

IESC - Market Oriented Dairy Project

Activity 3.A.

Financial Assessment

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1 Executive summary

The dairy industry in Sri Lanka requires additional investment in order to achieve the goal of self-sufficiency in dairy production. Although the local banking sector is relatively well-developed and has experience in providing loans to corporate borrowers including companies in the dairy value chain, the pace of lending is not aggressive. Furthermore, the terms, relative availability, and costs of loans can vary widely. The Sri Lankan government has programs which subsidize credit for dairy farmers in support of livestock acquisition and development, but such programs depend upon the availability of government funding and the cooperation of banks to administer the subsidies. Feedback from key local banks indicated that the subsidy programs were not economically attractive to the banks and therefore they were not priority products. Credit from microcredit institutions is available in Sri Lanka but micro loan rates are high; it is not yet known if recent Government moves to cap microcredit interest rates will reduce the supply of microcredit loans.

Equity investment capital for the dairy industry is in short supply. There are few local sources that provide patient growth equity for companies in the dairy sector (or any sector). Unfortunately, Sri Lanka is not a focus destination for international equity investors due to various factors including size of market and a historical pattern of elevated political risk. International and regional development finance institutions are open for business in Sri Lanka but investments from such entities have been relatively limited, crowded out by larger countries in the region, and constrained by the political environment.

Notwithstanding the relatively limited supply of equity capital, the enabling environment in Sri Lanka for inward capital investment is good. Despite recurrent political instability, macroeconomic growth in Sri Lanka has been consistently positive, and the legal environment for equity capital investment is well-developed and clear. Foreign investment in the dairy sector is not subject to specific taxes nor regulations, and there are no discriminatory rules against foreign investment in terms of repatriation or taxation. Profit and capital gains tax rates are low.

The positive enabling environment for investment in Sri Lanka provides a solid base for a series of targeted investments in the Sri Lankan dairy sector utilizing MOD program and co-investment capital. SEAF's initial review revealed that there are a meaningful number of quality local companies seeking to expand activity in the dairy sector across sub-sectors ranging from feed to processing to storage and delivery, etc. SEAF is confident that MOD starter capital can be deployed in attractive investments which are consistent with the goals of the MOD program and, importantly, which can attract debt or equity co-investment capital. While the orientation of the investment program will be towards equity capital (of greatest local need), SEAF recommends flexibility in approach so that investments made by the program could be either debt or equity (or quasi-equity instruments such as convertible preferred equity or mezzanine) depending on the nature of the project and the interests of the local partners and promoters.

To accomplish the investment activity, SEAF recommends the organization of a fund vehicle domiciled in the United States (Delaware limited liability company) to accept the starter capital and hold the proposed investments. Given expected challenges in raising substantial capital for a single-country, single-industry, single-subsector "blind pool" fund, SEAF recommends that the MOD fund raise co-investment capital on a deal-by-deal basis, whereby investors have an

ability to invest capital in identified, due-diligenced, and structured transactions. Co-investment capital can take the form of either debt or equity. In the case of debt capital, the Overseas Private Investment Corporation (OPIC) can be a key target candidate. OPIC's private equity funds practice would not be an applicable program for the MOD initiative given the challenges in raising substantial private sector capital for the effort (in view of the constraints noted above).

Following completion of this assessment phase, the next steps in the process include (i) the organization of the fund vehicle itself (legal incorporation, etc.), (ii) further evaluation of the universe of potential candidates for investment in Sri Lanka, (iii) in cooperation with MOD, development of priority sub-sectors within the dairy value chain for investment in order to further MOD program objectives, (iv) due diligence of high priority candidates for investment, (v) negotiation of commercially reasonable investment terms and conditions, (vi) completing and funding approved investments, and (vii) monitoring investments, adding value, and ensuring that programmatic investment targets are met.

SEAF appreciates the opportunity to provide an assessment of the Sri Lankan dairy sector investment environment and looks forward to the implementation phase of the project. SEAF acknowledges MOD staff and leadership for the excellent support and guidance they have provided throughout this assessment phase of the project.

SEAF Sri Lanka Team

2 Introduction

Project Summary

Market-Oriented Dairy Project (“MOD”) is a 4.5 year U.S. Department of Agriculture (USDA) project funded by the Food for Progress program. The project is divided into 6 key activities:

- Activity 1 aims to support farmers by providing technical knowledge in the field of developing artificial insemination, delivery service, developing dairy management and animal husbandry, technical practices as well as developing business management skill sets for farmers;
- Activity 2 focuses on developing the input side of the dairy sector being silage or fodder suppliers, animal breeders or input retailers;
- Activity 3 focuses on finance and investment;
- Activity 4 aims to develop a trading platform that people could utilize to trade animals and inputs by utilizing an IC&T approach;
- Activity 5 aims to improve the quality of milk at farm/processor/consumer levels including better hygiene practices, milking practices and managing animals, milk collection; working with processors on pricing for quality and drink milk campaign; and,
- Activity 6 is specifically focused at building the capacity of a trade, advocacy, policy and private sector focused trade association.

Activity 3 – Financing consists of two components:

- Establishment of a dairy fund: i.e., the establishment of an investment vehicle/fund that provides debt and equity financing to targeted dairy investments; and,
- Stimulate debt financing through existing financial institutions: evaluate local debt financing capacity in Sri Lanka (SL) through local commercial banks and work with those banks and existing financial mechanisms to accelerate the flow of loans (mainly small-scale loans) to farmers for development of the dairy sector.

Activity 3’s specific performance will be measured using four MOD project indicators:

- Value of OPIC/USDA investment fund supported debt and/or equity financing disbursed to enterprise/individuals within target areas: US\$ 4 million (including co-investment) – direct SEAF responsibility
- Value of public and private sector investment leveraged as a result of USDA assistance: US \$24,150,000 (SEAF will contribute towards this indicator)
- Value of loans provided as a result of USDA assistance: US\$ 5,600,000 (SEAF will contribute towards this indicator)
- Number of loans disbursed as a result of USDA assistance: 2,160 (SEAF will only contribute minimally to this indicator as the vast majority will come from existing commercial debt institutions)

Scope of work

SEAF has been engaged to perform work in support of Activity 3 of the Market-Oriented Dairy project. Under the terms of our contract, SEAF has conducted a Base Period (as defined in the contract) financial assessment to analyze the demand and currently-available target candidates for dairy-related investment and financing. Our assessment has analyzed debt and equity investment types currently available to the dairy value chain and related terms, the strength and weaknesses of existing investment types available for the dairy sector, and demand analysis for additional investment types for the dairy value chain, amongst other topics. Specific tasks are undertaken during the Base Period included:

Supply side

- Analysis of current debt or equity investment types available to the dairy sector; strengths and weaknesses;
- Analysis of existing financial institutions and products highlighting strengths and weaknesses; and,
- Analysis of outside funding sources and determine level of financial interest.

Demand side

- Assessment of the demand/appetite for funds in the dairy sector either as debt or equity and an approximation of required capital base.

Legal and regulatory

- Assessment of the current fiscal, legal and financial environment and proposal for the most suitable fund mechanism to complement MOD activities;
- Studied the process of setting up an investment fund;
- Analyzed how OPIC operates and the best mechanism to partner with them; and,
- Reviewed and analyzed foreign exchange (FX) risks and challenges to investment in the dairy sector in Sri Lanka as it is likely that investment returns will be in local Sri Lankan rupees.

Investment fund

- Recommendations for investment fund strategy including scope, investment types and terms, funding sources, management requirements, industry potential, and exit strategy;
- Proposed steps to set up the fund and anticipated timeline;
- Provided an initial estimate of resources required to establish the investment fund and develop a 10 year financial model, where the equity fund will hold on to a maximum of 25% of the target investment opportunity until exit. The model presented herein meets OPIC's financial modeling requirements for OPIC-supported investment funds; and,
- Defined a role for MOD in facilitating the implementation/operation of a fund.

Timeline of Tasks under approved Scope of Work

Financial Assessment Workplan											
TASKS	WEEK OF:										
	24/09	1/10	8/10	15/10	22/10	29/10	5/11	12/11	19/11	26/11	3/12
A. Preparatory phase											
1 Kick off call with MOD	★										
2 Assess the current fiscal, legal and financial environment											
3 Study the process of setting up an investment fund											
4 Assess OPIC programs and policies relevant for this project											
5 Meeting with IESC and OPIC in Washington/London											
6 Travel to Sri Lanka											
B. Field visit (Sri Lanka)											
1 Interviews with Financial institutions											
2 Interviews with Central Bank, Treasury, etc											
3 Interviews with potential investee companies											
4 Interviews with Lawyers											
5 Interviews with Fund Managers											
6 Present initial findings				★							
7 Travel from Sri Lanka											
C. Post Field Activities											
1 Submit list of persons met and meeting notes						★					
2 Analysis of existing financial institutions and products											
3 Analyze current debt or equity investment type available											
4 Analyze outside funding sources											
5 Assess the demand/appetite for funds in the dairy sector											
6 Recommendation on investment fund strategy											
7 Build investment fund model											
8 Submit Draft Report								★			
9 IESC review and comments on report											
10 Review IESC comments and finalize report											
11 Submit Final Report											★
★ Milestones											

All tasks called for under the proposed Timeline and Scope of Work have been completed generally in accordance with the envisioned schedule.

3 Macroeconomic view

Sri Lanka has achieved reasonably good recent growth, driven by steadily rising external revenues since the beginning of the current decade.

Following the conclusion of the long civil war in 2009, Sri Lanka has experienced several economic growth spurts. The first came in 2010-11, in the aftermath of a comprehensive ceasefire and the first influx of Chinese infrastructure investment. The Sri Lanka government thereafter pumped the economy with liquidity, bringing interest rates down dramatically. Faced with rising domestic optimism and historically low cost of capital, the corporate sector borrowed heavily; domestic lending activity exploded upwards, and credit ratios picked up sharply from the 2009 floor. Real GDP growth jumped to nearly 9% per annum, driven by double-digit consumption and investment growth, and the local stock market outperformed the EM stock index by a large margin.

The result of this local euphoria, as always, was a sharp deterioration of the external balance of trade, with the current account deficit reaching 10% of GDP. Local monetary authorities responded with interest rate hikes and other measures to protect the value of the rupee. This caused a near-recession in 2013-14, which led to renewed easing and lower rates – just in time to catch another upswing over the past couple of years as the booming tourist sector and a further round of Chinese financing had positive influence on domestic sentiment and the credit cycle.

Gratefully, the significant decline of oil prices beginning in 2015 was sufficient to prevent another large expansion in SL's current account deficit. However, concerns about Sri Lanka's rising public debt as well as fears of a hard landing and/or forced devaluation in China led to a sudden exit of portfolio capital from local markets. This resulted in foreign exchange reserve losses and renewed pressure on the rupee.

The outcome, over the past quarters, has been the combination of renewed tightening at home and a new IMF program to support both currency reserves and domestic fiscal tightening. As a result, the lending cycle is now visibly weaker again, with local interest rates back up to double-digit levels. Accordingly, 2018 has seen weak economic growth. On the positive side, the current correction may improve underlying macro conditions and thus create the framework for a more positive and sustainable medium-term outlook.

Notwithstanding the trade deficit and weak public accounts, private sector balance sheets are in relatively good shape; with the caveat of widening trend towards net foreign funding exposures in the banking system over the past five years, neither corporates nor households nor the financial sector appear stretched. Sri Lanka's key macro issue appears to be large and chronic public deficits, far larger than EM-wide averages, which add significant volatility to the macro picture (especially since nearly half of Sri Lanka's public debt is foreign currency denominated). Consequently, reducing fiscal imbalances is a clear priority going forward – recent IMF program documents underscore this obvious need.

4 Supply side

4.1 Existing Financial institutions and products

Analysis of existing financial institutions and products highlighting strengths and weaknesses

According to chief regulator, the Central Bank of Sri Lanka (CBSL), the country's banking sector comprised 26¹ licensed commercial banks (LCBs) and 7² licensed specialist banks (LSBs), as of end-2017 (latest available figures). In addition to the banks, the CBSL identifies and regulates 43³ finance companies as non-bank deposit-taking institutions, though these account for a minimal proportion of assets and deposits (8.0% in 2017) as well as 65⁴ registered finance leasing establishments.

The main difference between the two types of license is that LCBs have the authority to accept demand deposits from the public (i.e. current accounts) and to engage in offshore banking and foreign-exchange transactions. The LCBs are, by far, the most important subsector of Sri Lanka's entire financial services industry, accounting for more than half of total assets. Within this, the majority of banking sector assets are held by the six largest local groups which the CBSL identifies as being systemically important. Two are state-owned (Bank of Ceylon and People's Bank) and the other four are private domestic banks. Although 12 foreign-owned banks are currently present in Sri Lanka - and some have operated in the country for over a century - none holds a major share of the market. The seven LSBs are public savings and development banks including two housing institutions. Of these, the most significant is the state-owned National Savings Bank (NSB) which is among the leading banks overall in terms of scale.

