-sustaining basis.

The project also meets PRE guidelines for prudent management of Revolving Fund investments. These are as follows:

- <u>Has a Demonstration Effect</u> by: a) introducing a new type of financial institution; and b) mobilizing alternatives to public sector, subsidized credit. (see executive summary)

- <u>Exhibits Financial Viability</u> based on qualified effective demand, proven management, and focused marketing.

- <u>Targets Development Impacts Appropriate to Sri Lanka</u> by responding to identified constraints on capital expansion and diversification of the private sector production base.

- <u>Makes Resources Available to the Small-Scale Enterprise Sector</u> by leveraging the PRE/AID facility to create a pool of credit for investment in smaller-scale agribusinesses.

In addition, the facility meets project-specific financial constraints, namely: a) the facility cannot exceed US$3,000,000 (the proposed amount is US$1,000,000); b)the facility cannot be more than 50 percent of project capitalization (the proposed facility would amount to no more than 50 percent); and, c) the facility must be near market interest rates (the yield to A.I.D. will be considerably above cost to USG reflecting the risks). The facility will be financed under Section 108 as legislatively permitted.

D. Economic Impacts on the Small-Scale Enterprise Sector

6.07 The proposed PRE/AID facility specifically targets the small and medium-scale enterprise sector defined as firms with total assets not exceeding US$ 4.0MM equivalent with a matched pool of funds totalling US$4.0MM equivalent. This amount will be made available to provide long-term financing to principally agribusiness enterprises. This source of capital represents additive credit and, as such, will stimulate incremental investment, sales, and employment.

E. Environment

(to follow)

F. WID

(to follow)

VII. **MONITORING AND EVALUATION**

7.01 Project monitoring will consist of review of: a) loan and financial performance; and b) adherence to investment guidelines. Both (a) and (b) will be done on a semi-annual basis based on debt service schedules and reporting requirements imposed on the borrower. It is not anticipated that project monitoring will require site visits; this will be left to the evaluation function.

7.02 Reporting on the project will consist of annual reporting by borrower of data describing subprojects population by size, product, sales, exports and estimated increased employment as a result of financing.

7.03 An augmented audit of the project is planned two years after first disbursement. The evaluation is planned five years after disbursement. Its objectives will be to determine:

- o Whether venture capital investment in Sri Lanka by private institutions has proved viable;
- o The effectiveness of the technical assistance provided by A.I.D., if any;
- o The replicability of this model elsewhere.

IX. PROPOSED TIMETABLE

IOP	July 29, 1987
IP	August 25, 1987
L/A Negotiation	August 1987
Authorization	September 1987
Obligation	September 1987
First Disbursement (latest)	March 1988
Last Disbursement (latest)	September 1988

(See annex for implementation plan).

X. **DISBURSEMENT SCHEDULE**

10.01 Disbursement will be made only in anticipation of an immediate public offering.

ANNEX II

INVESTMENT PROGRAM AND VENTURE PARAMETERS

CONTROLLED ENVIRONMENT FARMING

Business Concept

Establish a joint venture to produce tomatoes, fancy lettuce or cucumbers in a controlled environment facility.

Product would be exported to the Japanese market.

Resources Requirements

Total Funding: $2,800,000
$ 750,000 in equity; $2,050,000 debt

Capacity: 6 hectares with yields of around 750,000 pounds per hectare per annum

Land Requirements: 7 hectares

Number of Employees: 55 workers

Expatriates: 1 for two years

Profitability: 15 acre facility should break even the first year after breaking ground (6 month construction, 6 month operation).

Thereafter, earnings before income tax should by approximately $1,000,000 each year if tomatoes are the prime crop, more if fancy lettuce is selected.

Resources from Local Operating Company: suitable land

Resources from Technology Proprietor: know-how. market access

ACTIVATED CARBONS

Business Concept

Establish a joint venture to process activated carbons from coconut shells, or charcoal, for sale to U.S., European or Japanese marketplaces.

Resources Requirements

Total Funding: $1,200,000
$ 500,000 equity, $700,000 debt

Capacity: 3 tons per day or 1000 tons each year

Land Required: 1 hectare to accomodate large inventories of raw material and finished activated carbons.

Number of Employees: 35-70 employees depending upon whether charcoal is processed on site.

Number of Expatriates: 1 for one year

Profitability: Breakeven point is about 400 tons per year which is about 40% capacity. At full capacity, the plant recovers equity, through dividends, by the middle of the third year after breaking ground.

Construction period is around ten months in duration.

Resources from Local Operating Company: supply of coconut shells or charcoal.

Resources from Technology Proprietor: know-how, external market access

DIAMOND CUTTING

Business Concept

Establish a joint venture engaged in the importation of sawn diamonds and exporting these same diamonds in cut and polished form.

