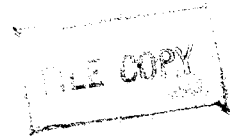


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Report No. 3847-CE

STAFF APPRAISAL REPORT

SRI LANKA

INDUSTRIAL DEVELOPMENT PROJECT

June 6, 1983

Industrial Development and Finance Division
South Asia Projects

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CURRENCY EQUIVALENTS

Currency Unit = Sri Lanka Rupee

Sri Lanka has a floating exchange rate: on December 31, 1979, the rate was US\$1 = Rs 15.45; on December 31, 1980, US\$1 = Rs 18.00; on December 31, 1981, US\$1 = Rs 20.55 and on December 31, 1982, US\$1 = Rs 22.90. The following rate is used in this report.

US\$1	=	Rs 23.00
Rs 1	=	US\$0.044
Rs 1 million	=	US\$44,000

PRINCIPAL ABBREVIATIONS

BOC	-	Bank of Ceylon
CBOC	-	Commercial Bank of Ceylon
COPE	-	Parliamentary Commission on Public Enterprises
DFCC	-	Development Finance Corporation of Ceylon
EDB	-	Export Development Board
EPR	-	Effective Protection Rates
FIAC	-	Foreign Investment Advisory Committee
FMO	-	Nederlandske Financierings Maatschappij voor Ontwikkelingslanden NV
GCEC	-	Greater Colombo Economic Commission
GOBUS	-	Government Owned Business Undertakings
GOSL	-	Government of Sri Lanka
ICICI	-	Industrial Credit and Investment Corporation of India
IDP	-	Industrial Development Project
LIAC	-	Local Investment Advisory Committee
LOLC	-	Lanka Orient Leasing Company
MISA	-	Ministry of Industries and Scientific Affairs
MOFP	-	Ministry of Finance and Planning
NDB	-	National Development Bank of Sri Lanka
NSB	-	National Savings Bank
SMI	-	Small and Medium Industries
UNDP	-	United Nations Development Programme

FISCAL YEARS

Government of Sri Lanka	=	January 1 to December 31
Commercial Banks	=	January 1 to December 31
NDB	=	January 1 to December 31
DFCC	=	April 1 to March 31

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This report was prepared by C. Bam, J. Balkind, N. Barry, and R. Heaver (ASPID) following their appraisal mission to Sri Lanka in November/December 1981. Messrs. J. Simmons and H. Darmawi participated in the appraisal mission. The report was updated and finalized by Mr. Balkind and Ms. Barry following a post-appraisal mission in March/April 1983.

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Number 17278: Sri Lanka Industrial Development Project

SRI LANKA

INDUSTRIAL DEVELOPMENT PROJECT

STAFF APPRAISAL REPORT

I. INTRODUCTION

1.01 Since 1977, the Government of Sri Lanka (GOSL) has focussed its industrial development efforts on the private sector. Trade liberalization measures have been geared to facilitate imports of inputs and equipment. Manufactured exports have been promoted by: encouraging joint ventures with foreign partners; providing special export expansion and credit schemes; and improving export and product development. The system of industrial finance has been strengthened by: establishing the National Development Bank of Sri Lanka (NDB); attracting a number of foreign banks; and improving the local commercial banks' project lending capabilities, particularly for smaller industrial projects. Growth in private industrial output and exports have been significant, reflecting: recovery from the stagnation of the previous period; rapid expansion of the construction sector; and entry into easier export products. The industrial base in Sri Lanka is still thin, with relatively few medium and large private firms. Also, efforts to improve performance of the large state industrial sector have been limited largely to reducing government financing and introducing some measures to increase private participation in ownership and management.

1.02 Industrial Development Project. The proposed project is designed to promote growth of larger private industries and improve efficiency of state enterprises. Operations of the two development banks would be supported by IDA financing of foreign exchange requirements of eligible industrial subprojects, and technical assistance in improving promotion and lending operations. The Development Finance Corporation of Ceylon (DFCC) has been an intermediary in two previous loans and two IDA credits. The Project Performance Audit Report (PPAR) for Loan 634-CE, dated December 7, 1977 concluded that DFCC had performed well under a difficult environment of excessive government controls and low activity. NDB, established in 1979, has received an ADB line of credit and substantial technical assistance under the First and Second Small and Medium Industries Projects (IDA Credits 942 and 1182-CE). In addition to assisting direct lending operations of NDB and DFCC, technical assistance would be provided in establishing an equity fund to be administered by NDB and in strengthening consortium financing arrangements involving the development and commercial banks. The project also would incorporate a program to improve performance of state industrial enterprises, by installing corporate plans, increasing autonomy, introducing performance incentives, and encouraging various modes of private sector involvement. The project would build on the effective protection work supported under a previous project, in launching tariff reforms and improving industrial and export incentives. This report outlines a US\$44 million project, with SDR 23.1 million (US\$25 million equivalent) in IDA financing, composed of US\$23 million for industrial loans, and US\$2 million in technical assistance and training.

1.03 Previous Industrial Bank Group Operations. In addition to the previous two loans and two credits to DFCC, totalling US\$24.5 million, the Bank Group has been involved in two Small and Medium Industries (SMI) Projects, with US\$46 million in IDA financing. The commercial banks are providing term loans to SMIs; technical services are being strengthened in major product groups; and exporters are being assisted in product development. The first SMI Project financed the Effective Protection Study, the results of which are to be used in tariff reforms. The IFC has: financed equity in DFCC and the Lanka Orient Leasing Company; made two loans, totalling US\$7 million, to Bank of Ceylon (BOC) to finance medium scale industries and to improve BOC's industrial appraisal capabilities; and invested in two hotels and three manufacturing projects in textiles and plastic bags.

II. SECTORAL FRAMEWORK

A. Economic Setting

2.01 From 1970 to 1977, economic growth in Sri Lanka slowed to 2.9% p.a., and was no longer sufficient to support traditionally high levels of spending on social sectors. Import controls and unresolved conflicts with the private sector resulted in limited investment in industry, while government funds were funnelled into inefficient public enterprises. After 1977, most import controls were lifted, the exchange rate was allowed to depreciate, and priority was given to private sector development and export-led growth. GDP growth accelerated sharply to 8.2% in 1978 and averaged 6.8% per annum in the 1977-80 period. Consumer subsidies were reduced. A large share of development spending went to three "lead" projects--the Mahaweli Scheme, the housing program, and a new free trade zone.

2.02 More rapid growth and the public investment program brought both budget and foreign exchange deficits. Inflation of over 35% in 1980 and inadequate resource mobilization led to a cutback of one-quarter in the oversized public spending program. The housing program and the Mahaweli Scheme, with its long gestation period, have exacerbated inflationary pressures. In agriculture, improved producer prices led to a sharp increase in paddy production, but plantation crops, which comprise 60-70% of all exports, have stagnated. The proposed credit would finance industrial projects with reasonably short gestation periods, and relatively rapid returns.

B. Industrial Structure and Performance

2.03 Manufacturing industry's contribution to GDP has remained roughly 14% in the past four years. Industry's share in exports has more than doubled to about 30%, reflecting both industrial expansion and deterioration in the plantation sector. Manufacturing industry consists of: 29 public sector corporations; about 9,000 registered private factories, composed mainly of small and medium firms; 1/ and over 20,000 unregistered small and cottage industries.

1/ Units with investments in plant and equipment of under Rs 2 million (at original cost), excluding land and buildings, the official definition adopted in the SMI credits.

Excluding the Petroleum Corporation, about 40% of gross output in 1981 in the large scale sector was accounted for by the public corporations, with about 25% of production from the five largest public corporations. Large scale private production is heavily concentrated in the food, beverage and tobacco subsector, and in garments. The 5% real growth in manufacturing for 1981 hides widely divergent trends. Excluding petroleum, the most rapid growth has been in textiles and garments. ^{1/} Other expanding product groups have been non-metallic minerals, structural steels, and wood products, stimulated by growth in construction.