4.1.1 Banking

Sri Lanka's banking industry dates back to the country's 19th-century Colonial era under British rule when foreign-owned banks (some of which still operate today) dominated the market with a focus on trade finance activities. The modern banking sector was shaped in the aftermath of independence in 1948, with the Central Bank of Sri Lanka established as the primary regulator a few years later. For decades, the state held a near monopoly of banking services and, though there were waves of liberalization in the late 20th century, reforms were not as deep as in other markets. The Sri Lankan banking sector remains relatively underdeveloped today, with strong state influence.

Partly because of limited deregulation and its comparatively shallow financial markets, Sri Lanka's banking sector did not suffer the same level of distress and restructuring as seen in other markets during and after the global financial crisis. As a result, the cornerstone Banking and Monetary Law Acts (dating originally from 1988 and 1949, respectively) have been amended over time rather than rewritten altogether. The sector's regulatory framework has

¹ <https://www.cbsl.gov.lk/authorized-financial-institutions/licensed-commercial-banks>

² <https://www.cbsl.gov.lk/authorized-financial-institutions/licensed-specialised-banks>

³ <https://www.cbsl.gov.lk/authorized-financial-institutions/licensed-finance-companies>

⁴ <https://www.cbsl.gov.lk/en/authorized-financial-institutions/registered-finance-leasing-establishments>

remained broadly stable, with the CBSL as the chief regulator and supervisor, and reforms mostly centered on adhering to new international standards such as the Basel III framework to enhance supervision and risk management.

The Ministry of Finance, or Treasury, sets the broad policy agenda for the banking sector, prompting amendments to the relevant legislation as required, and instructing the CBSL to implement regulatory proposals.

Under the existing regulatory framework, the CBSL is responsible for:

- Licensing new commercial and specialized banks.
- Issuing prudential directions, determinations, orders, and guidelines to banks.
- Conducting continuous supervision and monitoring of banks.
- Enforcing regulatory actions and the resolution of weak banks.

Bank licensing is carried out by the Monetary Board, which is the legal governing body of the CBSL and is made up of the Central Bank Governor, the Secretary to the Ministry of Finance, and three other non-executive members appointed by the president. The Board considers the benefits that a new bank may offer the economy and any threats it may bring on the finances of entities already operating in the system. The CBSL's Bank Supervision Department is responsible for monitoring licensed institutions. Within the central bank lies the Financial System Stability Committee, which was founded in 2002 and focuses on assessing the risks and vulnerabilities in the banking sector before providing recommendations to the Monetary Board. The bank has recently acted in the face of vulnerable entities: in March 2018, the CBSL revoked the license of (non-deposit taking) financial company Central Investments and Finance after it had failed to resolve financial difficulties over four years. The resolution will include compensation of up to LKR 600,000 for insured deposits, according to the CBSL.

In its 2017 Road Map, the CBSL stated that it would be seeking to update the Banking Act with provisions to strengthen the bank's enforcement powers for violations of the law. It also said it would roll out a Bank Sustainability Risk Index to better examine the efficiency, effectiveness, and sustainability of individual banks, and the sector as a whole.

The current administration⁵ favors a more market-led approach to banking sector reform, though is also implementing a series of regulatory tweaks. The 2017 budget included a number of planned changes for the sector, including an increase in the minimum core capital requirement to LKR 20 billion for LCBs and LKR 7.5 billion for LSBs; the merger of the state-owned LSBs HDFC Bank and State Mortgage Investment Bank (SMIB) to form a new Housing Bank; revisiting the single shareholder limit and a maximum tenure for Boards of Directors; directing banks to ensure their lending portfolios are allocated so that at least 10% is for agriculture, 10% for SMEs, 10% for exports, 10% for tourism, and 10% for Youth and Women's initiatives. The budget also called for 'voluntary consolidation' among smaller private banks, in preparation for new Basel III capital requirements that are being phased in from July 2017.

⁵ Albeit future course remains to be determined once political situation stabilizes.

In October 2017, the Central Bank raised the minimal capital requirements for newly LCBs, to LKR 20 billion, and newly licensed specialist banks to LKR 7.5 billion, in line with plans previously outlined in the 2017 budget. New foreign banks will be required to hold minimal capital of LKR 10 billion. Existing banks will have three years to meet the new requirements. In December 2017, the CBSL also introduced new limits on the level of foreign currency borrowing at LCBs, based on the external long-term credit rating and the total capital ratio of the bank. Short-term foreign currency borrowing (with a maturity of three years or less) will be capped at 1.5% of total assets, while the total limit will range from 5.0% to 10.0% for the highest rated and capitalized banks. It also introduced new restrictions on bank lending for motor vehicle hire and purchase.

Meanwhile, in the 2018 budget, the government introduced a new banking transaction levy - originally planned to be introduced in April 2018, but later delayed - and be in place for three years, part of renewed efforts to raise revenues to repay the country's foreign debt obligations. The tax was originally planned to be in the form of a small charge on all cash banking transactions, but in August the government instead proposed a tax on the value added attributable to the financial services of banks.

Banks have overseen rapid credit growth in recent years, which has seen the sector-wide capital adequacy ratio fall from over 17.5% at the end of 2013 to 15.2% at end-2017. This is a concern as the transition period for new capital requirements based on the Basel III framework began in July 2017, with banks required to boost capital. The six largest banks, designated as systemically important institutions, will have extra capital requirements (a 1.5% buffer), with compliance required by 2019. The CBSL also announced higher capital requirements for all newly licensed banks starting from October 2017, with existing banks obliged to meet the new standards before the end of 2020. In June 2018 Fitch concluded that Sri Lankan banks would require fresh capital of around LKR 19 billion in the face of economic headwinds and tighter regulatory requirements in force from 2019.

Table 1: Top 10 commercial and retail banks by total assets, LKR million

	Total Assets	Common Equity Tier 1 Ratio (%)	Date
Bank of Ceylon	2,092,668	10.0	31/03/2018
People's Bank (Sri Lanka)	1,654,991	10.7	31/03/2018
Commercial Bank of Ceylon	1,230,722	11.3	31/03/2018
National Savings Bank	1,049,777	11.6	31/03/2018
Hatton National Bank	1,044,272	13.0	31/03/2018
Sampath Bank	900,262	12.0	30/06/2018
Seylan Bank	431,533	10.3	30/06/2018
National Development Bank	421,893	9.9	30/06/2018
HSBC Sri Lanka	394,451	15.5	31/03/2018
DFCC Bank	362,873	11.1	30/06/2018

Note: Data is latest available, Source: Company reports

Bank of Ceylon is the leading commercial bank in Sri Lanka and is owned by the government. It provides retail, wholesale, international, development and investment banking, credit cards, SLIPS, RTGS payments, safe deposit, custodial and pawn broking services. It has a network of over 620 domestic branches and 15 SME centers, as of end-2017 (latest available data).

The other top-tier state commercial bank, People's Bank, had a wider network of 737 branches and 541 ATMs that served around 17.4 million customers as of June 30, 2017. In February 2017, the government agreed to increase the bank's authorized share capital and permit it to issue debentures without government guarantees. The moves came in response to the bank's strong growth in recent years, which the Finance Ministry said necessitated a change in its legal corporate framework.

Table 2: Top 10 banks – asset quality

	Growth of Gross Loans (%)	NPL Charges (% of Gross Loans)	Date
Bank of Ceylon	2.1	0.8	31/03/2018
People's Bank (Sri Lanka)	4.3	0.4	31/03/2018
Commercial Bank of Ceylon	5.8	0.8	31/03/2018
National Savings Bank	2.8	0.3	31/03/2018
Hatton National Bank	5.5	0.8	31/03/2018
Sampath Bank	10.5	0.9	30/06/2018
Seylan Bank	8.8	0.9	30/06/2018
National Development Bank	10.0	0.9	30/06/2018
HSBC Sri Lanka	6.1	0.0	31/03/2018
DFCC Bank	10.7	1.2	30/06/2018

Note: Data is latest available, Source: Company reports

Commercial Bank of Ceylon (CBC) is the leading private Sri Lankan bank operating primarily in Sri Lanka, Bangladesh, and the Middle East. It provides corporate banking, private banking, treasury services, trade financing, offshore banking and resident and non-resident foreign currency operations. As of the end of H118, CBC had 262 branches and 778 ATMs across the country.

The National Savings Bank is the country's largest LSB and the fourth largest overall after passing over LKR1trn in assets in 2017. It is a government-owned specialized bank, originally established as The Ceylon Savings Bank in 1832. The bank now has a network of over 250 branches and 287 ATMs.

In 1888, fifth-largest entity Hatton Bank started business in the hill country around the town of Hatton as a small bank that served the tea industry. In 1970, Hatton Bank merged with the Kandy and Nuwara Eliya branches of National & Grindlays Bank, becoming Hatton National Bank (HNB). The bank has grown by acquisitions such as the Sri Lankan interests of Emirates Bank in 1989 and the business of the Colombo branch of Banque Indosuez in 1996. Today, HNB has more than 250 branches and nearly 600 ATMs in Sri Lanka. It was the first and remains the only, Sri Lankan Bank to be listed internationally on the Luxembourg Stock Exchange.

The last of the 'Big Six' is Sampath Bank, a private entity, established as a licensed commercial bank in 1988 after being listed on the Colombo Stock Exchange. Like other major banks, Sampath is currently focused on raising capital to meet new Basel-III requirements.

Table 3: Top 10 banks – funding & liquidity

	Loans (% of customer deposits)	Customer deposits (% of total funding)	Date
Bank of Ceylon	77.8	85.1	31/03/2018
People's Bank (Sri Lanka)	95.0	88.5	31/03/2018
Commercial Bank of Ceylon	88.1	83.9	31/03/2018
National Savings Bank	48.4	76.8	31/03/2018
Hatton National Bank	95.3	84.4	31/03/2018
Sampath Bank	104.9	86.1	30/06/2018
Seylan Bank	97.3	84.1	30/06/2018
National Development Bank	103.3	79.4	30/06/2018
HSBC Sri Lanka	116.8	56.8	31/03/2018
DFCC Bank	118.1	67.3	30/06/2018

Note: Data is latest available, Source: Company reports

4.1.2 Non-Bank Finance and Leasing

Non-Bank Finance and Leasing Sector includes Licensed Finance Companies (LFCs) and Specialized Leasing Companies (SLCs). The directions, regulations, and rules issued under the provisions of the Finance Business Act (FBA) mainly cover minimum capital adequacy, liquidity requirements, provisioning for bad and doubtful debts, single borrower limits, limits on equity investments, etc.

The regulation and supervision of LFCs is governed by the FBA No. 42 of 2011 which was enacted on 09.11.2011 repealing and replacing the Finance Companies Act No 78 of 1988 to strengthen the regulation and supervision of LFCs and to curb unauthorized finance businesses.

In terms of Finance Leasing Act, No. 56 of 2000 (FLA), a certificate of registration issued by the Director of SNBFI is necessary to conduct finance leasing business having a prescribed amount of capital. There are four categories of institutions that are eligible to register as Registered Finance Leasing Establishments (RFLEs). They are Licensed Commercial Banks, Licensed Specialized Banks, Licensed Finance Companies and Public companies (Specialized Leasing Companies). The regulation and supervision function of SLCs licensed under the FLA is carried out by the SNBFI Department of the Central Bank.

SLCs are not permitted to accept money from the public as deposits. However, they may borrow money by issuing debt instruments such as promissory notes, commercial paper and debentures etc. with the prior approval of the Director of SNBFI.

4.1.3 Microfinance companies

Microfinance is defined as “provision of financial services to low-income people.” It brings credit, savings and other essential financial services to people who are too poor to be served by

regular banks, mainly because they are unable to offer sufficient collateral. Microfinance is expected to expand and improve income generation activities and capacities of low-income persons.

Sri Lanka has a long history in having a rudimentary system of microfinance. ‘Cheetu’ in Sri Lanka, operating at least since the early 20th century, is an informal but an effective way of savings and capital accumulation, and therefore, functions as a basic method of microfinance for the poor. The microfinance sector in Sri Lanka has grown into a diverse range of institutions and products and represent a significant method of financial inclusion, and empowerment for the low income and poor segments of society.

There is a variety of institutions providing microfinance in Sri Lanka, such as licensed banks, licensed finance companies, co-operative rural banks, thrift and credit co-operative societies, divinaguma banks and other community-based organizations, microfinance companies, non-governmental organizations that engage in microfinance business. The Central Bank regulates licensed banks and licensed finance companies. Co-operative rural banks and thrift and credit co-operative societies are regulated by the Department of Cooperative Development, with Divinaguma Banks being regulated by the Department of Divinaguma Development. However, many microfinance providers are not under the purview of a regulatory authority.

For over a decade several attempts were made to enact legislation to regulate the unregulated institutions in the microfinance sector in Sri Lanka. Finally, the Parliament enacted the Microfinance Act, No. 6 of 2016 (the Act), which came into effect on 15th July 2016. The Act provides for the licensing, regulation and supervision of companies carrying on microfinance business, which are called licensed microfinance companies (LMFCs). LMFCs would be directly regulated by the Monetary Board of the Central Bank of Sri Lanka (the Monetary Board).