The proposed facility would buy unworked diamonds for its own account and undertake to market the worked stones in Europe.

The U.S., Japan and Europe are the largest importers of diamonds in the world. Among developing countries, India and Thailand would be the principal competitors.

Resources Requirements

Total Funding: $1,000,000

$ 400,000 Equity
$ 600,000 Debt

Capacity: 125-150,000 10 pointer stones each year.

Land Required: 15,000 square feet

Number of Employees: 35 skilled operators

Number of Expatriates: 1 for one year

Profitablility: Approximately $400,000 each year after the second year of operation. Breakeven is around 10% of capacity.

Resources from Local Operating Company: Land near airport, experience in trade, reputation.

Resources from Foreign Proprietor: Know-how, market access

ORCHID PRODUCTION

(Dendrobium)

Business Concept

Establish a joint venture, with a Dutch or West German distributor, to produce orchids, using polypropelene nets over the growing areas.

West Germany is the leading European importer of orchids. Approximately 83% of these imports come from the Netherlands. The best opportunities for non-European orchid producers exist in supplementing European varieties in the winter and early spring, when demand is strong and domestic greenhouse energy requirements are the hightest.

Thailand is the largest non-European supplier of orchids to most European countries.

Resources Requirements

Funding: $ 300,000 to initiate operations

$ 120,000 in equity; $ 180,000, debt.

Capacity:

Year 1	0	spikes
Year 2	180,000	spikes
Year 3	450,000	spikes
Year 4	630,000	spikes
Year 5	810,000	spikes

Land Requirements: 2 hectares (normal entry level plot which can be expanded as markets are assured.)

Number of Employees: 50

Expatriates: 1 for several years

Profitability: At maturation (fifth year), venture should be booking net earnings of $80,000 each year, or 66% return on equity.

Resources from Local Operating Company: Access to suitable land, experience with mericloning technology. (The nucleus estate and other local operating companies might be suitable venture partners.)

Resources from Technology Proprietor: technical expertise, planting material, external market access.

FOLIAGE PLANT PRODUCTION

(Polyscias and Dracaena Purple Compacta)

Business Concept

Establish a joint venture, with a European importer, of indoor ornamental foliage plants for the European market. The plants would be exported in the form of rooted cuttings and rooted stems of 30 cm in length, as air freight costs make the export of fully grown plants prohibitive.

Resources Requirements

Funding: $300,000 approximately

$120,000 Equity
$180,000 Debt

Capacity: Own capacity would amount to 100,000 exportable net pots the first year, augmented by 200,000 net pots grown from stems bought from suppliers.

By maturation, the fourth year of operation, own capacity would amount to 800,000 exportable net pots, augmented by 400,000 net pots grown from stems bought from suppliers.

Land Required: 2 hectare (normal entry level plot which can be expanded as markets are assured.

Number of Employees: 50-60

Number of Expatriates: 1 for several years.

Profitability: Around 70% of equity after the fourth year.

Resouces from Local Operating Company: Suitable land, experience with propagation technology.

Resources from Technology Proprietor: Know-how, market access.

TEA BAGGING AND PACKAGING

Business Concept

Establish a joint venture, with a U.S. distributor of tea, to bag and package tea under proprietary label.

U.S. market is widely regarded as having vast potential to increase its consumption of up-scale tea products in light of health concerns related to coffee. Currently, a very significant percentage of U.S. imports of tea come from Asian countries.

Resources Requirements

Total Funding: $1,000,000
$ 400,000 Equity
$ 600,000 Debt

Capacity: Approximately 500,000 kilograms of packaged tea per year, assuming the plant is operated at 65% capacity using 3 shifts per day, 240 days per year. This would entail four tea bagging machines, each producing 160 conventional bags per minute weighing 2 ounces apiece.

Land Required: Factory building of 20,000 square feet on 1/2 hectare of land.

Number of Employees: 80-90

Number of Expatriates: 1 for 1 year

Profitability: At 65% capacity, plant would generate approximately $200,000 per year in net earnings, assuming packaged tea is wholesaled at around $4.25 per kilogram.

Resources Required from Local Partner: Ability to access very fine CTC (crush, tear, curl) tea

Resources Required from Technology Proprietor: Know-how, market access.

CANTALOUPE PRODUCTION WITH SORGHUM ROTATION

Business Concept

Establish a joint venture to produce high quality cantaloupe for attractive winter markets with a rotation of sorghum for domestic consumption.

Crucial to the project is the use of modern production expertise, planning, and control.

Resource Requirements

Funding: $2,550,000 which includes a reasonable estimate for the cost of 400 hectares of land and preparation costs.

$1,275,000 in equity; $1,275,000 in debt.