2.04 There are built-in limits to further expansion of the successful subsectors. The volume of garment exports will be constrained by import quotas from Western countries. The pace of both private and public construction activity has slowed, and reduced rates of growth are already visible in steel and certain non-metallic minerals. Much of the rest of large scale industry is going through a painful period of readjustment in the face of foreign competition. Industrial export growth was concentrated in petroleum and garments, each with a heavy import content. As industrial growth has slowed in the "boom" sectors, the policy thrust must be toward further development of non-traditional exports, greater competitiveness of existing firms, and diversification into viable import-substitution areas. This project would assist in appropriate adjustment of the industrial tariff and incentive systems, financing export-oriented projects, and improving public enterprise efficiency. It also would help finance further development of the tourism sector which has experienced strong growth since 1977 and for which selected segments remain promising (Annex 2).

C. Industrial Policies and Prospects

2.05 Investment Incentives. In 1982, gross domestic capital formation of Rs 30.4 billion (US\$1.3 billion) represented about 31% of GDP. In 1980, GDCF represented about 33% of GDP. The two largest investment components were: construction (39%), of which two-thirds was for the Mahaweli and housing programs; and transport equipment (28%), stimulated by a 100% lump sum depreciation allowance, which was removed in March 1981. From 1978 through 1980, private industrial investment probably was not more than Rs 3 billion (US\$130 million). The initial increases in industrial output after 1977 were mainly due to increased capacity utilization, from 60% to 75%, responding to the availability of imported raw materials. Incentives implemented in the 1977-1983 period included 5 to 10 year tax holidays and investment relief for approved projects. The wide range of Inland Revenue Act concessions encouraged

^{1/} Garment exports expanded by 132% in 1979, 54% in 1980, and 40% in 1981 in nominal dollar terms, and contributed 80% of industrial exports in 1981. Detailed structure and performance figures by subsector are given in Annex 1.

investment mainly in tourism and transport. The 1983 Budget withdrew the tax holidays for new hotels 1/, but maintained these incentives for new export-oriented manufacturing firms; this should increase the relative attractiveness of investing in export projects. The incentive system is crucial to shaping investment; given that much of the post-liberation growth was in tourism, transport, real estate and construction, a fresh examination of relative incentives is needed. The proposed project would help finance such a study (para 3.09).

2.06 Tariffs. A study 2/ of effective protection rates in industry, financed under the first SMI Project, highlighted three major problems of the present tariff system: (a) high levels of protection for import-substitution industry and low incentives for export products; (b) a number of consumer essentials with low effective incentives and high protection for several luxury goods; and (c) 62 product lines (about 20% of the sample) with negative value-added at world prices. Most tariff revisions since the 1977 liberalization have been ad hoc, and in the direction of greater protection. The project includes technical assistance in the implementation of systematic tariff reform incorporating findings of the study, and a date by which the band between products receiving excessively high and low effective protection rates will be reduced (para 3.08).

2.07 Export Incentives and Promotion. In addition to the Greater Colombo Economic Commission (GCEC), 3/ two institutions have been developed to support export-oriented industry: the Foreign Investment Advisory Committee (FIAC) and the Export Development Board (EDB). FIAC examines the viability and financing plans of all applications involving foreign investment, except GCEC projects. Export incentives are administered by the EDB, which was established in May 1979. Incentives include duty drawbacks on imports of materials used for export products; an Export Expansion Scheme offering payments according to increased exports, based on rough calculations of net foreign exchange earnings 4/; equity participation in innovative projects; and export and product development programs, which are being assisted under the Second SMI Project. The EDB also recommends and monitors projects under the Central Bank's Export Refinance Scheme. However, commercial banks have been reluctant to process most subprojects on grounds of lack of viability, inadequate spread, and distrust of EDB appraisals. As of March 31, 1983, only 43 projects, totalling

1/ In early 1983 there was a large spurt of hotel investment applications to qualify under the old framework.

2/ Effective Protection to Manufacturing Industry in Sri Lanka, A. G. Cuthbertson and Mohammad Zubair Khan, prepared with the Ministry of Finance and Planning, September 1981.

3/ The incentive package for the GCEC, which is responsible for projects located in the export processing zone, is outlined in Chapter V of the 1981 Country Economic Memorandum for Sri Lanka (Report No. 3466-CE).

4/ Under the Second SMI Project (Credit 1182-CE), EDB is assessing the extent to which effective protection rates can be utilized to improve the calculation of value-added under the Export Expansion Scheme and other export incentives.

Rs 110 million in loans, had been approved by the banks; 78 projects with loan amounts of Rs 250 million were pending. Sri Lanka's export performance has been disappointing, with total real value of exports in 1977-81 being about the same as in 1971-75.

2.08 The Public Sector. Public sector enterprises still account for the majority of industrial investment and output (para 6.01). Since 1977, GOSL has concentrated on introducing financial discipline into the public corporations by reducing their dependence on the government budget. Some initial steps to increase private participation have been taken (para 6.10). Under the proposed IDP, technical assistance to state industrial enterprises will be provided in the development of corporate planning and related performance incentives; improved firm-level operations; and enabling legislation and pilot schemes to increase private sector participation in ownership and management of public enterprises (paras 6.05-6.14).

2.09 Investment Trends and Prospects. After the liberalization measures of 1977, investment in medium and large industry increased. The textiles and garments sector was the most active, both in and outside the GCEC. However, as Sri Lanka approached its export quotas under the Multifibre Agreement (MFA), investment has declined, from Rs 680 million of FIAC approvals in 1979 to Rs 162 million in 1982. The food processing and vegetable oil group represented 32% of the amount invested in manufacturing in 1982, while basic metals and engineering industries accounted for 17%. Chemicals, rubber and plastic industries are most promising, particularly rubber, due to Sri Lanka's extensive raw material base. The tourism sector continues to be the area of most interest to investors. In 1982, out of Rs 3.1 billion of FIAC approvals, nearly 63% was for hotels. The 1983 Budget removed the tax holidays for five- and four-star hotels, which should increase the relative incentive to invest in industry, particularly export firms, which are still eligible for tax holidays. While less buoyant expectations are necessary as compared to 1978-80, several industries based on indigenous resources offer growth opportunities e.g. rubber products; wood products, including furniture exports; gem-mining and jewelry; non-metallic minerals, particularly mineral sands and graphite; and processing of agricultural products.

D. Industrial Finance

2.10 The Financial System. Prior to 1977, the institutional sources of credit for industry were: the four domestic commercial banks; the Development Finance Corporation of Ceylon (DFCC); and four foreign commercial banks. Traditionally, private industry relied on self-financing for up to 80% of its fixed capital needs and on commercial bank credit to finance working capital, with some rollovers used for term credit. Public sector industrial corporations used budgetary allocations for up to 80% of their financial requirements. Commercial bank credit accounted for up to 85% of all institutional finance to industry. DFCC was the only source of long term equity and credit, with a monopoly in providing foreign exchange loans to private industry. Since liberalization, the number and size of investments in projects have increased and the traditional reliance on self-financing has declined, resulting in an increased demand for term loans and equity participation. With DFCC's financing capacities hampered by a lack of domestic resources, a low capital base and exposure limit, term lending needs have been met largely by the newly created National Development Bank (NDB) and domestic commercial banks. The expansion

in the volume of credit available, partly through the opening of branches by 22 foreign banks, has helped fund increases in trade financing and working capital for industry. In addition, project finance has been obtained through suppliers' credits and, in a limited number of cases, through foreign currency denominated term loans by foreign and domestic commercial banks. Equity finance has been provided by project sponsors, usually amounting to 30-40% of project costs; the lack of an effective equities market (para 2.12) has limited the supply of equity funds for most companies.