4.1.4 Insurance

Sri Lanka's insurance sector has low levels of penetration for the region but is expected to continue expanding at a rapid pace going forward. After insurance companies were recently obligated to split their life and non-life businesses and be listed on the Colombo Stock Exchange, the potential for growth is strong, particularly given favorable demographics. However, the sector also faces significant challenges from higher taxes, natural disasters, and broader instability.

Sri Lanka's insurance industry remains relatively small compared to other states in the region, with total assets accounting for just 3.4% of the financial services sector in 2017 (latest annual data available). Gross premiums, meanwhile, represented just 1.2% of GDP, showing minimal penetration compared to peer countries. Total gross premiums reached LKR 164.6 billion at end-2017, split between the life (LKR 71.5 billion) and non-life segments (LKR 93.1 billion).

According to principal regulator, the Insurance Regulatory Commission of Sri Lanka (IRCSL), there are 27 insurance companies licensed to operate in the country: 12 specializing in long-term (life) insurance, 13 in general (non-life) insurance, and two composite companies active in both businesses as well as 61 licensed insurance brokers.

4.1.5 Asset management

Sri Lanka's asset management industry is young and still relatively small. The industry is made up of unit trust (mutual fund) companies, which were first introduced to the country in the early 1990s and reported total Assets under Management (AuM) of LKR 128.8 billion at the close of 2017 (latest official data), up from LKR 103.1 billion a year earlier, though still below the LKR 130 billion posted in 2015. The big swing was largely due to a major withdrawal of assets in late-2016 and early 2017 over fears of new taxes in the sector - the trend was reversed when this was suspended. Despite the rebound, as of end-2017 total AuM accounted for less than 1% of total assets in the financial services sector.

Fund management companies (unit trusts) are licensed and regulated by the Securities and Exchange Commission of Sri Lanka (SEC), which was established in 1987. Its primary role is to regulate the securities market of Sri Lanka; grant licenses to stock exchanges; manage companies in respect to each unit trust, stock brokers and stock dealers who engage in the business of trading in securities; to register market intermediaries; to set up a compensation fund, and for matters connected therewith or incidental thereto.

According to the Unit Trust Code of 2011, fund management companies are forbidden to make investments in commodities, futures, options, and real estate (other than real estate investment companies), without prior approval from the SEC. This restriction on commodity investments does not apply to passive investments tracking the price of approved commodities, such as gold.

The SEC recently released its 'Capital Market Strategy 2020', a transformative plan that is set to include the approval of a new SEC Act to regulate capital markets. As part of this, the SEC is working towards supporting the unit trust industry by cultivating a conducive environment and creating awareness among the general public. It aims to encourage more engagement by institutional investors, which traditionally concentrate their exposure to government securities.

The sector has also been subject to shifting tax proposals, as part of wider government efforts to raise revenues. In its 2017 budget, the government included a proposal to remove tax incentives from April 2017, which, although was later delayed, prompted a sharp decline in AuM in the first few months of 2017 due to significant outflows. The plans were later revised so that beneficiaries of earnings from unit trust funds would be liable to pay income tax, while unit trusts would be subjected to taxes on investment. However, unit trusts where beneficiaries are not entitled to income will be taxed at a rate of 24-28%. The new Inland Revenues Act came into force in April 2018.

According to the SEC, there are 14 unit trust companies currently operating in Sri Lanka, managing around 80 mutual funds (as of end-June 2018). There are also 23 registered market intermediaries categorized as investment managers. Most have fewer than 1,000 unit holders, with around 80% of the industry in the hands of corporate and institutional investors.

Open-ended money market funds are the most popular option among investors, accounting for nearly half of total AuM. Open-ended growth funds and balanced funds have attracted more assets in recent years, while there is also a handful of Shariah funds available from Candor Asset Management and Comtrust Asset Management.

The SEC does not publish rankings, but the largest unit trust company is Capital Alliance Investments (CAL), with around LKR 20 billion in AuM. Another influential player is Ceylon

Asset Management, which manages the country's only US Dollar Bond Fund. Meanwhile, Ceybank Asset Management is the main public unit trust company, majority-owned by the Bank of Ceylon and Sri Lanka Insurance Corporation.

4.1.6 Colombo Stock Exchange

The Colombo Stock Exchange (CSE) is Sri Lanka's licensed stock market operator, incorporated as a limited company 30 years ago. At the end of October 2018, the CSE had 297 companies listed representing 20 business sectors and with a total market capitalization of LKR 2,793 billion. At present, the CSE only offers trading in spot markets, though it plans to add exchanges for financial derivatives in the coming years.

Aside from operating exchanges for both equity and debt, the CSE provides post-trading services of settlement and safekeeping via its subsidiary Central Depository Systems (CDS). It also oversees compliance through a set of rules and promotes improved standards of corporate governance among listed companies.

The government is making a concerted effort to encourage more listings on the stock exchange and develop the capital market. After a period of sharp decline, data showed the market capitalization of the CSE climbed to 24.5% of GDP in 2017, compared to 23.2% a year earlier. However, the market is yet to recover fully from a scandal-induced slump in 2012, with prices on the benchmark indices still far below the peak of 2011. Part of this expansion is coming through legislative requirements such as the obligation for insurance companies to be listed; so far, enforcement has been irregular. In November 2017, Renuka Hotels began trading on the CSE while LVL Energy Fund Limited (LVEF), Jetwing Symphony and Hatton Plantations completed Initial Public Offerings (IPOs) in the first two months of 2018.

In July 2018, the CSE in conjunction with the SEC launched a new market listing board 'Empower' for Small and Medium Enterprises (SMEs). The goal is to facilitate access to equity-based capital for smaller companies, which account for around three-quarters of the total number of enterprises in the country. It is unknown at this time if the Empower market will develop into a credible source of capital for SL SMEs, but for purposes of MOD investment planning, we do not expect the Empower market to be a likely source of co-investment capital for our targeted investee companies.

The CSE has two main equity indices: the All Share Price Index (ASPI) and the S&P Sri Lanka 20 (S&PSL20), the latter operated in conjunction with S&P Dow Jones Indices and included the 20 most traded companies on the primary market. The goal of the S&PSL20 is to provide an easily replicable yet representative benchmark, which could be tracked by exchange-traded funds (ETFs).

Table 4: Top 10 companies by market capitalization on the Colombo SE

Company Name	Market Capitalisation (LKR billion)	% of total
Ceylon Tobacco Company	266.75	10.29%
John Keells Holdings	211.18	8.15%
Commercial Bank of Ceylon	107.53	4.15%
Dialog Axiata	96.65	3.61%
Nestle Lanka	88.23	3.40%
Hatton National Bank	85.02	3.28%
Distilleries Company of Sri Lanka	77.03	2.98%
Ceylon Cold Stores	63.38	2.68%
Sampath Bank	64.02	2.47%
Melstacorp	59.55	2.30%

Note: Data as of 14 November 2018. Source: Colombo Stock Exchange

The top ten companies by market capitalization account for around 40% of the total market. In terms of the sectoral breakdown, banks, finance, and insurance lead (around 27% share); beverage, food and tobacco (23%); and diversified holdings (around 18%) led the market.

The largest listed company in Sri Lanka is the Ceylon Tobacco Company, which has posted strong growth and profits during 2018 despite facing pressure from taxes on cigarettes. Conglomerate John Keells, for a long time the market leader, is now in second place - it operates across seven industries via 70 companies, though it is best known for its hotels and resorts. The company has seen its value decline in recent months after it was dropped from the MSCI Frontier Markets 100 Index in June.

Only three of the country's leading banks - Commercial Bank of Ceylon, Hatton Bank, and Sampath Bank - are among the country's biggest listed firms, though the financial sector is well represented in the top 50 listed companies and overall represents the biggest sector on the exchange.

SEC is in the process of updating the rules and laws governing the country's stock exchanges. This comes after a turbulent period for the main sector regulator, in which a period of stellar growth following the end of the country's civil conflict was brought to a halt by a series of financial scandals that forced two SEC chairpersons to quit in 2012. Though conditions have since stabilized, the country's benchmark indices remain far below their peak.

In its *Capital Market Strategy 2020* plan, the SEC outlines its goals to enhance supervision and risk management, raise standards of capital market participants, deepen liquidity in the stock market, and build domestic capacities. This transformation is set to include the approval of a new SEC Act to replace the original 1987 legislation (and amendments), a revision of the rules for listing on the CSE, and a review by the International Organization of Securities Commissions (IOSCO). It also calls for enhanced surveillance and oversight of listed entities and trading, and new mechanisms for deterring and curbing misconduct, including tougher sanctions for insider trading and market manipulation. In addition, the new bill proposes

increasing the independence of the SEC. One of the goals of the ambitious transformation is to regain status as an Emerging Market on MSCI Indices; Sri Lanka has been categorized as a Frontier Market for the last decade. The new SEC Act was tabled for parliamentary debate in October 2017, but its debate was affected by delays due to political instability, and presently the timetable for approval is uncertain given the political developments in the country.

4.2 Current debt and equity investments

Analyze current debt or equity investment type available to the dairy sector, its strengths and weaknesses

The CBSL on behalf of the Government of Sri Lanka, seeks to enhance access to finance with the intention of achieving balanced growth and financial inclusiveness in the country. To achieve these objectives, the CBSL coordinates, facilitates, and implements various refinance schemes, interest subsidy schemes, and credit guarantee schemes while delivering credit supplementary services through Regional Development Department (RDD) of the CBSL.

The strategic objectives of the RDD include the enhancement of regional growth, reduction of poverty, creation of income generating activities and employment opportunities, provision of skills development and training, facilitation of formal financial services, strengthening economic activities in the lagging regions and enhancement of production of essential food items including organic food to ensure food security and food safety.

The RDD provides affordable finance for beneficiaries in the Agriculture, Animal Husbandry and Micro, Small and Medium-scale Enterprises (MSMEs) in the country through a network of Participating Financial Institutions (PFIs) which are mainly Licensed Commercial Banks and Licensed Specialized Banks. Funds are made available to qualified people and business ventures at concessionary terms and conditions through PFIs with a view to ensuring those beneficiaries are well-gearred to meet the challenges ahead. These schemes are funded by the Government of Sri Lanka, the CBSL, Donor Agencies, and PFIs. Through these schemes, RDD serves the beneficiaries in a wide spectrum of sectors including Agriculture and Animal Husbandry, Microfinance and MSME sectors, by providing affordable finance facilities.

Multilateral agencies and donors such as World Bank, Asian Development Bank, etc. have created mechanisms through the CBSL to subsidize or underwrite guarantee funds for losses via existing banking channels. As a result, most financial institutions in Sri Lanka are familiar with engagements or “schemes” which aim to reduce the interest rate for a period of time or buy down the risk of underwriting losses for qualified borrowers.

Commercial Scale Dairy Development Loan Scheme (CSDDLs)

With the aim of promoting regional development through the PFIs, the Central Bank of Sri Lanka introduced in 2013 a new interest support loan scheme titled CSDDLs, to cater to the financial needs of farmers and entrepreneurs in the dairy sector. Considering the importance of achieving self-sufficiency in milk production, CSDDLs was in operation island-wide to facilitate the transformation of the subsistence level dairy production in to a viable commercially oriented activity.

Chart 5: Commercial scale dairy development loan scheme (CSDDLs)⁶

Purpose	<ul style="list-style-type: none"> • Increase of milk production of the country • Establish farms with a minimum of 7 cows per farm • Encourage commercial scale dairy farming activities and milk supply chain, etc.
Amount of loan	<ul style="list-style-type: none"> • Maximum LKR 25 million (US\$ 150,000)
Repayment period	<ul style="list-style-type: none"> • 60 months (Inclusive of an optional grace period of 12 months)
Area of operation	<ul style="list-style-type: none"> • All regions
Eligibility	<ul style="list-style-type: none"> • Be a citizen of Sri Lanka • Be an individual or any business model like sole proprietorship, partnership, limited liability companies, co-operative societies and any other privately owned enterprises with the industry knowledge/background
Eligible activities	<ul style="list-style-type: none"> • Purchase of cows • Establishment of cattle sheds/building in appropriate manner • Fodder cultivation • Farm development / farm expansion / establish new farms • Construction of Biogas units • Purchase of dairy agro equipment • Transport / storage of milk / milk products • Innovation activities to promote consuming liquid milk

Source: People's Bank, SEAF analysis

The funds granted by PFIs under the CSDDLs scheme enjoyed double digit growth over the last five years but recorded a slight slowdown in 2017. So far, under the scheme over US\$ 40 million has been granted over the last five years to approximately 7,500 farmers for the purposes of dairy-related activities such as dairy farm development, processing, transportation, storing and marketing.