Capacity: A start-up operation should have 400 hectares of production. Marketable cantaloupe yields are conservatively projected at 690 pounds per hectare the first year. By the third year, the maximum yield of 1000 pounds per hectare should be achieved. The sorghum yield is projected to be 13,750 pounds per hectare in the third and succeeding years.

Land Requirements: 400 hectares

Number of Employees: many local laborers will be required for harvesting the cantaloupe; sorghum can be harvested mechanically; experienced managers and technicians will be required.

Expatriates: At least three for several years.

Profitability: Net profit is US$ 359,000 in the first year, US$ 737,000 in the second year, and over $1,000,000 by the end of the fifth year.

Resources from Local Partner: land. (The nucleus estate and/or venture capital company could provide the required land.)

Resources from U.S. Partner: technology, market access.

AUTOMOBILE COMPONENTS MADE FROM RUBBER

Business Concept

Establish a joint venture with a U.S. automobile interiors manufacturer to process automobile components made from rubber.

Rubber parts are usually bulky; therefore, sea freight is utilized in most cases. Thus, a high labor content per pound or per cubic foot is desired.

Note that most rubber products would qualify for exemption from duties entering the United States.

Resources Requirements

Total Funding: Unknown. Exact costs will depend on labor content of the item to be produced, quantity, cost of equipment and tooling needed, quality required in the product, and many other such variables.

Land Required: 15,000 square feet approximately

Number of Employees: 20-25

Number of Expatriates: 1 for 3 years

Profitability: Depends upon the product. Generally, the more labor intensive the product, the higher the profitability. It is estimated that Sri Lanka has an 88% per standard hour cost advantage over similar U.S. rubberized product production.

Resources from Local Operating Company: Access to raw material, suitable land near sea port, etc.

Resources from Technology Proprietor: Know-how, market access.

CONFINEMENT PIGGERY

Business Concept

Establish a joint venture involving ecologically clean, fully integrated hog confinement unit with grow-out systems, feed mill and slaughterhouse.

Pork could be sold to importers in Hong Kong or Singapore, reportedly looking around for additional sources of supply since their own piggeries are being closed.

Resources Requirements

Total Funding: $3,500,000
$1,250,000 equity; $2,050,000 debt

Capacity: 600 sow unit, each sow producing 20 pigs per year;
12,000 pigs slaughtered each year;
50 slaughtered each day.

Land Requirements: 1 hectare

Number of Employees: 30

Expatriates: 3 for one year

Profitability: Normally, in the United States, a confinement piggery is in the black at the 20th month after beginning operations. Earnings stabilize at around $500,000 per year beginning the 28th month.

In a developing country, a confinement piggery of this kind might plateau earlier, and at a higher level of earnings, because of lower labor costs involved.

Construction period is approximately six months.

Resources from Local Operating Company: Suitable land near airport, also access to corn which would be used as feed for the pigs. Note nucleus estate could provide the corn.

Resources from Technology Proprietor: know-how, market access.

ANNEX III

TIMING OF PRINCIPAL TASKS TO COMPLETE SRI LANKA VENTURE CAPITAL COMPANY

Codes on the left margin opposite each task refer to the three separate, but interrelated, sets of activities which will be taking place more or less simultaneously:

A = those activities which relate to the formation of the VCC, itself. Messrs. de Silva and Parra are the individuals which will provide the most time

B = those activities which relate to PRE loan obligation and the establishment of the PRE portion of the escrow account

C = those activities which relate to USAID loan obligation and the establishment of the USAID portion of the escrow account

<u>CODE</u> <u>TASK NUMBER</u>

B/C 1. USAID Mission and Bureau for Private Enterprise to decide whether to go ahead with development of Sri Lanka Venture Capital Company, based on internal as well as other considerations.

Responsibility: Shapleigh and Chase-Lansdale
Timing: 20 working days
Completion June 30, 1987

A 2. Prepare informational materials that are to be provided to foreign technology proprietors. Materials should describe venture capital initiative, its state of play, estimated timing etc. They should also describe the country (very briefly), the incentives available for foreign exchange generating ventures and other pertinent materials.