2.11 Leasing. In 1980, the Lanka Orient Leasing Company (LOLC) was created with equity investments from IFC, Orient Leasing Company of Japan, NDB, DFCC and Bank of Ceylon. In 1982, 355 leases were concluded with a total value of Rs 132 million; manufacturing accounted for 22% of the number of leases and 30% by amount. In March 1983, the Lloyds Group (UK) and Mercantile Credit Company Ltd. in Colombo formed a new leasing company. The large trading houses also conduct low-volume hire-purchase operations.

2.12 Capital Markets. The market for shares and other securities in Sri Lanka is poorly developed and has not been a significant source of finance for industry. Although a small number of brokers make a market for shares, and about 90 companies are listed, most are closely held or dormant, and trading volume is thin. Development of the market has been hampered on the supply side by the relatively small number of medium to large companies in Sri Lanka and the strong tradition of closely held ownership; and, on the demand side, by high returns available on fixed interest deposits and commercial activities. Steps are being taken to revitalize the market. In addition to the formation of an equity fund, the Government is drawing up securities legislation aimed at establishing a formal Stock Exchange and improving the regulation of the market.

2.13 Interest Rates and Inflation. Current projections of Sri Lanka's inflation are 15% for 1982/83 (July 1 - June 30), and in the range of 10% to 13% in the 1984 to 1987 period, with an average of 11%. Inflation during 1981/82 was 11%. The projected increase in 1982/83 reflects the one-time impact of tax adjustments incorporated in the 1983 Budget. In spite of current and projected inflation rates, deposit and short-term lending rates of the commercial banks have been kept high, largely due to the influence of the rates paid by the National Savings Bank (NSB). Until recently NSB offered a rate of 20% compounded annually on 12 and 24 month deposits, providing a yield of about 30% on a tax adjusted basis; these high rates were supported by a Government subsidy, which amounted to Rs. 400 million in 1982. To compete for deposits, commercial bank deposit rates have been kept high, with term deposit rates ranging from 20% to 22% (Annex 3); resultant lending rates, mainly for trade and working capital finance have been artificially high, with minimum rates of 20% to 22% when lending from the bank's own resources. In contrast, until recently, the Central Bank provided 100% medium and long-term refinance for "export-oriented projects", onlent by the commercial and development banks at 11% and 12%, depending on the size of the project. The term structure of industrial finance has remained roughly constant, with over 75% of outstandings for less than one year and about 20% from one to five years; the remaining 5% of industrial finance with maturities of over five years was provided by NDB and DFCC at rates of 17% until recently.

2.14 In April 1983, two important measures to rationalize the interest rate structure were taken. NSB eliminated the 24 month deposit scheme, and reduced

the rate on 12 month deposits to 18%; GOSL intends to reduce the NSB rate still further, to better reflect current and expected inflation levels, encourage the flow of savings into productive investments, and reduce government subsidies. Managements of commercial banks expect to reduce their deposit and lending rates accordingly. The other significant move was taken by the Monetary Board Central Bank which, at the recommendation of the IDP post-appraisal mission, reduced the percentage of refinance from 100% to 70% under its Export Credit Scheme, which increases the effective onlending rate to subborrowers to about 14%.

2.15 Under the proposed project, term lending rates from NDB and DFCC would be 14%, which would be positive in relation to medium-term inflation projections. The onlending rate would be reviewed semi-annually to ensure that it remains positive in real terms, and takes into account the overall interest rate structure. During negotiations, agreement in substance was reached on a draft side letter from GOSL, which confirms the Government's intention to continue taking measures to rationalize the interest rate structure, including progressive reduction in the NSB rate and GOSL's subsidy. The letter also confirms the commitment by the Central Bank to adjust rates and/or percentage refinanced under its medium and long-term industrial refinance schemes, to ensure that lending rates to borrowers are not lower than the rate charged by NDB and DFCC under the Industrial Development Project. Given fluctuations in inflation experienced in Sri Lanka, it would be useful to consider introduction of a variable interest rate system for individual subloans; however GOSL would need to consider carefully the impact on investment and administrative requirements of such a system.

2.16 Credit Demand. The reelection of the President in October 1982 and the extension of Parliament's term should reassure investors that government's emphasis on private sector development will continue. This should lead to continued growth in industrial credit demand from the private sector. The development banks' pipelines of manufacturing projects should continue to expand with elections completed, lowering of interest rates, improved prospects in foreign markets, and the change in relative incentives (para 2.05). As of March 31, 1983, NDB's pipeline of projects included Rs 200 million (US\$9.0 million) in foreign exchange requirements for projects in an advanced appraisal stage and Rs 300 million (US\$13 million) for projects in a preliminary stage (paras 4.20-4.21). DFCC's pipeline totalled Rs 100 million (US\$4.4 million), excluding tourism projects (para 5.20). The development and commercial bank consortium and associated technical assistance under the proposed project will help to strengthen the appraisal capacity of the commercial banks, enlarge the supply of term finance through risk-sharing, and improve coordination among the financial intermediaries.

III. THE PROJECT

A. Strategy and Scope

3.01 The proposed Industrial Development Project (IDP) is designed to increase output, efficiency and employment of viable private and public industrial enterprises. Operations of the two development banks would be enhanced, with finance to meet foreign exchange lending requirements and technical assistance in project promotion, appraisal and supervision. The system of industrial finance would be strengthened by: rationalizing the interest

rate structure for industrial lending; assisting in the establishment of an equity fund to be managed by NDB; and facilitating consortium financing arrangements among the development banks, commercial banks and other funding institutions. An objective would be to improve performance of public enterprises, which constitute a major share of industrial output, but which have operated inefficiently, draining resources. Technical assistance under the project would be geared to installing corporate plans, increasing autonomy in public enterprise management, introducing performance incentives and encouraging various modes to increase private sector participation in ownership and management. The project would help improve trade and industrial policies, building on the effective protection analysis supported under past projects; tariff reform would be assisted, and a study of industrial incentives would be undertaken.

B. Strengthening the System of Industrial Finance

3.02 NDB and DFCC: Relative Roles. Under the proposed project the two Sri Lankan development banks, NDB and DFCC, would have access to US\$23 million of IDA financing for the lending component; the banks would be encouraged to compete in utilizing the credit. The client base of these banks is complementary; DFCC's smaller capital base probably will lead to its continued concentration on medium-scale private industrial firms; NDB is likely to play a more significant role in financing larger private and public industrial enterprises.

3.03 Eligibility for Loans. Under the project, NDB and DFCC would be responsible for subproject appraisal, onlending and supervision. While commercial banks would not be lending intermediaries, their participation in consortium lending, training under this project, and continued experience in appraisal under the Second SMI Project could enable some commercial banks to participate directly in subsequent Industrial Development Projects. At present, capabilities of the commercial banks are inadequate for appraisal of larger projects, and two lead agencies are adequate for the limited number of medium and large industry projects likely to be financed in the next few years. NDB and DFCC subprojects eligible for financing under the first IDP would be new or existing private or public manufacturing, mining, and agro-processing enterprises. Other commercial undertakings, including transportation, retail trade, and property development and other services would not be eligible. ^{1/} However, hotels and related tourism projects, which contribute substantial foreign exchange, would be eligible provided that such lending would not lead to tourism exceeding 30% of NDB's or DFCC's respective portfolios (Annex 2). The Project would finance only loans; equity investments would be financed from NDB's and DFCC's own resources or by the equity fund (para 3.05). ^{2/} Public

^{1/} Exceptions would be for engineering workshops and for service investments which are integral parts of an eligible project e.g. transport.

^{2/} Although, under Credit 742-CE, DFCC was permitted to finance equity investments from credit proceeds, this concession was made due to lack of alternative sources of funds. Debt financing of equity investments could create cash flow problems and as DFCC now has more than trebled its share capital and has good profits, IDA financing for equity investments is no longer needed, and would not be provided under the proposed project.

sector industrial projects are expected to be mainly for balancing, modernization, and replacement, except when public corporations enter joint ventures with private partners; DFCC is not involved in financing public sector projects, while NDB's strategy would continue to be highly selective. Except for projects with a clear export orientation and in small equipment financing for larger projects, the minimum total loan size (including foreign and domestic portions) would be Rs 2 million, which is the maximum subloan size under the Second SMI Project. The maximum subloan size would be determined by the exposure limit of each development bank. NDB's exposure limit is about Rs 100 million (US\$4.4 million) on any subproject, and DFCC can now finance up to about Rs 40 million (US\$1.8 million) per subproject.