⁶ <https://www.peoplesbank.lk/sme-loans>

Table 6: Amounts disbursed by PFIs under CSDDLs

	2013	2014	2015	2016	2017
Amount disbursed (LKR million)	202.0	951.0	1,229.8	1,633.5	1,649.5
Variation y-o-y		371%	29%	33%	1%
Amount disbursed (US\$ million)	1.6	7.3	9.0	11.2	10.8
Variation % y/y		366%	24%	24%	-4%
Number of borrowers	60	604	1424	2667	n/a
Average loan/borrower (US\$)	26,076	12,060	6,353	4,207	n/a
LKR/US\$ average FX rate	129.1	130.3	135.9	145.6	152.5

Source: Central Bank of Sri Lanka, SEAF analysis

In response to the requests made by the stakeholders, considering the higher gestation period and the relatively longer period taken by the small-scale dairy farmers to transform into commercial-scale projects, in 2016 the grace period of the loans granted under CSDDLs was extended from 6 to 12 months, while the tenure of the loan was extended from 5 to 6 years (including 1-year grace period).

Based on our conversations with the representatives of Department of Development Finance at the Ministry of Finance, it is expected that this revolving scheme will probably continue for the next 2 to 3 years (of course depending on annual budget resources).

Hatton National Bank

A majority of HNB's clients are SMEs and retail customers located outside the Western province of Sri Lanka. HNB representatives indicated that they are very interested to expand bank's agricultural lending as their customer base located in areas with a lot of agriculture potential and even mentioned that dairy an area where the bank will give priority in its strategy going forward.

A typical loan application will start at branch level where the bank's personnel collect initial customer information using certain appraisal form, put data into the system and prepare the application and send it for approval. Depending on the amount of the loans, the approval can be given at branch, general or head office level.

Regardless of whether loans are provided under a subsidized interest scheme or commercial terms, The bank's policy is to always ask for security on the loans provided (albeit the security varies with the amount of the loan). Smaller loans are basically secured through personal guarantees or group guarantees (if the loan is provided to a group of several interlinked participants). Larger loans are secured with tangible assets such as farmland. Cows are not used as collateral but the insurance policy for the cows is assigned to the bank as beneficiary.

HNB estimates that each year they provide between LKR 800 million – 1 billion of loans to the dairy sector, both commercial and subsidized loans. Most demand for capital comes from

farmers (i.e. to buy cows, cattle shed, milking equipment, farm equipment, etc.) but there were few applications from processors as well.

According to their estimates about 80-90% of the dairy loan books is provided under the CSDDL 6.5% subsidized scheme, with HNB believing to be the leading allocator of such loans in Sri Lanka. This assessment seems correct, considering that in 2017 around LKR 1.6 billion of loans were allocated by the Central Bank under the subsidized scheme. The subsidized scheme can provide loans of up to LKR25million (US\$ 147,000) albeit towards the latest months when allocations are uncertain the loan values drop to LKR 1-2million (US\$ 6-12 thousand). The interest subsidy scheme works as follows: each year in January the government allocates a certain amount of money to be distributed among state and private banks on a first come first served basis. Once the money is fully allocated (this year it happened in October), the lending stops until the next year allocation. The bank believes that the scheme will continue into next year given the fact that dairy is a strategic sector which has seen consistent policies regardless of political affiliation of government.

HNB also provides loans under the Enterprise Sri Lanka scheme which is a 6.7% to 8.5% subsidized interest scheme, depending on the size of the loan. This scheme relates more to entrepreneurship development and the private sector, but dairy is a part of it. The tenure of the loans under this scheme is up to 7 years, and the bank had requests for such longer-tenor loans. However, they assess such requests based on the cash flow generation capacity of the respective projects and the tenure decision ultimately rests with bank officers.

Depending on the cash generation potential by the business, commercial loans are provided with a tenure of to 5 years max at a 14-15% annual interest. The term of the loan is generally driven also by HNB's sources of funding which are typically retail deposits for which the bank currently pays around 11%/yr.

HNB also participated in funding the government project to bring cows from Australia, including providing some of their own funds for the project. So far two batches of 5,000 cows have been imported, but there were issues reported with the animals, and the program is currently on hold. Nevertheless, the program could resume in the future with an additional 15,000 cows projected to be imported. Such a project could represent an opportunity to design a joint three-party package consisting of debt (HNB), equity (SEAF) and technical assistance (MOD) that could be promoted to potential entrepreneurs. Typically, such projects involve farms of 100 cows or more and given the fact that investment is roughly LKR 500,000/cow⁷ the minimum capital required could be in excess of US\$ 300,000/project.

People's Bank

People's Bank provides a significant amount of loans to agriculture customers, and they estimate their agriculture loan book is well in excess of 10% of their total loan book (i.e., in Anuradhapura total loans to agriculture are in excess of 75% of loan book). However, most of the loans are paddy loans for sugar cane, maize and other agricultural crops rather than dairy. Regarding dairy specific loans, the bank representatives estimated that around LKR 200 million

⁷ Calculations provided by HNB did not include an assumption that the Government will subsidize the purchase of cows. If budgetary resources are identified and allocated to such scheme (as in the past), then the capital requirement would be lower by the subsidized portion (i.e. +/- 50%, depending on the amount of subsidy provided),

(US\$ 1.2 million) of loans are provided each year to farmers although the figure was more of a rough estimate rather than actual loans given.

The average duration of the loans provided to farmers for equipment purchases is 3-5 years, and the average interest for commercial loans is around 15%/year. The loans are secured with either respective equipment (which covers 40-50% of loan amount) or land (which can cover up to 50% of loan amount). If it is a revolving credit for working capital, the guarantee can cover up to 80% of the loan amount. In addition to such guarantees, the bank will also ask for a personal guarantee from the borrowers. There are different levels of approvals for loans, with the head office reviewing only loans in excess of LKR 10million (US\$ 60,000).

According to the bank's representatives, small farmers with 4 to 6 cows find it difficult to access credit because they lack hygienic conditions to milk the cows as well as access to proper milk storage and chilling facilities. As a result, they cannot sell their milk to collection centers, and most of it ends up for self-consumption or becomes spoiled and is discarded. Companies such as Milco and Cargills have their own storage and chilling infrastructure and therefore are able to collect and store milk in proper conditions before being transported to processing plants. As a result, although the bank receives many applications from small farmers, they do not meet the conditions to qualify for such loans.

The bank also provides loans under *Enterprise Sri Lanka* subsidized interest program which provides loan tenures of up to 7 years (1 year grace and 6 year term). The scheme provides for a government interest subsidiary of 6.5% which means that the farmer will pay essentially only 6% interest on loans provided under this scheme.

According to bank representatives, the most significant problem with lending to small farmers (1-3 cows)⁸ is the fact that such farmers are typically already highly leveraged with loans from microfinance companies at very high rates. As a result, they are not able to repay the loans to the bank in due time. By way of example, the NPL ratio for corporate lending is generally 1.5% whereas the NPLs in the dairy sector is around 9-10% to banks, as customers typically prioritize repayment of microfinance companies first.

Regional Development Bank

Regional Development Bank has a network of 268 branches all across Sri Lanka. The bank provides a significant amount of loans to agriculture projects and estimates that about 20% of the loan book (or US\$ 10 million) goes to agricultural projects.

The bank provides both loans under the subsidized interest scheme as well as commercial loans to the dairy sector. Loan volumes for dairy-specific projects are quite small, although no indication was provided in this respect. Bank representatives estimate that probably over 80% of the total loan book to dairy projects is provided under the 6.5% scheme with the balance being provided as commercial loans. Commercial loans are mostly provided to large customers. RDB participates in the subsidized interest loan scheme of 6.5% using their own funds (deposits) typically attracted at a 12% interest rate. For commercial loans to agriculture projects, the interest is around 14-15%/year with a typical

⁸ Based on our conversations there appears to be no standard distinction among the banks interviewed about what represents a small farm; qualification of small farms ranged from 1 to 3, 4 or even 6 cows. We regard such differences as minimal and therefore include such references in the same group as "small farms"

duration of the loan between 3 to 5 years. Larger projects enjoy a 1-year grace period and a 4-yr repayment schedule. There are no restrictions from the central bank in regards to the tenure of the loan and longer tenures such as 7 years are also possible.

The bank is also involved in microfinance projects but the duration is shorter, and the interest is higher i.e., 18-20% year.

Microfinance

Microfinance is expensive to the farmer unless the rates are otherwise subsidized. Currently, market rates for commercial loans are in the range of 15-17% whereas microfinance loans are in the 30-35% range. SEAF continues to research the local microfinance sector to determine who the leading players are for the dairy sector and to analyze whether one or more of these institutions could be conduits for capital investments which could accelerate the flow of appropriately-priced capital to small dairy farmers or other smaller parts of the dairy value chain.

One of the fastest growing microfinance institutions in Sri Lanka is LOLC Finance, which is backed by the country's largest nonbanking financial conglomerate, the LOLC Group. LOLC's microfinance products and rates are set forth in the chart below:

Chart 7: LOLC Group Loans product before interest rate cap @ 35%⁹

Group	<ul style="list-style-type: none"> • 3 members in a group
Guarantees	<ul style="list-style-type: none"> • Personal guarantee: loans taken by each will be guaranteed by the other 2 members • No other collateral such as assets
1st cycle	<ul style="list-style-type: none"> • Amount: up to LKR 100,000 • Annual interest rate: 37% • Term: 12 months • Straight amortization, equal installments, no grace • Penalty interest: 48%/year
2nd cycle	<ul style="list-style-type: none"> • Amount: up to LKR 150,000 • Annual interest rate: 35% • Term: 12 - 24 months • Straight amortization, equal installments, no grace • Penalty interest: 48%/year
3rd to 5th cycles	<ul style="list-style-type: none"> • Amount: up to LKR 250,000 • Annual interest rate: 31% • Term: 12 - 24 months • Straight amortization, equal installments, no grace • Penalty interest: 48%/year

Source: LOLC

LOLC estimates that agricultural lending accounts for roughly 30% to 40% of their portfolio as their customer base is rural, mostly in northern and central areas. LOLC estimates that 5% to 10% of loans taken are used for other purposes than initially stated (i.e. to buy a motorcycle, etc).

Equity

Based on our conversations with existing funds managers and prospective companies as well as research into the sector, it appears that private equity is an underdeveloped and relatively untapped financing method in Sri Lanka. A handful of local private equity funds exist in Sri Lanka but none with substantial resources and none with a focus on investments into the dairy sector. Set forth below in Section 4.3 is a summary of the international private equity sector and an assessment of the number and scope of funds which could have interest in investment into Sri Lanka and the dairy sector in particular.

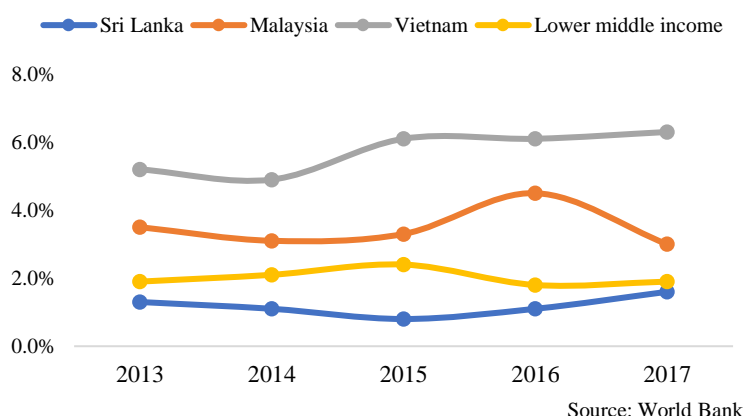
⁹ Per LOLC's past practice, interest on the first loan was capped at 37%; after the group members successfully repaid the loan within the first year they could move to the following loan cycles. Recently the Finance Ministry announced a regulation whereby all micro finance companies must cap their annual interest rates at 35%.

4.3 Outside funding sources

Analyzing outside funding source and determine level of financial interest

In 2017, Foreign Direct Investment (FDI) into Sri Lanka grew to over \$ 1.7 billion. The majority share of FDI inflows has been focused on infrastructure and foreign loans received by companies registered with the Board of Investment of Sri Lanka (BOI).¹⁰ Despite a more than doubling growth from the previous year, FDI into Sri Lanka has been lower than in peer countries on a per capita basis.

Chart 8: FDI as % of GDP (net inflows)



In terms of international private equity investment flows, Sri Lanka has long been overshadowed by India and larger markets in Asia / Southeast Asia, which have broader range of equity investment opportunities. Outside funding available for private equity investment in Sri Lanka is limited with only a handful of funds achieving closes since 2014. Of these funds, two are Asian regional funds which do not have a dedicated focus on Sri Lanka. A chart setting forth the known private equity funds for Sri Lanka is set forth below.