Responsibility: Parra
Timing: 5 working days
Completion: July 6, 1987

CODE	TASK NUMBER	
A	3.	Identify foreign technology proprietors with suitable market access interested in establisheing joint ventures in Sri Lanka, along the lines identified in Annex II. Responsibility: Parra Timing: 25 working days Completion: Aug. 10, 1987
A	4.	Do preliminary "due diligence" on the interested technology proprietors i.e., culling the less desirable ones from the others. Responsibility: Parra Timing: 25 working days Completion: Sep. 14, 1987
A	5.	Recommend to Mr. de Silva, in summary form, the terms and conditions which might be negotiated with the technology proprietors to acquire their know-how and market access; also present to him summary financial data which demonstrates effect of these terms and conditions on each joint venture e.g., sources and applications of funds, pro-forma income and balance sheet statements, etc. Responsibility: Parra Timing: 5 working days Completion: Sep. 21, 1987
B/C	6.	USAID and PRE to conduct their PID and IP meetings, respectively, in Washington, D.C. Responsibility: Shapleigh and Chase-Lansdale Timing: by Aug. 30, 1987
B/C	7.	Negotiate terms and conditions of Escrow Agreement. Responsibility: Chase-Lansdale w/USAID concurrence Timing: by Sep. 30, 1987

CODE TASK NUMBER

B 8. Draw up formal loan document, including conditions precedent.

Responsibility: AID General Counsil w/PRE and USAID concurrence
Timing: by Sep. 30, 1987

A 9. Arrange for by Mr. de Silva and others to conduct their "due diligence" visit to the United States and Europe to commence negotiations with technology proprietors; revise summary financial detail as appropriate for each joint venture e.g., sources and applications of funds, pro-forma income and balance sheet statements, etc. (building on Step 5).

Responsibility: Parra and de Silva
Timing: 20 working days
Completion: by Oct. 30, 1987

A 10. Identify one Sri Lanka local operating company for each potential joint venture materializing after steps 2 through 6, above. Provide local operating company with chance to critically review assumptions behind, as well as summary financial data for, the it is venture interested in.

Responsibility: Parra and de Silva
Timing: 15 working days
Completion: by Nov. 30, 1987

CODE TASK NUMBER

A 11. Prepare VCC Business Plan, including statement of mission, purpose, organization, business policies, description of investment program phasing, overall sources and applications pro-forma balance sheet and income statements, etc. (building on Steps 5,9 and 10)

Responsibility: Parra and de Silva
Timing: 25 working days
Competion:
by Dec. 31, 1987

A 12. Identify VCC Managing Director and VCC business domicile.

Responsibility: de Silva
Timing: by Jan. 15, 1988

A 13. Market business plan to "inner circle" of Sri Lankan companies who will purchase shares via private placement.

Responsibility: de Silva
Timing: 30 working days
by February 15, 1988

(Parra involvement for half of these days optional)

A 14. Secure regulatory approvals for VCC (See Step 15)

Responsibility: de Silva
Timing: 20 working days

A 15. Formally organize Sri Lanka Venture Capital Company.

by March 15, 1988

A 16. Formal commencement of operations.

Responsibility: de Silva
Timing: by March 30, 1988

CODE	TASK NUMBER
B	17. Set up the disbursement mechanism for the Escrow Account offshore needed to securitize Class B Shareholders. Responsibility: General Counsel of AID Timing: by March 30, 1988
A	18. Select Lead Securities Broker and Underwriter for Public Offering -- with USAID and PRE concurrence. Responsibility: de Silva Timing: by March 30, 1988
A	19. Prepare Public Offering. Responsibility: de Silva and Forbes & Walker Timing: by April 30, 1988
A/B	20. Execute first tranche of the Public Offering involving Rs. 37,500,000 along with the establishment of PRE Escrow Account. Responsibility: Forbes & Walker, PRE and other parties Timing: by May 30, 1988
C	21. Approval of USAID PP document in Washington, including their participation in the escrow account on virtually the same terms and conditions as that of the PRE participation. Responsibility: Shapleigh Timing: by June 30, 1988
A/C	22. Complete second tranche of the Public Offering involving Rs. 37,500,000 and establishment of the USAID Escrow Account. Responsibility: General Counsel of AID Timing: July 30, 1988

CODE TASK NUMBER

A 23. Establish interest bearing account in the home of the VCC. Interest earned off this account will support the VCC's operating budget for 2-3 years.

Timing: August 1, 1988

A 24. Booking of first deal

Timing: Approximate Sept 30, 1988

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D C 20523

July 23, 1987

MEMORANDUM

TO: AA/PRE, Neal Peden
SDAA/PRE, Charles Gladson
AA/PRE, Doug Trussell
AA/PRE, Aileen Kishaba
PRE/PR, Compton Chase-Lansdale
PRE/PD, Russ Anderson
PPC/PDPR, Neal Zank
ANE/PD, Dave Cahn
ANE/PD, Ron Venezia
ANE/SA/SL, Dave Garms
PRE/I Staff

FROM: PRE/I, Sean Walsh

SUBJECT: IOP Review for Sri Lanka Venture Capital Project

There will be an IOP meeting Thursday, July 30, 1987 in Room 6212 to discuss the proposed Sri Lanka Venture Capital project for FY 1987. Attached is the IOP document.

Attachment: a/s

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