3.04 Consultancy and Training. DFCC, established in 1955, has been an IBRD/IDA client during the last 15 years; technical assistance to DFCC under the project would focus on project identification and promotion activities (para 5.07). While NDB, which began business in late 1979, has received technical assistance under IDA-financed SMI Projects, the proposed project would represent the first Bank Group loan for NDB's direct lending operations. Technical assistance and training for NDB would include: the services of a senior advisor; consultancy in project promotion, operations, and development of the equity fund and consortium lending arrangements; and training in industrial appraisal (para 4.04).

Equity Fund and Capital Markets

3.05 Private entrepreneurs with limited financial resources have difficulty in floating share issues to finance large industrial ventures. Many public sector corporations, faced with depleted resources, have problems raising the capital necessary to modernize or enter into joint ventures with foreign partners. Initial work to restructure capital market arrangements has been undertaken (para 2.12); however, development of an active market for industrial finance will be a long process, due to the relatively thin base of larger enterprises and the higher yields on savings and commercial activities. NDB, working closely with the Ministry of Finance, proposed the establishment of an equity fund to bridge the gap in equity assistance. In February 1982 Cabinet approved establishment of the Sri Lanka Capital Development and Investment Company (CDIC), to be managed by NDB and owned by GOSL, NDB and other Sri Lankan financial institutions, including the state-owned commercial banks. CDIC will provide equity to new ventures receiving term loans from member institutions; stimulate development of the capital market by increasing the supply of attractive equities; and encourage joint ventures between public corporations and private parties. Initially, CDIC will issue share capital of Rs 300-400 million (US\$13-18 million), with NDB taking up Rs 100 million (US\$4.4 million). These funds will be used to build up a portfolio, which would be held through the development phase, and subsequently sold to the public. The proposed IDP would provide technical assistance to NDB to establish the fund and develop suitable policies and procedures for its operation.

Consortium Lending

3.06 Before 1977, DFCC, the only institution with direct access to foreign exchange, was the dominant source of term loans to industry, with some roll-overs of short term credits by commercial banks. After liberalization, commercial banks, able to convert domestic currency, became more active in term lending, both in rupees and foreign exchange. Also, the foreign commercial

banks and government-owned investment funds have made some industrial and hotel investments. Based upon suggestions by the IDP appraisal mission, a formal arrangement for consortium financing of industrial projects has been established to: (a) rationalize the use of direct foreign exchange resources; (b) provide lenders with a mechanism for spreading lending risks; (c) offer a wider range of financial services; (d) improve standards and procedures in appraisal of projects; and (e) provide an effective mechanism for the investment and pension funds to finance suitable industrial undertakings. The consortium consists of the development banks, the domestic commercial banks, the investment funds, and the proposed equity fund; membership also could be open to foreign commercial banks. The arrangement should allow institutions to refer proposals to the consortium and take up or offer participations in project financing, with no compulsion or obligation to participate in individual cases; the "lead" institution for a given subproject would be responsible for recoveries and normal project supervision. The proposed project would provide technical assistance in the development of suitable standards, procedures and operations (para 4.05). The project also would fund technical assistance and training to commercial banks participating in the consortium.

C. Improving Industrial Efficiency

Public Sector Enterprises

3.07 The project incorporates a program to improve performance of public sector enterprises (Chapter VI). The Ministry of Industries and Scientific Affairs (MISA), which oversees operations of most state industrial corporations, is establishing a Public Enterprise Cell which will work with the management of the corporations to develop and install: corporate plans for each corporation which will form the basis for increased autonomy; and a system of signalling and incentives to replace the controls which currently exist on investment, procurement, financing, personnel, and day-to-day operations of the corporations. The project would finance consultancy in the corporate planning and signalling systems (para 6.06). Also, operations of the corporations would be improved through practical firm-level consultancy concentrating in the areas of: (a) personnel policies and performance incentives; (b) cost accounting and market analyses to enable the corporations to concentrate on competitive products; (c) assessment of balancing, modernization and replacement, and energy efficiency investments needed to improve production performance; and (d) financial management. The program also would encourage and assist in establishing private management contracts and joint venture companies involving public corporations and private partners. Corporate plans and performance incentives would be formulated as "public management contracts", encouraging improvements in efficiency and profits, which would be necessary before outside parties would be interested in buying shares or purchasing most corporations. In addition, the project would finance consultancy to the Ministry of Finance and Planning (MOFP) in: improving management information and accounting systems for all public sector corporations, focussing on enterprises under supervising ministries other than MISA; tackling procedural and control issues which cut across public sector enterprises; and preparing legislation which would facilitate increased private participation in ownership and management of public sector enterprises.

Industrial Policies and Incentives

3.08 Tariffs. Under the first SMI Project, advisory services were provided to MOFP to calculate effective protection rates for industrial products, and to make recommendations on a program of tariff reform. The final report has been reviewed within the Bank and by the Presidential Tariff Commission, which was established during the period of the study. Systematic tariff reform, incorporating findings of the Effective Protection Study, was delayed due to pre-election caution and a deteriorating balance-of-payments situation. Despite this difficult environment, initial moves are needed to implement systematic tariff reform, beginning with product lines excessively over- and under-protected. The proposed IDP would provide six man-months of technical assistance to MOFP, with consultants seconded to the Presidential Tariff Commission, to: (a) update and extend effective protection calculations; (b) develop recommendations on reducing the band between products receiving extremely high and negative rates of effective protection; and (c) train counterpart staff. The Development Credit Agreement contains a covenant that GOSL would develop a phased action program for tariff reform based on findings of the Effective Protection Study, by June 30, 1984; and begin implementation of the first phase by September 30, 1984.

3.09 Industrial Incentives. The project would provide 12 man-months of consultancy services to MOFP to analyze absolute and relative incentives provided on industrial investment and exports. Under the study, biases which may be embodied in incentives available to tourism, transport, and import trade relative to industrial investment would be examined; any resultant effects on the flow of investments would be determined; and modifications in the incentive structure would be recommended. Also, the study would examine the appropriateness of existing export incentives, including cash payments, incentives available to GCEC and FIAC enterprises, and fiscal measures. The consultant would be expected to recommend changes needed to increase investment and value-added of efficient industrial enterprises.

D. Components, Costs, and Financing Plan

3.10 Project costs would total about US\$44.0 million equivalent, of which IDA financing would represent SDR 23.1 million (US\$25 million), with US\$23.0 million for eligible subloans by NDB and DFCC and US\$2.0 million for the technical assistance. During FY83-86, price contingencies of 8%, 7.5% and 6% for foreign costs and 15%, 13%, 12% and 10% for local costs are assumed. IDA financing would cover 100% of the foreign exchange costs of imported machinery and equipment, net of duties and taxes estimated at about US\$3.5 million equivalent. Foreign exchange is expected to represent about 55% of costs of sub-projects financed. NDB and DFCC would provide about 15% or Rs 138 million (US\$6 million) for local currency portions; and sponsors' equity is expected to constitute about 30% or US\$12.4 million equivalent. Under the technical service component, the US\$2.0 million would cover costs of advisors and foreign training to: (a) continue to build term lending capabilities of the development banks and other members of the consortium; (b) improve efficiency of public enterprises; and (c) analyze industrial and export incentives and make needed changes in the tariff structure. Technical assistance cost estimates (Annex 4) include about 298 man-months of consultants and advisory services, of which roughly 250 man-months are expected to be in foreign consultants, at an average of US\$7,000 per man-month, and 48 man-months in local consultancy at an

average of US\$1,000. The project also incorporates about 155 man-months in foreign training. The following table summarizes estimated project costs and sources of finance.