Chart 9: Private Equity in Sri Lanka

Fund Manager(s)	Fund Type	Geographic Detail	Sector Focus	Fund Size (US\$ million)
BOV Capital	Venture Capital	Sri Lanka	Technology	15
Kaizen Private Equity	Growth	Bangladesh, India, Philippines, Singapore, Sri Lanka	Multi-Sector	61
Creador	Growth	India, Indonesia, Malaysia, Philippines, Sri Lanka	Multi-Sector	415
BOV Capital	Venture Capital	Sri Lanka	Technology	4
NDB Zephyr Partners	Growth	Sri Lanka	Multi-Sector	43

¹⁰ World Bank

Ironwood Capital Partners	Growth	Sri Lanka	Multi-Sector	30
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Source: EMPEA as of December 2018

In addition to these funds, there are a range of South Asian and regional Asian funds which have capability to invest in Sri Lanka. However, such funds traditionally have not prioritized Sri Lankan investments due to the size of market opportunities, limited local infrastructure to support investments (e.g. limited pool of experienced M&A service providers, etc.) and competing opportunities to invest elsewhere. It is SEAF's view however that investors, both private equity funds and direct co-investment partners, will be willing to consider specific investment opportunities which are identified, due diligence, and structured for investment by via the MOD program given the positive enabling environment in Sri Lanka described elsewhere in this report. In other words, although the international private equity community historically has not actively targeted the Sri Lankan market, investors are open to considering specific opportunities that may be developed and offered for investment.

A further source of outside capital for Sri Lanka is the international Development Financial Institution (DFI) community. A list of the principle DFIs which are open for business in Sri Lanka is set forth below

Chart 10: DFIs In Sri Lanka

DFIs	Sector priorities	Direct equity
Belgian Investment Company For Development Companies (BIO)	SME in miscellaneous sectors, infrastructure (particularly renewable energy), financial inclusion, financial sector, agricultural sector.	Yes
CDC Group	Infrastructure, healthcare, education, and agribusiness.	Yes
Deutsche Investitions-Und Entwicklungsgesellschaft mbH (DEG)	Sector-agnostic	Yes
Finnish Fund For Industrial Cooperation (Finnfund)	Focus on low income and LDC countries, renewable energy, forestry, agriculture.	Yes
International Finance Corporation (IFC)	Technology, including renewable energy, energy efficiency/carbon offsets, agtech, fintech, edtech, healthtech, bottom of the pyramid.	Yes
Japan International Cooperation Agency (JICA)	Infrastructure, SDGs and poverty alleviation, climate change	Yes

Netherlands Development Finance Company (FMO)	SMEs	Yes.
Overseas Private Investment Corporation (OPIC)	Investments in regions around the world that are experiencing challenges such as poverty or conflict thereby helping promote economic and political stability.	No
Proparco	Agribusiness, healthcare, education, financial inclusion, infrastructures with a specific focus on renewables energies	Yes
Swedfund	Sector agnostic	Yes
Swiss Investment Fund For Emerging Markets (SIFEM)	Sector agnostic	Yes

Source: SEAF analysis

Assuming a climate of political stability, it is reasonable to expect that many of the listed DFIs will be interested in making incremental new commitments to private sector projects in Sri Lanka in the coming years. Most of the DFIs have experience in financing projects in the agribusiness sector including dairy, and we expect that one or more of these DFI's will be candidates to co-invest alongside MOD in the targeted future projects. Separately, in terms of private equity funds it is relevant to note that most DFIs have management policies which discourage commitments to single country funds, typically preferring regional funds for their diversification of risks and enhanced selection of investment opportunities.

5 Demand side

Assess the demand/appetite for funds in the dairy sector either as debt or equity and an approximation of required capital base

SEAF's discussions with various industry participants across the dairy value chain during our sessions in Sri Lanka involved a common theme: capital represents a limiting factor in the development plans of Sri Lanka agribusiness companies.

From inputs providers, small or medium farmers, dairy cooperatives, processors, retailers, and even public servants there is a vibrant determination to expand or to improve the dairy sector in Sri Lanka.

Such entrepreneurial mindset and determination represents in our view a fertile ground for capital to identify, fund and support those projects that have the chance to succeed and bring transformational change into a sector dominated by outdated and rudimentary practices.

Debt has been traditionally the common method to fund investment projects, and we believe that debt products would continue to represent the majority source of funding going forward. However, we believe that a flexible approach to structuring such a product (longer tenor, convertible options, etc.) could provide a competitive advantage over more traditional products that are currently marketed by commercial banks.

The idea of a freestanding commercially viable investment fund which has outside investors coming in and investing in the dairy sector is a new concept for the market. We believe acceptance of such product will require a longer educational process, but we are confident that there will be sufficient opportunities to execute equity investments as well. Moreover, a flexible fund that has the possibility to make both equity and debt investments will represent a significant competitive advantage, as typically conversations with investee companies are dynamic and an initial ideal can evolve into a much more complex project that would benefit from a hybrid equity/debt funding.

While subsequent conversations with outside investors are needed in order to assess appetite and participation, SEAF is confident that the initial capital envisaged by the MOD fund will be able to be deployed in the near-term.

Chart 8: Dairy value chain

Stages of value chain	Participants number and type	Constraints
1. Inputs	Veterinary Services – Department of Animal Production and Health – 331 offices Animal feed purchased from private sellers Breeding material: National Livestock Development Board and the private sector	High price of inputs, lack of coordination among suppliers Constant price increases Transport and prices; availability of breeding stock
2. Production farms	Total farms – approximately 219,233 Small-scale farms (1 to 5 litres): 131,698 farmers Medium scale (5 to 20 litres): 70,291 farmers Large-scale 17,244 farmers	Lack of proper training to all dairy farmers Lack of land ownership as a result lack of access to credit, Low productivity Lack of capital, lack of good animals, lack of space Lack of space, lack of proper training
3. Collection centers	2,999 centers (under/above 120 liters) Nestle (1,200) and Milco (76) collect from small farmers; Fonterra (7), Cargills and K Co-op from medium- and large-scale farms	Lack of capital (e.g., for chillers, transportation) Few firms are involved.
4. Chilling centers	Nestle (107, small farmers), Milco (81, small farmers), Other small farmers. Larger volume chilling centers are managed by Cargills, Fonterra and K Co-op	High operating costs; lack of knowledge on good housekeeping practices
5. Processors	27 main processors	Few products; little diversity; few players; low production
6. Importers	5 main importers (Fonterra, Nestle, Maliban, Sathosa, Lanka milk foods)	Low prices are putting a constraint on fresh milk production
7. Marketers	27 marketers	Over 80% of trade is not done through modern channels
8. Consumers		

Source: Hirimuthugodage, 2016

6 Legal and regulatory framework concerning an investment fund

6.1 Legal and regulatory framework

Assess the current fiscal legal and financial environment and proposed the most suitable fund mechanism that will complement MOD activities

6.1.1 General considerations

According to the Foreign Exchange Act No. 12 of 2017, foreign entities can operate in Sri Lanka and may carry a wide range of activities, albeit certain constraints apply. By way of example, an overseas company registered under the Companies Act No. 7 of 2007, may carry on in Sri Lanka:

- Any commercial, trading, or industrial activity (subject to limitations in certain sectors)
- Any non-commercial, non-trading or non-industrial activity such as the activities undertaken or carried on by a liaison office, representative office, regional office or other similar office, provided such activities do not provide any income directly or indirectly to the company
- In case of a place of business such as a branch office, project office or other similar office, the company shall invest a minimum of US\$ 200,000 or equivalent amount in other designated foreign currencies

Mention should be made that while certain pieces of archaic legislation exist (such as the Money Lending Ordinance), based on our interviews with legal counsel we understand that they have no application in respect to foreign loans granted to a corporation in Sri Lanka. Accordingly, what has to be followed is that in the case of an investment in debt it should come in through an Inward Investment Account (see below) and the debt should have a tenor of more than 3 years.

We expect that the MOD investment program will be primarily focused on the provision of equity and equity-style investments given the relatively broader availability of debt from local banks and other providers. However, as discussed in greater detail herein, SEAF believes based on our experience with similar rules in other jurisdictions (e.g. India, Bangladesh) that investment instruments can be negotiated which comply with local regulatory requirements and which also enable the fund to enjoy benefits of certain debt-like characteristics including fixed redemption dates and downside protections and/or collateral.

Company registration

To incorporate a company in Sri Lanka, an entity must register under the Companies Act. 07 of 2007. Equal treatment for local/foreign nationals is guaranteed under this Act. The incorporation procedure and the registration of a company will need to be done through the Registrar of Companies and may be liaised by a Company Secretary.

A breakdown of registration requirement and fees may be found on the Registrar of Companies website (http://www.drc.gov.lk/?page_id=11). Where relevant, companies with BOI approved projects under section 16 or 17 are required to obtain prior approval to the Articles of

Association of the company from the Legal Department of the BOI, before submitting papers to the Registrar of Companies.

Investment Requirements to set up an Overseas Company

In terms of the Companies' Law of Sri Lanka, any company incorporated outside Sri Lanka could register as a Sri Lankan establishment, primarily via either of the following types of establishments:

- Incorporation of a subsidiary
- An overseas company registered under Chapter XVIII of the Companies Act No.7 of 2007 which could be in the form of a Branch office, Project office, Liaison office or Representative office

Branch or a Project Office

Where an overseas company wishes to carry out any activities mentioned above, via a branch office or project office, it would be required to make a minimum investment of US\$ 200,000 or equivalent amount in any other designated foreign currency via an Inward Investment Account (IIA) (see section below), in accordance with the regulations made under the Foreign Exchange Act No. 12 of 2017.

Subsequently, the company would be required to provide evidence of such remittance to the Registrar of Companies within 30 days of registration. The company is also required to record such funds remitted in the company's books as an investment and maintain such records until the company ceases its business in Sri Lanka.

Liaison Office or Representative Office

For setting up of either a Liaison Office or a Representative Office, there would not be any minimum investment threshold, as in the case of a Branch/Project Office. However, the funds required for the maintenance of such place of business should be remitted from abroad via an IIA in a designated foreign currency.

6.1.2 Banking operations

Inward Investment Account

Inward Investment Account (IIA) is a special account designated for eligible investors with residence in or outside Sri Lanka to route funds to invest in permitted investments (as defined), including debt and equity investments. IIAs are opened in the name of the eligible investor by licensed commercial or specialized banks in accordance with the terms and conditions stipulated in the Government Gazette no. 2045/56 dated 17.11.2017. IIAs may be maintained in Sri Lanka rupees or in any designated foreign currency and may be held jointly by eligible investors.

An IIA may be opened for liaisons and representative offices as well.

According to Gazette number 2045/56 dated 17.11.2017, all funds required for capital investments, operational costs or disbursements must be made through an Inward Investment

Account. Funds may then be transferred to a corporate account for the day-to-day running of the business but must be remitted to the IIA, prior to remitting the funds abroad.

All income received from such investments and proceeds of disposal, liquidation, the maturity of the investments, dividends or any other related income received from capital transactions must be credited to the Inward Investment Account through which the investment was made.

Eligibility

- A Sri Lankan citizen, resident outside Sri Lanka
- A company incorporated outside Sri Lanka
- Country and regional funds, mutual funds, unit trusts, and other institutional investors who are established outside Sri Lanka
- A receiver or liquidator of a company that maintained an IIA with that authorized dealer until proceedings are concluded
- Any other person or category of persons who may be authorized by the Central Bank of Sri Lanka from time to time

6.1.3 Taxation

The significant development in the Sri Lanka tax scene is the enactment of the New Inland Revenue Act, No. 24 of 2017, which took effect from 1 April 2018. The New Inland Revenue Act is aimed at simplifying the tax system, make the tax system more equitable and efficient, and help generate more revenue for social and economic development purposes. The New Act departs from the hitherto practice of granting liberal tax exemptions and concessions, provides tax relief for a limited category of investment incentives, eliminates multiplicity of corporate tax rates by introducing a three-tier corporate rate structure (14%, 28%, and 40%), and simplifies the expense deductibility rule. It seeks to enhance revenue generation by broadening the tax base, in particular by eliminating the vast range of tax holidays, partial tax holidays, reliefs, and other concessions; introducing taxation of capital gains; and expanding the coverage of withholding taxes (WHTs).

Capital gain tax

Since 2002 capital gains were exempt from tax, while business profits were taxed at a rate of 28%.

Beginning April 1st, 2018, the government introduced a new capital gain tax of 10% on gains realized on the transfer of ownership including sale, exchange, transfer, distribution, cancellation, redemption, destroy, loss, expire, expropriation or surrender of an investment asset. Capital gain is calculated as the difference between the consideration received and the cost of the investment asset at the time of realization.

Every liable person shall file a capital gain tax return and make payment after the realization of investment asset but no later than one month after such realization occurred, after which the investor can take out the money from Sri Lanka. Other than such tax return there is no need for additional information (such as filing annual accounts, etc.).

Dividend tax

A dividend tax is payable at 14% (prior to 1 April 2018, it was at 10%) on the gross dividends distributed by a resident company, other than such dividends distributed out of any dividend received from another resident company.

Withholding tax

Resident companies are required to withhold tax at 14% on interest, discount, charge, natural resource payment, rent, royalty, premium or retirement payment, or pay amounts as winnings from a lottery, reward, betting, or gambling, and where the payment or allocation has a source in Sri Lanka.

Every bank and financial institution is required to withhold income tax at 5% on the amount of any interest paid to a company on any sum of money deposited with it. The depositor is entitled to receive a certificate setting out the gross amount of interest, the amount of tax withheld, and the net amount of interest paid.