<u>Project Financing Plan</u> (US\$ million equivalent)					
	<u>IDA</u>	<u>NDB/DFCC Commercial Banks</u>	<u>GOSL</u>	<u>Sponsors</u>	<u>Total</u>
<u>Subloan Component</u>	<u>23.0</u>	<u>6.0</u>	-	<u>12.4</u>	<u>41.4</u>
<u>Technical Assistance Component</u>					
(i) Public Enterprises (MISA and MOFP)	1.1	-	0.3	-	1.4
(ii) NDB and DFCC	0.4	0.1	-	-	0.5
(iii) Commercial Banks	0.3	-	-	0.1	0.4
(iv) Policy Studies/ Follow-up Work	0.2	-	0.1	-	0.3
<u>Subtotal, Technical Assistance</u>	<u>2.0</u>	<u>0.1</u>	<u>0.4</u>	<u>0.1</u>	<u>2.6</u>
<u>Total</u>	<u>25.0</u>	<u>6.1</u>	<u>0.4</u>	<u>12.5</u>	<u>44.0 /a</u>

/a Inclusive of taxes and duties, estimated at US\$ 3.5 million.

IV. THE NATIONAL DEVELOPMENT BANK OF SRI LANKA

A. Institutional Aspects

Ownership and Resources

4.01 NDB was established in January 1979, 1/ with the principal objectives of: providing medium and long-term credit to private and public industries; and mobilizing internal and external resources, including stimulation of capital markets. NDB is empowered to offer a wide range of financial services, including: direct lending; refinancing; underwriting and financing equity and debenture issues; providing guarantees; accepting deposits; and issuing letters of credit. NDB's authorized share capital is Rs 2 billion (about US\$88 million), of which Rs 600 million has been paid up. 2/ Although NDB's Act makes provision for issuing shares to the public, the initial issue was subscribed fully by GOSL and its agencies: 67% by GOSL, 17% by the Central Bank and 8% each by People's Bank and the Bank of Ceylon, the two state-owned commercial banks. On December 31, 1982, NDB's resources totalled Rs 1.9 billion (US\$83

1/ Under the National Development Bank of Sri Lanka Act of 1979.

2/ Of this amount, Rs 450 million was in cash and Rs 150 million in promissory notes of the Government.

million) with foreign exchange equivalent to Rs 1.0 billion (US\$43 million) accounting for 52% of the total. NDB's foreign currency resources consist of: (a) US\$28 million of an IDA Credit (SMI II) for refinance of small and medium industrial loans made by the four local commercial banks and DFCC; and (b) US\$5 million balance on a loan of US\$10 million made by ADB in September 1981. NDB's domestic currency resources consist of paid-up capital and retained earnings, which stood at Rs 962 million as of December 31, 1982 (para 4.19).

Board, Management and Staffing

4.02 Board and Management. While NDB falls under the general supervision of the Ministry of Finance and Planning, it has operating autonomy under its Board of Directors. The Board meets regularly to set NDB's overall policies and approve all direct lending proposals. Mr. C.A. Coorey is Chairman and acts as Managing Director. ^{1/} The other five Board members appointed by the Minister of Finance and Planning, reflect NDB's shareholdings: the Secretary of Finance; one director from the Central Bank, one from each of the two state-owned banks; and an additional director from the Ministry of Finance and Planning. The Act makes provision for a seventh member to represent private shareholders, yet to be filled.

4.03 Organization and Staffing. A General Manager supervises NDB's seven departments: three projects departments, with two for appraisal of direct assistance and one for refinance operations; and departments for follow-up finance; administration; and legal and secretarial. With the growth of NDB's refinance and direct financing operations, the creation of a second level of management (Assistant General Managers) plus expansion of project development and supervision activities is necessary. Management of NDB prepared a Board paper outlining such managerial and organizational improvements, which was discussed during negotiations. On March 31, 1983, NDB's staff totalled 185, including 87 professionals. Staff turnover has been low, due to the opportunities for promotion in a new, growing institution, and the strong reputation which NDB has been able to build in its initial years of operation.

4.04 Advisory Assistance and Staff Training. The SMI Projects have financed technical assistance to establish sound operations in NDB: a Bank Group staff member was seconded to NDB for two years as a senior advisor to top management; SMI II is financing the initial man-months of assistance by a senior development banker from India; the Industrial Credit and Investment Corporation of India (ICICI) provided 24 man-months of consultancy in establishing systems and procedures; and staff training programs were financed. Under the Second SMI Project, technical assistance is being provided in: follow-up and supervision; revision of the operating manual; accounting methods; and project appraisal. The proposed project would fund: a senior advisor (eight man-months) and a consultant on development bank operations (12 man-months) to assist in strengthening overall operations and building the second tier of management; and four man-months to assist in structuring and launching operations of the equity fund. Short-term training with Asian development banks will be provided

^{1/} Mr. Coorey has been Secretary, Ministry of Finance, and an Executive Director of the Asian Development Bank. Mr. Coorey's four-year term is due to expire in December 1983, and it is expected that the Minister of Finance and Planning will re-appoint him to a second term.

for NDB staff members. It is expected that, under future operations, NDB's technical assistance needs will be limited to new operations or specialized aspects.

B. Operating Policies, Procedures and Standards

Operating Policies and Strategy

4.05 NDB's Policy Statement, approved by its Board in January 1980, establishes clear guidelines for direct project financing, refinance activities, and equity investments. In addition, it specifies prudent financial exposure limits, including: (a) a maximum exposure of 10% of NDB's own equity in any single enterprise; (b) total equity investments not to exceed NDB's own equity; and (c) NDB's equity investment in a single enterprise not to exceed 5% of NDB's own equity and 25% of the share capital of the enterprise. Other appropriate financial policies cover collateral, sponsors' contributions and a debt:equity limit of 8:1. Following discussions with IDA, NDB's management prepared a draft Strategy Statement for 1982-86, which outlines NDB's objectives, sectoral priorities, major operational plans, and resource mobilization goals during the period. In February 1983 NDB completed an Operational Plan for 1983 detailing operational and staffing targets in accord with the Strategy Statement. During negotiations, minor modifications in the Strategy Statement were discussed with agreement in substance reached on the revised draft (Annex 5). The adoption of the Strategy Statement by NDB's Board would be a condition of NDB's participation in the project. Any changes in the Strategy Statement would require prior consultation with IDA and, in the case of the Policy Statement, IDA's prior approval.

Procedures and Standards

4.06 Appraisal Standards. In the initial period of NDB's operations, extensive local and foreign training in project appraisal was provided: ICICI developed a detailed operations manual, and the senior advisor assisted in strengthening NDB's appraisal standards. As a result, NDB's appraisals are of good quality, providing adequate coverage of technical, market and financial aspects. For all projects receiving direct assistance, NDB calculates the financial rate of return; for subloans of over US\$400,000 equivalent, NDB calculates the economic rate of return and, normally, the domestic resource cost ratio (DRC). While most projects have substantially higher economic rates of return (para 4.11), 10% is used as the normal minimum cutoff point. Appraisals and management review are completed in four to six months which is satisfactory for large scale projects. NDB is modifying its appraisal format and procedures to accelerate processing of smaller equipment loans, to become more competitive with leasing.

4.07 Implementation and Supervision. In March 1982, NDB created a Supervision and Follow-up Department. The operations manual includes adequate supervision procedures; ICICI is training NDB's six follow-up officers. The department is expected to expand to ten officers by December 1983 and 15 officers by December 1984. This should be adequate for supervision of NDB's direct loans. NDB's procedures require the follow-up officers to visit all projects in the direct loans portfolio every six months, with more frequent visits made to complex or problem projects.