Sri Lanka has entered into treaties relating to the avoidance of double taxation with 44 states. The vast majority of such treaties in force signed with the USA, the UK, most of Western Europe, Russia, Australia, Middle East and much of Asia (including China, India, Japan, and Singapore) are comprehensive treaties. Limited treaties form a small minority of the treaties in force and are currently entered into with Hong Kong, Oman, Jordan, and Saudi Arabia to cover limited areas such as shipping and air transport.

A complete list of treaties in force may be found on the Inland Revenue website (<http://www.ird.gov.lk/en/publications/sitepages/International%20Relations.aspx?menuid=1401>).

Most of the treaties do not provide for great concessions, however. For instance, the dividend withholding tax is 14% whereas the DTT agreement provide for a 15% tax, with the actual tax saving being a modest 1%.

Based on our interviews with legal counsels we understand that new piece of legislation was considered in order to revert to the old law in force prior to March 31st, 2018 whereby interest earned by a non-resident person from a Sri Lankan entity will be exempt from tax. There is no indication when such provision will be reinstated or whether it will apply only to banks and/or financial institutions. Nevertheless, if nonresident lender will be defined again broadly like in the past, any kind of debt (whether straight or convertible) will be more tax efficient than equity when structuring an investment.

6.2 Setting up an investment fund

Study the process of setting up an investment fund

Domicile

While the legal and regulatory framework for establishing an investment fund is simple and straightforward in Sri Lanka, based on interviews with PE funds and legal counsels active on the market, we understand that most PE funds have been structured on the basis of NOT having an intermediary legal entity (or SPV) registered in Sri Lanka. Such structuring prevalence could be due to (i) the tax regime in Sri Lanka, and/or (ii) the type of fund investors. Prior to April 2018, the Sri Lanka tax authorities could rule that the proceeds (i.e., from sale of shares)

obtained by intermediary companies such as funds may be deemed business profits rather than capital gains and therefore taxed at the prevailing tax rate of 28% (vs. capital gains which are tax-free). After April 1, 2018, the distinction between business profits and investment capital gains remains, however investment gains are taxed at 10% whereas business profits are taxed at 28%, regardless of whether the investor is a domestic or foreign entity. Thus, there is no tax advantage in organizing the investment fund for the MOD project in Sri Lanka.

When evaluating an investment in different funds, investors consider the jurisdiction where the partnership agreement will be domiciled, and the fund will be managed. Jurisdictions that have a longstanding tradition in regulating such relationships as well as the required infrastructure (e.g., Singapore, etc.) are favored over less sophisticated jurisdictions. In addition, an internationally-recognized investment domicile tends to ensure that other important aspects such as enforcement of contracts are more certain, thus providing potential investors important comfort.

Mindful of these considerations, the relatively nascent private equity enabling environment in Sri Lanka will likely not provide the optimal basis for the formation and operation of a long-term private investment fund; SEAF recommends therefore that the fund be established in a more commonly-recognized investment jurisdiction. Based on our review and assessment, we believe that the United States, specifically the State of Delaware, is an appropriate jurisdiction for the activities contemplated by the MOD initiative (see Section 6 below for more details).

A fund vehicle organized in Delaware will be able legally to make both equity and debt investments in Sri Lanka. For both types of investment, the funds must flow into the country through an IIA (described earlier). Further, in the case of a debt investment, the instrument should have a tenor of more than 3 years. At realization, the following procedures will apply:

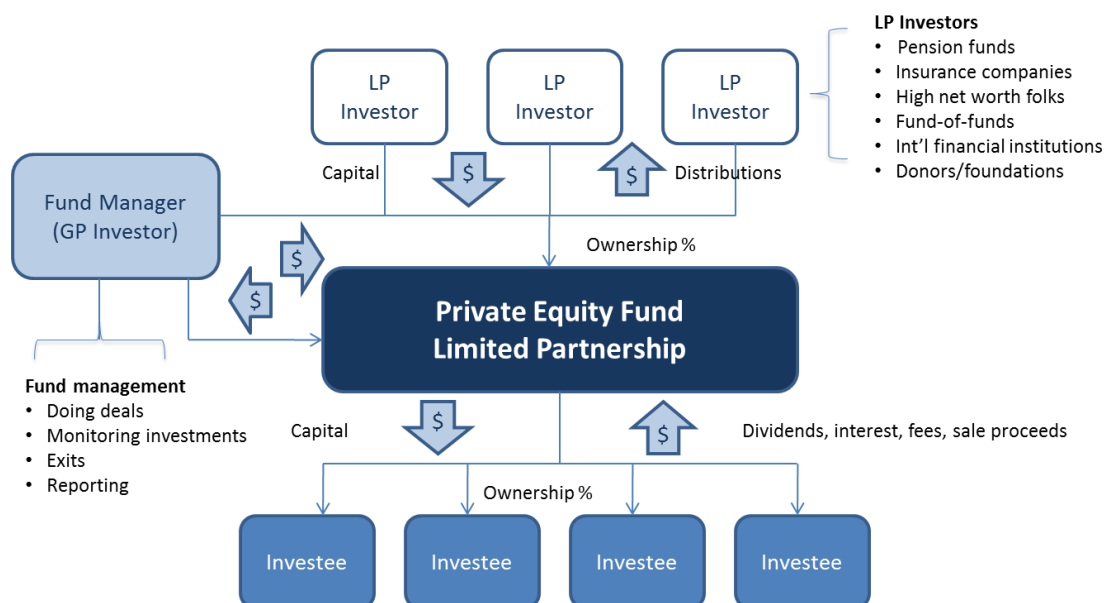
- If an investment in Sri Lanka shares is made by through a special purpose vehicle (“SPV”) organized in Delaware or otherwise, and such SPV is sold to another buyer, the fund can receive the proceeds of such sale outside of Sri Lanka, and the IIA will remain intact.
- If the SPV sells the shares of a Sri Lankan company, the buyer must establish and fund its own IIA. The money would move from the buyer’s IIA to the SPV’s IIA in Sri Lanka and, following payment of the 10% capital gain tax, proceeds would be remitted to the fund.

Structure

The structure chosen for the organization of a fund’s investment activities is directly linked to the investment objectives and tax characteristics of the fund’s investors. Most investors prefer that a fund has a defined limited life (typically 10 years, with extension periods) and is tax transparent, meaning that the fund itself is not taxable but rather passes taxable income and capital gains (and losses) directly through to its investors without deduction. In this way, tax-exempt investors (DFIs, pension funds, etc.) do not lose economic returns due to taxation. The most common forms of tax-transparent entities are general and limited partnerships. In the United States, the limited liability corporation (LLC) also has the ability to elect to be taxed as a partnership.

Such fund LLCs or partnerships gather and comingle capital from investors and then invest the capital in portfolio companies selected and managed by the fund manager (the “general partner”). The chart below sets forth a typical fund structure.

Chart 12: Typical Fund Structure



Source: SEAF analysis

Terms

Once a domicile and a preferred fund structure has been determined, the next key element to the set up on an investment fund is to agree on terms with investors. Key terms include management fee, incentives, fund expenses (administration, accounting, tax filings, audit, regulatory compliance, etc.) and other details of fund operations. The chart below summarizes some of the most important discussion points regarding fund terms:

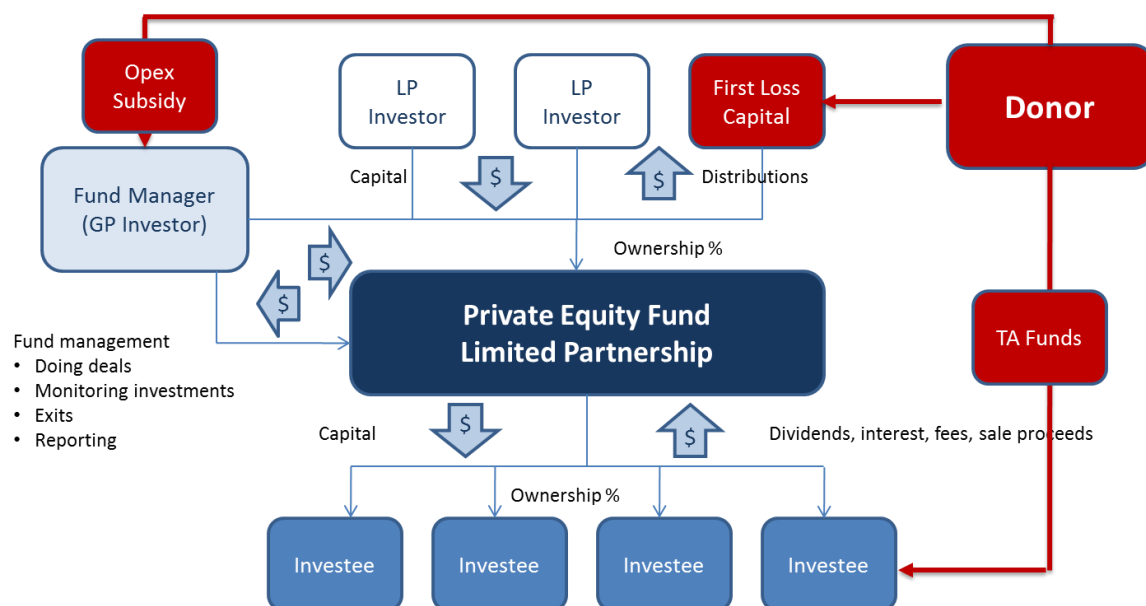
Chart 13: Key terms of PE fund structure (“2 and 20”)

Term	<ul style="list-style-type: none"> • 10 years with 2 possible 1 year possible extensions • 5 year investment period at beginning
Legal Structure	<ul style="list-style-type: none"> • Limited partnership or LLC • Sponsor sets up fund management co. AND general partnership • Two “closes” (when investors actually invest) <ul style="list-style-type: none"> ○ “First close” – at launch of fund ○ “Second close” – within one year of first close ○ After second close, no more investors (“closed-end fund”)
Fund Manager Compensation	<ul style="list-style-type: none"> • Annual percent of committed capital (typically 2 percent) • Carried interest (i.e. bonus) based on investment performance <ul style="list-style-type: none"> ○ 20 percent of final investment proceeds above “hurdle” for investors ○ Hurdle is typically invested capital plus IRR of 8 percent
Other Features	<ul style="list-style-type: none"> • Management fee is to cover operating expenses of fund • Fund expenses: annual fund audit, D&O insurance, etc. • Investor receive cash as investment reflows occur!

Source: SEAF analysis

For impact-oriented funds, a newer element to the fund formation process is the potential to involve governmental or impact-oriented philanthropic support to the capitalization and formation of the fund. The inclusion of “soft” capital to the organization of the fund is called blended finance and can serve to substantially accelerate the organization of a fund, improve the chances of its successful launch, or expand the potential size of the vehicle. A chart summarizing one example of blended finance is set forth below:

Chart 14: Examples of blended finance components



Source: SEAF analysis

Depending on the selection of investments for the MOD investment fund, it may be appropriate to consider utilization of the starter capital in some form of blended capital format, which could include subordination or other structuring to provide incentives for targeted co-investment or more complex structures to share risk/reward in ways that maximize the attractiveness of the investment opportunity for co-investors.

Strategy

The final key link in the set up on an investment fund is the articulation of a clear and consistent investment strategy and approach. The rationale for targeted sectors and sub-sectors must be developed, and a consistent approach for developing deals that fit the targeted profile must be presented. Investors also typically seek portfolio construction approaches which require diversification by size (cap on the percentage of the fund invested in any one company), by sector (or sub-sector), and in the case of regional funds, by country. The key fund organization ingredients of domicile, structure, terms, and strategy and typically set forth in a carefully prepared private placement memorandum (PPM) and other materials relating to the offering of interests in the fund.

6.3 How OPIC operates and mechanisms for partnering

Analyze the how OPIC operates and the best mechanism to partner with them

The Overseas Private Investment Corporation (OPIC) is an agency of the United States Government which provides financing for privately-owned and sponsored projects in “eligible countries” (most emerging and frontier markets, with limited exceptions for policy purposes) with a view towards development and where possible, support for U.S. businesses. OPIC provides its support through well-developed political risk insurance facilities (covering such things as currency inconvertibility, government interference, official contract defaults, and similar matters) and long-term debt for private companies and projects ranging from SME borrowers to larger infrastructure investments. Starting in the early 1990s, OPIC began the practice of providing long-term, non-recourse loans to private equity funds, which pooled OPIC’s debt capital with equity from fund limited partners to make long-term equity investments in targeted emerging markets. This program was accelerated in 1995 through the creation of the Investment Funds Department, which organized and accelerated OPIC’s participation in private equity funds. The program is now a major investor in global emerging market funds, having committed \$4.1 billion to 62 private equity funds in emerging markets since 1987.