4.08 Procurement, Legal and Accounting. NDB's procurement standards are satisfactory for the proposed project (para 7.06) and conform to the Bank's recommended practices for development banks. Three competitive quotations are required for both domestic and foreign procurement, and procurement decisions are checked for price and technical adequacy of the equipment. Simplified procurement practices would be adopted for small equipment financing operations, and for contracts for goods and services of below US\$50,000 equivalent. As part of the consortium arrangements, NDB's legal agreements are being streamlined and standardized to conform with those of other lenders. NDB's accounting procedures and standards also are satisfactory and are subject to an adequate annual audit by the Auditor General, or an auditor acting on his behalf.

C. Operating Performance

Characteristics of Past Assistance

4.09 At December 1982, NDB had approved finance totalling Rs 1.1 billion (US\$48 million) for 1,910 projects (net of cancellations). Direct loans to 62 projects accounted for Rs 833 million (US\$36 million), or 75% of the total; refinance of 1,848 SMI projects since January 1980 represented Rs 249 million, or 23%; and eight equity investments accounted for the remaining Rs 21.2 million, or 2%. During the same period, NDB's disbursements totalled Rs 694 million (US\$30 million) with 70% against direct loan approvals, 28% in refinance, and the remaining 2% in equity.

4.10 Direct Lending Operations. In FY80, NDB's net approvals of direct loans amounted to Rs 240 million for 17 projects with costs totalling Rs 809 million (Annex 6). In FY81, net approvals amounted to Rs 236 million for 19 projects costing Rs 702 million. In FY82 NDB increased its direct lending assistance by 55% to Rs 365.2 million for 31 projects; total investment in these projects amounted to Rs 692 million, of which 53% was financed by NDB, 12% by other institutions, and 35% by sponsors' equity. NDB's assistance to the public sector, which was almost exclusively to support balancing, modernization and replacement, increased from 20% of the FY81 amount to 33% in FY82. In FY82, the private sector accounted for 23 projects; the public sector, seven; and one project was jointly owned. Projects were well distributed by subsector, with metals, chemicals and engineering accounting for 34% of the amount of lending, hotels 18%, rubber and leather products 15%, agro-industries 11%, textiles 9%, and miscellaneous 13%. Fourteen loans (45% by number) were for less than Rs 10 million (US\$442,000) and one loan was over Rs 25 million (US\$1.1 million); the majority were in the Rs 10 to 25 million range. Of the 31 projects, 17 were for new enterprises and 14 involved balancing, modernization, rehabilitation or expansion (BMRE). About 44% of total approvals were for projects located outside the Colombo area.

4.11 The weighted ex-ante average financial rate of return of projects approved for direct loans since 1980 is 18% with a range of 11% to 46%. Estimated ERRs of 14 larger projects range from 18% to 50%, with a weighted average of 32%. These investments are expected to earn or save about US\$33 million in foreign exchange annually and are expected to create some 4,700 jobs; average fixed asset costs per job are about US\$23,000. This ratio reflects NDB's concentration in hotels, some capital intensive investments in

the public sector (e.g. Ceylon Oxygen), and the relatively high proportion of BMRE lending in NDB's portfolio.

4.12 Refinance Operations. Under SMI I, NDB approved refinance for 1,547 subloans (net of cancellations) amounting to Rs 255 million. Of this amount, Rs 194 million had been disbursed and Rs 54 million repaid, leaving an outstanding portfolio of Rs 140 million. Arrears have been low with about 70% of amounts falling due having been repaid. Most SMI loans have been for food processing, construction materials, wood products, and engineering firms. The average subloan size is Rs 167,000 (US\$7,260). An estimated 17,000 jobs have been created, at a fixed capital cost of about US\$1,100 per job. The Second SMI Project provides a further US\$28 million in refinance, and as of March 31, 1983, 165 subprojects had been refinanced by NDB.

4.13 Equity Investments. NDB has invested Rs 10.3 million in ordinary shares of five of its clients. It also has underwritten the ordinary share issues of two companies to a value of Rs 6 million. In addition, NDB has invested Rs 3 million in preference shares of a rubber based manufacturing company client. The proportion of NDB's resources invested in equities is expected to increase (para 3.05).

Other Developmental Activities

4.14 Objectives and Focus. In addition to its normal financing operations, NDB's activities include: stimulating the capital market through development of an equity fund; taking the lead in development of consortium arrangements; preparing detailed subsector analyses; identifying and actively promoting new projects; and undertaking relevant economic analysis and industrial studies.

4.15 Subsector Analysis and Project Development. NDB has given inadequate attention to subsector analysis, project promotion and business development. Under the project, NDB would establish a Project Identification and Business Development Unit to conduct subsector studies aimed at identifying opportunities for investment, promote suitable projects and entrepreneurs, and undertake market potential studies. The IDP would provide 12 man-months of consultancy by a person experienced in project and business development, and subsector analysis. In addition to these direct efforts by the new Unit, NDB would emphasize: the development of close ties at a senior management level with existing businessmen; appropriate publicity to advertise NDB's facilities; close coordination with established investment promotion bodies, including FIAC, EDB and LIAC; business development with existing and potential clients; and investments for energy efficiency. During negotiations, the functions and staffing of the Project Identification and Promotion Unit were agreed, as well as the terms of reference for the Project Promotion Advisor (Annex 7). Establishment of the Unit, with adequate initial staffing, would be a condition of NDB's participation in the project; at a minimum, a Unit head and two officers with experience in project and business promotion and subsector analysis would be needed.

4.16 Project Development Facility (PDF). NDB has a PDF of US\$750,000, of which US\$500,000 is financed by UNDP under an IDA executed TA program and US\$250,000 equivalent in Rupees has been contributed by NDB. The facility is designed to provide consultancy on feasibility studies, the costs of which are recoverable in project implementation, or written off if the study fails to result in a project. Utilization of the PDF, established in October 1980 with

UNDP financing has been slow. By December 31, 1982, a total of US\$110,000 had been committed: US\$25,000 for the preparation of eight project profiles and US\$85,000 for five project feasibility studies and one rehabilitation study. Five additional studies are under discussion and are likely to be included under the PDF, which would commit about an additional US\$200,000.

D. Financial Aspects

Portfolio

4.17 Quality. As of December 31, 1982 NDB loan portfolio stood at Rs 612.2 million (US\$27 million), of which 75% was in direct loans. Of the 62 projects approved for direct lending, only three were in arrears of principal and interest payments, amounting to Rs 16.6 million or 3.6% of the portfolio. Thus, NDB's arrears situation is satisfactory. The quality of NDB's portfolio should be monitored closely to avoid a build-up of arrears. On SMI operations, for which arrears also are low, the commercial banks bear credit risks. The quality of the equity portfolio is satisfactory; two of the six companies have declared dividends, while the other four projects are still under construction.

Financial Performance

4.18 Profitability. In FY81, NDB's gross income was Rs 120 million (Annex 8), of which 28% was from interest on project lending, 71% from term deposits and 1% miscellaneous. 1/ In FY82, gross income was Rs 154.2 million of which nearly 50% was in interest on project lending. The ratio of income from direct operations is expected to increase to about 75% in FY84 as disbursements increase. NDB's administrative costs, amounted to 2.1% and 1.7% of portfolio assets in FY81 and FY82 respectively. After deduction of administrative costs, interest and other expenses, and making provisions for doubtful debts, NDB showed substantial net profits of Rs 105 million in FY81 and Rs 125 million in FY82. 2/ As NDB is exempt from taxation for the first ten years of operations, and no dividend has yet been declared, reserves and retained earnings have contributed substantially to NDB's total resources; retained earnings stood at Rs 12.1 million on December 31, 1982, and general and special reserves were Rs 350 million, after annual appropriations from the profit and loss account.

4.19 Capital Structure. At December 31, 1982, NDB's shareholders' equity totalled at Rs 962 million, of which Rs 362 million, or 38% represents reserves and retained earnings (Annex 8). NDB's total borrowings at that date amounted to Rs 283 million, resulting in a debt:equity ratio of 1:3.4. As a result of NDB's substantial equity, returns to equity from direct lending operations in its initial years of operation have been low, around 8%. However, total return, including income on term deposits, is about 13%, which is satisfactory.