On October 5, 2018, President Trump signed the Better Utilization of Investments Leading to Development Act of 2018 (BUILD Act) which amongst other matters dramatically expanded the capabilities and funding capacity of OPIC, which will soon be renamed the U.S. International Development Finance Corporation (USIDFC). Under its new authorization, OPIC for the first time will be able to invest equity in projects as well as investment funds. However, the transition to the USIDFC and implementation of an equity investment program is subject both to the adoption of further management policies as well as Office of Management and Budget approval of a subsidy model for equity fund investments (the USIDFC will continue to operate under the guidelines of the Credit Reform Act of 1990). It is SEAF’s understanding from discussions with OPIC that equity authority will only be considered for projects beginning in fiscal 2020, or from October 2019 onward. Therefore, for purposes of our analysis and assessment for the MOD project we have assumed potential utilization of OPIC’s debt programs as they currently exist.

As noted above, OPIC provides debt financing for both individual projects as well as investment funds. For project financings, OPIC has two departments which handle direct loans, one which focuses on larger project finance/infrastructure investments, and another which focuses on financing small and medium-sized businesses. Each of these departments can be approached directly by “eligible sponsors” (generally, a person or entity with U.S. domicile), and there are online tools to make formal application for OPIC finance. OPIC also maintains a business development department and the staff is always willing to discuss OPIC programs and policies with any interested party. In short, OPIC has a reputation for investor-friendly operations, and it can be accessed directly through multiple points of contact.

In terms of project support, despite its status as U.S. government agency, OPIC operates on commercial terms and seek to underwrite loans only to borrowers who have a reasonable capacity to repay and to service the loans throughout. OPIC only provides senior secured credit and does not provide mezzanine, subordinated, or other credit that is not fully collateralized.

Consequently, all loan requests submitted to OPIC must be supported by a full business plan, a clear application of funds statements, and appropriate modeling of future cash flows which demonstrate a capacity to repay the OPIC loan. OPIC generally does not fund start-ups or very early stage companies but rather seeks to provide expansion financing for firms which are cash flow positive and which have demonstrated some potential to scale.

Launched in 2014, OPIC's *Portfolio for Impact* (PI) program seeks to support early-stage projects that demonstrate significant potential to achieve a positive impact. PI provides term loan financing or guarantees between US\$1 and US\$5 million with a loan tenor from 3 to 10 years, PI has a strong preference for senior or *pari passu* financing terms and against loan subordination. Loan proceeds can be allocated for various uses, such as working capital, CAPEX, and on-lending. In terms of sector focus, PI targets business operating in sectors with social impact objectives, including agriculture, with a priority to projects that target low-income populations and provide economic livelihood for vulnerable populations. PI applicants will be evaluated based on various criteria, including the following:

Chart 15: OPIC portfolio for impact program eligibility and evaluation guidelines

Social Impact	<ul style="list-style-type: none"> • Business model with intrinsic measurable and scalable social impact • Socially responsible investors/partners
Innovation	<ul style="list-style-type: none"> • A product, service, or business model that is innovative and/or targets a new customer segment or geography
Management	<ul style="list-style-type: none"> • Ability to execute strategy based on team experience, background, and composition
Track Record	<ul style="list-style-type: none"> • At least 1 year of operating history • Beyond “proof of concept” phase with quantifiable results
Financial	<ul style="list-style-type: none"> • At least \$1 million in assets or annual revenue • At breakeven or on a credible path to breakeven within 12 – 24 months • Positive net equity position • Financial ratios on a case-by-case basis

Source: OPIC, SEAF analysis

In addition to its direct debt financing programs, OPIC as noted above has a robust program of providing loans to private equity and private credit funds. The Investment Funds Department accepts fund investment proposals via application on the agency's website, although IFD department personnel and the OPIC investment development department are generally available to respond to questions and provide informal feedback and guidance on investment fund proposals. The IFD program seeks funds that are at least \$100 million in target capitalization and range up to \$1 billion. Such funds have a clear commercial mandate which attract private sector capital in addition to OPIC's catalytic commitment.

To respond to the interest of managers to organize funds less than US\$ 100 million, particularly those funds which have a highly developmental or innovative investment strategy, OPIC launched the Innovative Financial Intermediaries Program (IFIP) in 2013. The IFIP program provides a special window of access to OPIC's financing programs, with a review that takes into account both policy and development objectives as well as financial viability. To be clear, IFIP does not provide a different type of capital or on different terms that OPIC's "regular" project financing and investment funds programs but rather provides a perhaps more guided entry into the OPIC financing process. A chart setting for the types of funds which participate in the IFIP program and the range of financing available is set forth below:

Chart 9: OPIC innovative financial intermediaries program categories

IFIP-Eligible Structures	Maximum Fund Capitalization* (US\$ million)	OPIC Commitment	Description
Small Equity Funds	100	<ul style="list-style-type: none"> Up to 1/3 of total fund capitalization capped at US\$ 33.3 million 	Funds that make equity and equity-like investments, including mezzanine and subordinated debt, into portfolio companies.
Hybrid Funds and Debt Funds	100	<ul style="list-style-type: none"> Up to 2/3 of total fund capitalization** capped at US\$ 50 million 	Includes, inter alia, funds that make investments into portfolio companies in the form of: both debt and equity; solely senior debt; or both senior and subordinated debt.
Non-Bank Financial Institutions and Intermediaries	No Limit	<ul style="list-style-type: none"> Up to 1/3 of total fund capitalization (equity-focused NBFIs) and up to 2/3 (debt-focused NBFIs) capped at US\$ 50 million 	Non-Bank Financial Institutions and Intermediaries deploying 25% or more of their capital as equity investments into portfolio companies.
Hybrid Microfinance Investment Vehicles (MIVs)	No Limit	<ul style="list-style-type: none"> Up to 2/3 of total fund capitalization** capped at US\$ 50 million 	MIVs investing 25% or more of their total portfolio as equity.

* Including OPIC's participation

** The level of financing that OPIC will consider is largely commensurate with the risk of the investment strategy of the fund, in terms of forms of capital the fund will deploy and the target portfolio composition. Generally, the higher end of the range will be considered for funds investing a higher level of debt than equity.

Source: OPIC, SEAF analysis

We have considered the applicability of the IFIP program window for the MOD project and the concept of a dairy-focused fund for Sri Lanka. While the potential fund size would surely be less than the cap of US\$ 100 million and thereby eligible for IFIP consideration, there are a number of hurdles to clear for an investment fund to be interesting and appropriate for OPIC financing. First and foremost, OPIC fund financing is a competitive process. It is SEAF's understanding that during the first few years of the IFIP program, only one proposal made it through the OPIC process to closing although more than 100 proposals were submitted by interested fund sponsors. The pace of approvals has increased, but OPIC has no mandate to accept any minimum number of projects. All OPIC projects, including those submitted through

the IFIP window, are subject to commercial viability and sustainability assessment. In other words, OPIC seeks to finance funds and projects which attract meaningful amounts of private capital and which have a size and scale to be sustainable. Since funds often have a life of upwards of ten years and individual investments remain in the portfolio for five years or more, the funds need a viable plan to attract and maintain sufficient investment personnel to supervise and add value to the investments over the entire holding period. Since most funds have a management fee of not more than 2% or 2.5% per annum of committed or invested capital, OPIC typically views a fund size of US\$ 25 million or so as the minimum level to be sustainable over the long-term, unless the fund team has other related business income to support itself. A dairy-focused fund for Sri Lanka organized on a “blind pool” basis thus would need to provide reasonable assurance that it could achieve US\$ 25 million or more in initial capital commitments prior to the commencement of operations in order for it to be an appropriate candidate for OPIC investment. As addressed above and elsewhere in this report, SEAF does not believe that the current appetite for investment in Sri Lanka, and more particularly in a narrow field of investment like dairy, is sufficient to generate a high probability for a successful raising of a blind pool investment fund with minimum size of US\$ 25 million.

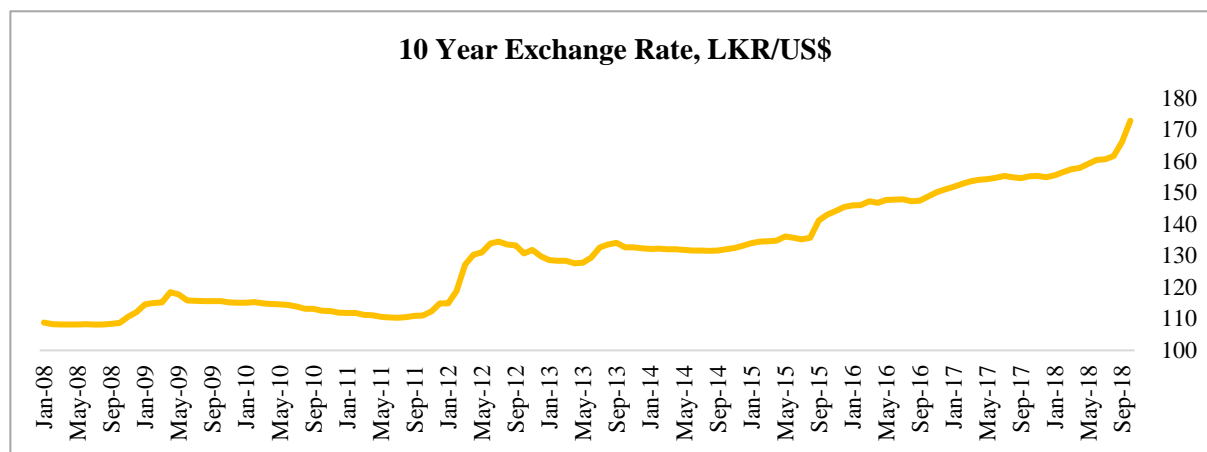
Consequently, SEAF believes that the best way to partner with OPIC is to approach the agency on a deal-by-deal basis to seek senior debt financing for specifically identified investments. Most likely, OPIC’s SME Finance group would be the normal port of entry but a project may be applicable for OPIC’s Portfolio for Impact program depending upon investment size and characteristics. A determination of which OPIC funding window is most appropriate will be made at the time of submission depending upon the facts and circumstances of each transaction. Regardless of access window, OPIC’s financing instrument would be a long-term (typically 5 to 10 years), non-recourse loan in U.S. dollars which would feature an interest rate based on prevailing U.S. Treasury securities (or the U.S. government lending rate published monthly by the Treasury), various commitment, facility, and monitoring fees, and a collateral package tailored to the borrower’s situation.

6.4 Foreign exchange risks and challenges

Discussion on foreign exchange risks and challenges as most likely returns will be in local currency

Exchange rate movement is a material risk associated with investment in emerging or frontier economies. Countries lacking significant currency reserves, or which have macroeconomic or political conditions which do not support the long-term stability of the domestic currency, are especially susceptible to meaningful exchange rate movements. Particularly at risk for sustained or sharp currency devaluations are those countries which have significant current account deficits or other macroeconomic imbalances. Sri Lanka has experienced a significant movement of its currency in recent years, as shown by the charts below:

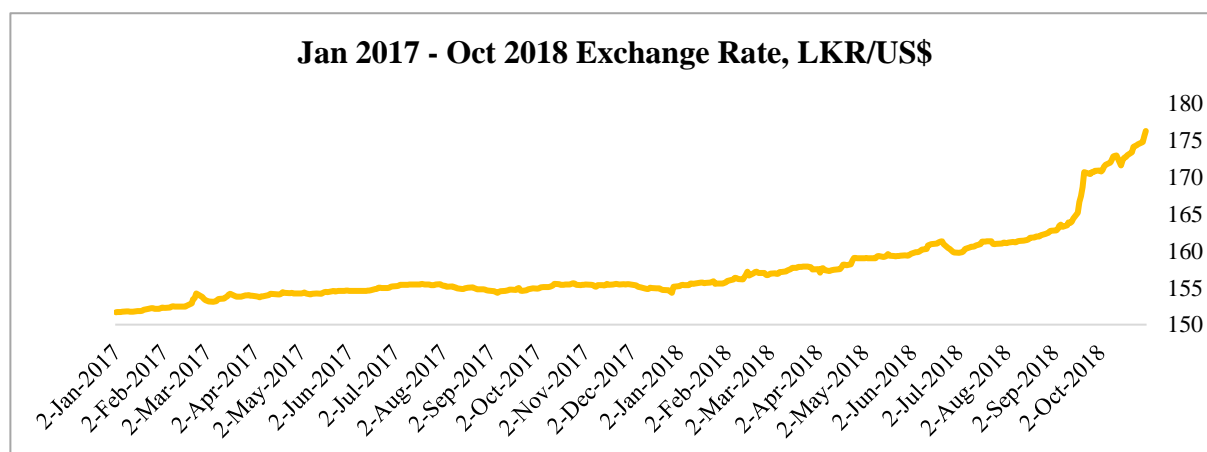
Chart17: 10-year Exchange Rate LKR/US\$



Source: Central Bank of Sri Lanka

Over the past decade, LKR depreciated 37% relative to the US\$ (January 2008 – October 2018). In 2011, the SL government aimed to devalue the LKR by 3%, seeking to provide some limited support to exporters. The budget proposal surprised the market and the CBSL soon was unable to continue intervention in the foreign exchange market. Subsequently, the exchange rate depreciated by 12% during 2012. After the sharp depreciation, the exchange rate stabilized for the following two years, showing only marginal depreciation of 3%. In 2015, a newly-elected government emphasized the need to adopt an export-driven growth model, and the maintenance of a competitive currency has since been a priority. Against the backdrop of a stronger U.S. dollar in 2018, LKR depreciated 10% over the first 10 months of the year. Market consensus estimate that LKR will depreciate nearly 8% relative to US\$ during the year 2019.

Chart 2: Jan 2017-Oct 2018 Exchange Rate LKR/US\$



Source: Central Bank of Sri Lanka

In the short term, the LKR is expected to continue weakening due to several factors. First, following the CBSL 25bps rate cut in April, it is expected that the Central Bank will hold its rates through 2018 as it seeks to accommodate growth. This will likely further narrow interest

rate differentials between Sri Lanka and the US during the ongoing Fed rate hiking cycle. Moreover, given Sri Lanka's status as a net oil importer, the ongoing recovery in oil prices will continue to weigh on its terms of trade. Third, the CBSL cited moderating inflation and gradual depreciation of the nominal exchange rate, suggesting a preference for a weaker currency so to support external competitiveness. Lastly, further US dollar purchases by the CBSL to meet IMF foreign reserve targets will also weigh on LKR strength.

Over the longer term, it is expected for the rupee to underperform the US dollar in spot terms, as inflation continues to outstrip that of the US and as the CBSL continues to accumulate foreign reserves meet targets from the IMF. Having said that, potential fiscal reforms such as the Fiscal Liability Management Act would aid in the management of public finances and provide support for the rupee. Additionally, real GDP growth is expected to pick up in the medium term and should continue to provide support to the currency.

Incorporating an assessment of foreign exchange risk into an investment depends on whether one is investing equity or debt. Each will be discussed in turn below.

Foreign Exchange Considerations: Equity

Equity investments involve the acquisition of an ownership stake in a company. While the company shares may pay dividend, the ownership stake does not have a fixed return nor is it known in advance when the shares may be sold. Since there is no certainty of cash flows associated with equity investments, such investments are difficult or impossible to hedge using standard currency hedging instruments such as options or swaps. However, equity investors typically rely on the prospect that a company's terms of trade will adjust to the movement in the currency and therefore over the long run a currency depreciation will not result in a permanent reduction in value for a foreign investor. For example, a currency depreciation often results in a sharp spike in inflation in the devaluing country. Inflation leads to higher sale prices for a company's products and, over time, such increases in revenues and profitability result in convergence to the targeted "hard currency" value of the portfolio company. Investors can seek to mitigate or manage the risks associated with equity investments in countries with devaluing currencies by putting emphasis on companies which may have some share of hard currency revenues through exports or which otherwise are not heavily exposed to currency depreciation through imports of raw materials or other goods priced in foreign currency. Equity investors also must take care to ensure that their portfolio companies are not burdened with foreign currency-denominated debt or other liabilities which can balloon in size and threaten the capital adequacy of a company in the event of a significant currency devaluation. Through careful investment selection, prudent liability management and patience to deal with devaluation episodes, equity investors can typically manage the bumpy ride of a currency devaluation and achieve attractive returns on investments in solid and growing local companies.

Foreign Exchange Considerations: Debt

Debt investments in local currency, including senior and subordinated debt and mezzanine, face significantly greater risks associated with the devaluation of currencies than equity investments. The flows associated with loans are usually fixed at the time a loan is disbursed, with interest payments and principal repayments clearly agreed and scheduled. A sharp depreciation in the borrowing currency obviously damages the lender as the value of local currency payments will be substantially less in foreign currency than the foreign lender expects. Foreign lenders often seek to put currency depreciation risk on the borrowers by emphasizing loans denominated in foreign currency. Obviously, this approach does not eliminate the risk but rather simply pushes it from lender to borrowers. Local borrowers are usually not keen to accept this long-term currency risk. In SEAF's discussions with a select group of local companies, there was general consensus around a wariness to borrow long-term in U.S. dollars or Euros; such companies expressed a clear interest in equity investment or loans in Sri Lanka rupees.

Fortunately, financial instruments exist which can be purchased to mitigate or eliminate risks associated with fixed payments in currencies other than the reference currency of the lender. These instruments include currency put and call options, forward contracts, and other currency swaps. The foreign exchange hedging market is broad and deep with a wide array of products. Unfortunately, most of the products are available for major international currencies such as the U.S. dollar, Euro, Japanese Yen, and similar. Hedging products for frontier or emerging market currencies including the Sri Lankan Rupee are not widely available from Wall Street dealers of hedging products.

However, SEAF is pleased to have developed a relationship with MFX Solutions, Inc., the first dedicated currency hedging facility created by and for microfinance, SME and impact investment lenders. MFX, founded in 2009 and based in Washington DC, is a non-profit organization that is sponsored by a range of large development finance institutions (including OPIC) and larger impact investors and development organizations. MFX provides long-term (up to 15 years) hedges and currency swaps for nearly every emerging and frontier market currencies, including Sri Lanka Rupees. Since MFX is a non-profit, it provides long-term currency swaps at competitive rates. Importantly, MFX has received long-term guarantees from OPIC and the Dutch FMO which enable clients of MFX to purchase currency hedging products including currency swaps without any requirement to post collateral.

Through the use of MFX products, the MOD-funded dairy project could make, say, a five-year loan denominated in Sri Lankan rupees at 18% interest to a Sri Lankan borrower but then swap the payments with MFX to receive instead U.S. dollars at 8% from MFX. Hybrid securities such as mezzanine, which typically have a fixed return component (interest) as well as variable component (equity participation, stock options, profit sharing, etc.), would therefore be eligible to have the fixed component hedged via MFX while the equity component would be unhedged (subject of course to the valuation adjustments discussed above in the section entitled Foreign Exchange Considerations: Equity).

The use of hedging instruments would require explanation and clarification for the local borrowers. However, the bulk of the work is handled by the lender, not the borrower, and so the administrative steps of implementing an MFX hedging regime is not burdensome to the local borrower.

7 Investment fund

7.1 Investment fund strategy

Recommendation on investment fund strategy

As outlined in earlier Sections of this report, there is a lack of long-term investment capital for growing businesses in Sri Lanka including companies in the agribusiness sector. Both long-term debt and equity capital are required by such businesses, but the shortage of equity investment capital is most acute.

Consequently, SEAF recommends an investment effort focused on the provision of equity or equity-like capital as the most useful and developmentally effective approach for the planned fund. Given challenges in securing exits for minority equity investments in SME companies, we also recommend that the fund consider organizing the equity investments in ways that provide additional structure for eventual exits. For example, the fund could offer a convertible loan instrument, which would advance the money as a long-term loan with a redemption date, interest (often deferred or accrued), and other debt-like features but which could be convertible into equity shares at the future election of the fund. The conversion would occur if the portfolio company performs as expected and has reasonable prospects for sale. This approach enables the company to receive long-term patient capital but provides the investor with protections on the downside including a fixed redemption date but full equity participation in the event the company is successful and is able to be sold.

From our review, we understand that there are investment needs across all parts of the dairy value chain. We recommend therefore that the investment effort focuses on those sub-sectors within the value chain that are identified by the MOD project as the most acute bottlenecks to the expansion of milk supply. Obviously, the fund will need to determine if commercially-reasonable transactions can be negotiated in companies in the identified acute sub-sectors, but hopefully, there is a correlation between investment in the most critical areas for demand/supply imbalance and the prospects for commercially-reasonable returns on such investments.

SEAF believes that an effort to organize a “blind pool” fund of any sustainable size (at least US\$ 25 million or more) for a long-term investment effort narrowly focused on the dairy sector in Sri Lanka is unlikely to be successful. Institutional investors, including DFIs, generally have an unfavorable view of single-country funds. A single country fund focused on a single sector is even more challenging for investors, and a single-country fund focused on a single sub-sector within a sector is almost unheard of. SEAF understands from direct dialogue that the principle regional development finance institution covering Sri Lanka, the Asian Development Bank, has a policy to invest only in regional funds; they will not consider investment in a pooled single-country fund, particularly a small country like Sri Lanka.

SEAF recommends therefore that the way forward should be the organization of a vehicle which enables investment to be sourced on a deal-by-deal basis for identified and diligenced transactions which have a clear investment thesis. This approach provides confidence for investors as they can fully understand how their capital will be utilized. Impact-oriented investors are also better able to select opportunities that align with their priorities, which may range from support for smallholder farmers to improvement in food quality and safety to food

access, etc. SEAF believes that there is significantly higher probability of sourcing capital on a deal-by-deal basis rather than attempting to raise capital on a “blind” basis for a series of future, unknown investments, particularly since there are currently no investment teams based in Sri Lanka with demonstrated experience and track record in making and exiting private equity investments in the targeted sector.

Such a deal-by-deal investment can be organized within a single Fund vehicle, the “MOD Sri Lanka Investment Fund” that issues separate classes of shares for each specific fund investment. SEAF, via the starter capital provided by the MOD program, will invest proportionately in each issued share class and individual investors can acquire the shares in the class associated with their investment. For example, for an initial investment in, say, a cold storage company, SEAF and a co-investor would acquire Class A shares of the Fund and then the Fund would make the targeted investment and hold it in a segregated account on the books of the fund. The second investment would be funded through the issuance of Class B shares, and so on. The Fund, therefore, is infinitely scalable while providing a mechanism for the organization and management of the portfolio under the direction of an engaged fund manager. We anticipate that each investor in a share class will bear annum management fees and other expenses associated with the on-going management of the underlying investment. When investments are ultimately exited, the cash proceeds associated with such investments are allocated solely to the applicable share Class holders; such shares would be fully redeemed in the event of a complete exit. This process would continue until the final fund investment is sold and Fund thereby would be fully liquidated and wound up.

7.2 Proposed steps and anticipated timeline

Proposed steps in setting up the fund and anticipated timeline

SEAF has prior experience and success in setting up and managing deal-by-deal Funds as described above in Section 6.1. Such “Flex Fund” (as SEAF calls the structure) can be organized relatively quickly utilizing document precedents in SEAF’s possession. Based on the legal, regulatory and tax analysis summarized in Section 4, we propose that the Fund be organized as a Limited Liability Company in the State of Delaware. This structure provides maximum flexibility and minimal operating costs and tax transparency (i.e., the vehicle, while providing limited liability for investors, is considered a partnership for U.S. tax purposes and therefore is not a tax paying entity; taxable income flows through to the Fund’s investors directly). If SEAF is selected to organize the Fund under the terms of the Option Period, we would also arrange for a SEAF affiliate to serve as the ‘Managing Member’ of the Fund and generally handle its overall operations and administrative activities.

The Fund and associated documentation can be prepared within a matter of several weeks. Thereafter, the initial Class A shares can be issued upon receipt of the first tranche of starter capital and work would commence on the development of the initial investment candidates for the Fund. Additional Shares would be issued (Class A, Class B, etc.) as Fund investments are sourced, and co-investors for each investment are identified. To the extent that co-investment consists of debt financing provided directly to a portfolio company, SEAF, via the MOD starter capital, would be the only holder of the specified share Class. The Fund could theoretically have an indefinite life, although it may be advisable to provide for a specified fund life (10

years is typical) which is extendable if appropriate for the further management and liquidation of the portfolio.

7.3 Estimate of resources needed

Provide an initial estimate of resources required to establish the investment fund; develop a 10 year financial model that incorporates the assumption of OPIC participation in the Fund.

The establishment of the Fund along the lines described herein will require various legal and administrative work of SEAF professionals, along the lines contemplated in the Option Period scope of work. Given SEAF's successful precedents, the formal establishment of the Fund vehicle can be accomplished efficiently through SEAF's internal administrative and legal resources.

Per the Scope of Work, we have also prepared a detailed financial model which incorporates OPIC participation in a Fund that is organized in OPIC's standard format. As indicated herein, it is highly unlikely that OPIC would consider participation in a small, single-country fund through its funds program but nonetheless, we have prepared the model to show the financial dynamics of the fund given that such model is an agreed deliverable of the overall MOD project. To be clear, we do believe that OPIC SME debt financing programs will be available for specific individual investments sourced by the Fund in the dairy sector, and we look forward to engaging actively with OPIC Finance at the time these investments are identified and structured.

7.4 Role of MOD

Define role of MOD in facilitation the implementation/operation of fund

SEAF looks forward to working closely with MOD personnel on the implementation and operation of the Fund. Key interactions are expected to include the following:

- Review of key findings of MOD's overall work, and assessment of areas of greatest need in the dairy value chain;
- Dialogue regarding potential candidates for Fund investment;
- Dialogue regarding due diligence matters, particularly identification of local reference to confirm reputation and business integrity of potential partners;
- Advice and guidance on potential technical advisors to assist in the assessment of identified investment candidates;
- Advice and guidance on Sri Lankan agricultural policies, particularly any changes in policies or programs during the term of the MOD project;
- Referral of potential co-investor candidates with whom the MOD project may come in contact;
- Participation as an observer in SEAF's formal investment discussions to approve investment commitments, giving MOD an opportunity to discuss such investment and review contributions towards meeting overall MOD targets;
- Meetings with potential co-investors during their local due diligence review of targeted investment opportunities; and,
- Communication of any changes to MOD program or objectives during the course of the project