1/ Primarily commitment fees, syndication fees and other project related charges.

2/ Excluding provisions for bad debts of Rs 10.8 million in FY81 and Rs 11 million in FY82, or 2.6% of the direct lending portfolio.

Operational Forecasts

4.20 Operations and Pipeline. NDB's operational forecast (Annex 6) is based on relatively conservative assumptions. Direct lending and equity approvals are expected to maintain the same level in FY83 as in FY82 (about Rs 370 million), to grow by 15% to Rs 434 million in FY84; and thereafter increase by between 11% and 15% p.a. Foreign exchange commitments are estimated to be about US\$7.0 million in FY83, US\$8.0 million in FY84, US\$9.2 million in FY85, and US\$10.4 million in FY86, with foreign exchange commitments of about US\$35 million during the project period. NDB's pipeline as of March 31, 1983 consisted of 26 projects in various stages of appraisal, with total foreign exchange requirements of about Rs 500 million (US\$22 million). NDB's foreign exchange commitments in those subprojects likely to be financed are projected to be roughly Rs 345 million (US\$15 million). While pipelines might represent no more than 50% of ultimate lending over a project period, NDB's current pipeline indicates a firm basis for the proposed credit amount. As of March 31, 1983, NDB had uncommitted foreign exchange of US\$5.0 million, ^{1/} which is expected to be fully utilized by October 1983. Domestic currency requirements for direct lending, any other refinance schemes and equity investments will be met from NDB's own domestic resources.

4.21 Of the 26 projects in NDB's pipeline, only one is for a new public sector enterprise (a caustic soda project as a joint venture involving three public sector corporations, for which NDB is considering a loan of about Rs 40 million (US\$1.7 million); five projects involve BMR for existing public enterprises, amounting to US\$7 million of foreign exchange requirements, or 32% of NDB's foreign pipeline. The remaining 20 projects are in the private sector. Thus, the pipeline reflects NDB's strategy to concentrate on the private sector and to restrict its public sector lending largely to corporations positioned to make viable balancing and modernization investments. The proposed technical assistance component for improving public sector efficiency (Chapter VI) has direct linkages to NDB's investment strategy. The subsector distribution of projects in the pipeline is similar to NDB's past investments (para 4.10) with less emphasis on textile investments due to the difficulties of some of the larger spinning and weaving mills, and greater emphasis on agro-industries (projects for sea food processing, vegetable oils, sugar and fruit canning). With interest rate rationalization (para 2.13), NDB will be involved in financing a greater proportion of export-oriented projects utilizing IDA funds.

^{1/} The ADB loan of US\$10 million less US\$5 million in committed subprojects, based on authorizations by ADB. The ADB loan moved more slowly than expected since: ADB questioned the viability of a few projects; procurement problems arose as the country of origin was not an ADB member; the ADB line of credit excluded tourism; and the subsidized rate for export projects under the Central Bank refinance scheme limited ADB's subloans mainly to import-substitution projects.

4.22 Financial Projections. NDB's financial projections are provided in Annexes 8 and 9. Net profits are projected to increase from Rs 125 million in FY82 to Rs 206 million in FY86, an annual increase of 13%. Average returns on equity are expected to be between 14% and 16%. As disbursements on direct operations increase from their FY82 level of Rs 213 million (US\$9.3 million) to Rs 510 million (US\$22 million) in FY86, interest on project lending as a percentage of total income is expected to increase from 45% to 95%. In FY83/84, NDB expects to invest Rs 100 million in the equity fund. Total assets (excluding SMI operations) are expected to grow from Rs 1.3 billion in FY82 to Rs 3.2 billion in FY86, an annual growth rate of about 25%. During the period, NDB expects to expand its borrowings from the FY82 level of Rs 76 million (US\$7.9 million) to Rs 900 million (US\$40 million) in FY86. The expected high retention of profits is forecast to increase shareholders' equity from Rs 962 million (US\$42 million) in FY82 to Rs 1.6 billion (US\$70 million) in FY86, resulting in a low debt:equity ratio of around 1:1 in FY86. NDB's debt-service coverage ratio (DSCR) is expected to be above 2.0, which is satisfactory.

V. THE DEVELOPMENT FINANCE CORPORATION OF CEYLON (DFCC)

A. Institutional Aspects

Ownership and Resources

5.01 DFCC was established in 1955 by an Act of Parliament 1/ to finance private enterprises involved in industry, agriculture, commerce, hotels, transportation, and construction; the Bank's first loan to DFCC was made in 1967. DFCC's Rupee resources consist of authorized share capital of Rs 300 million, of which Rs 100 million is paid-up, and an interest free loan of Rs 16 million from GOSL. In two "rights issues" offered during March/April 1983, DFCC successfully raised Rs 70 million. The improved profitability of DFCC's operations in recent years, and the fact that one-third of dividends on DFCC shares are tax free, contributed to the high demand for the shares. After the share capital increases, the private sector held 56% while government-owned banks (Bank of Ceylon and People's Bank) owned 44%; IFC (9.9%), FMO (12.5%), 2/ DEG (10%), 3/ and foreign commercial banks (3%) held 35% of DFCC's share capital. Sri Lankan private sector shareholders (21%) consist of companies and individuals; most of the 500 private shareholders own less than 500 shares each, illustrating DFCC's broad-based ownership. DFCC's shareholding by the two main commercial banks will help DFCC develop joint working capital and term funding arrangements (para 5.21). The enlarged share capital should provide DFCC with adequate financial flexibility in the medium term.

1/ In November 1982 Parliament passed an amendment to DFCC's Act which made several changes in the authorized share capital, dividend payout ceilings, and composition of the Board of Directors.

2/ Nederlandse Financierings Maatschappij voor Ontwikkelingstanden NV (the Netherlands Finance Company for Developing Countries).

3/ Deutsche Gesellschaft für Wirtschaftliche Zusammenarbeit (German Corporation for Economic Cooperation).

5.02 IBRD loans of US\$4 million and US\$8 million in the 1960s, IDA credits of US\$4.5 million and US\$8 million in 1975 and 1977, and loans from ADB for US\$5 million and US\$10 million in 1976 and 1980, respectively, have comprised the majority of DFCC's foreign exchange resources. In 1982, FMO approved a loan of 8 million guilders (US\$3.0 million) for DFCC's operations. Rupee loan resources have been provided by Central Bank refinance, the Bank of Ceylon and the National Savings Bank.

Board, Management and Staffing

5.03 Board and Management. DFCC's revised Act provides for an eleven member Board of Directors: six members elected by the shareholders; two appointed by the Government; two representing foreign investors (IFC and FMO/DEG); and the General Manager as an ex-officio member. Two of the positions to be elected by shareholders are vacant as a result of resignations by directors who had served in excess of the newly stipulated maximum of eight years; these members will be elected once the composition of shareholdings as a result of recent share issues is finalized. In December 1981 the Board approved the creation of an Executive Committee consisting of the Chairman, General Manager and three Board members to discuss administrative issues on a semi-monthly basis. The full Board meets monthly, with meetings proceeding smoothly under the new Chairman, Mr. B. Mahadeva, appointed in December 1982. 1/ The General Manager (GM), formerly Deputy General Manager in Bank of Ceylon, also has made a positive impact on the organization during his first two years of office. The Board has delegated approval of projects up to Rs 2 million to the GM.

5.04 Organization and Staffing. DFCC's organizational structure consists of six departments. In December 1981, to reduce the supervisory load on the General Manager, the Board approved the appointment of Assistant General Managers for Operations, Administration, and Consultancy/Merchant Banking. At March 31, 1983, DFCC had 108 staff, including 39 professionals. DFCC's salaries are reasonably competitive with NDB, but not with the foreign banks and private industry. The quality of DFCC staff remains good and management continues to place an appropriate emphasis on training; in 1982, eight officers were sent on courses abroad, and seven officers attended local training seminars. DFCC also organized a management seminar with external consultants, mainly to train DFCC staff. Under the proposed project, 24 man-months of short-term training would be provided at Asian development banks and regional institutes.

B. Operating Policies, Procedures and Standards

Policies and Strategy

5.05 DFCC's Statement of Policies provides a satisfactory framework for its assisting private sector manufacturing projects. It also establishes exposure limits: (a) total exposure in a single enterprise is limited to 20% of its own equity; (b) individual share investments are limited to 10% of its own equity

1/ Mr. Mahadeva is Director-General of Planning in the Ministry of Finance.

and 25% of the share capital of the enterprise; and (c) the aggregate of ordinary share investments is limited to the amount of its own equity. In the past, these limits, particularly the total exposure limit of 20%, hampered DFCC's operations, restricting its maximum loan size to less than US\$750,000 equivalent. However, the recent increases in DFCC's share capital have increased its maximum exposure in a single project to about Rs 40 million (US\$1.8 million). The Policy Statement also requires DFCC to maintain its debt:equity ratio at 7:1. ^{1/} To supplement the Policy Statement, DFCC's management prepared a draft Strategy Statement for the period 1982 to 1986 (Annex 10). This statement outlines DFCC's priorities and confirms its primary focus on project financing. Although the statement also refers to other activities including leasing, underwriting, and merchant banking functions, DFCC's management has decided that DFCC will continue to focus on project lending, due to staff and resource constraints, and the competitive edge which other financing institutions have in providing these services. Emphasis will be given to identifying and financing export-oriented projects and to developing new subsectors, particularly agro-based industries, rubber products and light engineering. Import-substitution projects will be eligible, provided that the projects are efficient and not dependent upon heavy protection. During negotiations, the draft Strategy Statement was discussed and agreed. Adoption of the Strategy Statement by DFCC's Board would be a condition of DFCC's participation in the project. Any changes to the Policy Statement would require IDA's prior approval; changes to the Strategy Statement would require prior consultation with IDA.

Procedures and Standards

5.06 Appraisals. DFCC's appraisals are of good quality; the Bank's past suggestions for improvements have been adopted, notably in the area of economic evaluation. The draft Strategy Statement specifies that DFCC staff will calculate the economic rate of return for all projects involving foreign exchange subloans of more than US\$250,000 equivalent, and as with NDB, a 10% minimum limit is prescribed. ^{2/} The domestic resource cost (DRC) per unit of foreign exchange earned or saved also would be calculated for these sub-projects.

5.07 Promotion. Since DFCC is now in competition with other financial institutions, it needs to become more active in business and project promotion. DFCC should liaise with FIAC, LIAC and individual entrepreneurs to ascertain which projects are being developed. A project promotion unit, with staff experienced in subsector analysis and business development, would enable DFCC to identify suitable projects and entrepreneurs. The AGM, Operations, would oversee the work of the Promotion Department, given the close links needed with appraisal staff. The functions and staffing of the proposed promotion unit were agreed in substance at negotiations; establishment and adequate staffing of the unit would be a condition of DFCC's participation in the proposed

^{1/} Until recently DFCC was at its debt/equity limit. The recent share capital issues have decreased the ratio to 4.9:1, which should provide DFCC with sufficient flexibility to raise additional loans in the future.

^{2/} DFCC is reviewing the Bank's guidelines for calculation of economic rates of return and will confirm to IDA the appropriateness of this limit.

project; minimum initial staffing would be one experienced senior officer and a junior professional.

5.08 Advisory Assistance. To assist DFCC in its promotion efforts, the proposed project includes 18 man-months of technical assistance which would consist of three short assignments (about four months each) from advisors specialized in the economic, technical and business development aspects of light engineering, rubber products and agro-based industries; draft terms of reference were agreed. The remaining six man-months would be used for assistance in specific areas arising from DFCC's strategy reviews during the project period. One key area would be in formalizing collaboration arrangements with commercial banks. The advisor would be experienced in operations of development and commercial banks, and in joint financing techniques.

5.09 Project Implementation. DFCC's supervision procedures are satisfactory. The Project Implementation Department consists of disbursements and follow-up sections. During FY82, the follow-up section handled a portfolio of 195 projects, excluding the SMI projects handled by the SMI Department. The section officers make quarterly visits to projects under construction; problem projects are visited more frequently, and projects in operation are visited at least once a year. A problem projects cell was created within the follow-up section to focus attention on companies in arrears (para 5.20). The follow-up section has eight officers each handling an average of 25 projects during FY82. DFCC needs to recruit about three additional officers to handle the increased size of its portfolio and to visit problem projects more frequently. DFCC's follow-up reports are generally good.

5.10 Procurement, Legal and Accounting. DFCC's procurement standards are satisfactory. For foreign exchange subloans, at least three quotations from foreign suppliers are required, which are reviewed by DFCC's engineers and the consultancy unit. For local currency loans, DFCC requires the sponsor to obtain three alternative quotations wherever possible. With the increased interest in Sri Lanka by foreign suppliers in recent years, DFCC is able to ensure greater responsiveness to bid offers. For small equipment subloans, DFCC will ensure that machinery procured is competitive in price and quality, but three quotations would not be required if the contract does not exceed Rs 1.2 million (US\$50,000). DFCC's legal procedures and accounting statements are satisfactory.

C. Operating Performance

5.11 Operations. DFCC has assisted about 500 companies with disbursements totalling Rs 535 million. About 85% has been in loans and 15% has comprised equity investments consisting of ordinary and redeemable preference shares. For the first 20 years of its existence, DFCC's experienced slow growth, and its impact on industrial development was small. Since 1977, DFCC's operations increased significantly, but still fluctuate excessively (Annex 11). In FY79, total net approvals reached Rs 124 million, up from Rs 72 million in FY78, while in FY80 net approvals declined to Rs 49 million, largely due to management problems in DFCC and cancellations of import-substitution projects which had become unviable under the liberalized import regime. In FY81, DFCC's net approvals almost quadrupled to Rs 183 million, and in FY82, increased to Rs 211 million. However, in FY83, net approvals fell to Rs 49 million. Commitments show a similar pattern, while disbursements have increased steadily: Rs 71

million in FY79, Rs 95 million in FY80, Rs 118 million in FY81, Rs 163 million in FY82 and Rs 148 million in FY83. DFCC's management has instituted measures to restore activity to the FY82 level (para 5.07).

Characteristics of Past Assistance

5.12 Subsector and Area Distribution. DFCC's financing of tourism projects increased in FY79-82, accounting for 10%, 21%, 35% and 47% of approvals in those years. Since April 1982, DFCC has refused all applications for hotel projects and by December 31, 1982 the tourism sector accounted for 28% of DFCC's portfolio, down from 32% in the previous year. Chemical products were the second largest subsector (14%), followed by textiles and ready-made garments (9%), rubber products (8%), light engineering (4%), and food processing (4%). DFCC's projects continue to be concentrated in the western region, particularly in and around Colombo, where most medium-scale manufacturing opportunities exist; hotel projects are more dispersed in the south and central regions. The average size of DFCC's loans and investments rose from Rs 1.3 million in FY79 to Rs 2.3 million in FY82, due to inflation and to fewer equity investments.

Development Impact

5.13 Foreign exchange costs of manufacturing projects approved by DFCC during FY79-FY82 amounted to Rs 573 million (US\$25 million), or 54% of total costs. DFCC assistance totalled Rs 232 million (US\$10 million) with the remainder from NDB, commercial banks, equity contributions and suppliers' credits. Of the 201 manufacturing projects financed in this period, 71 were small-scale and 130 were medium and larger-scale; 108 new projects created employment of some 8,210 jobs at an average investment cost of US\$5,380; the remaining 93 projects were for balancing, modernization and replacement. The foreign exchange earned or saved by a sample of 36 of these projects is about Rs 270 million (US\$11.8 million per annum). An analysis of a random sample of 25 of DFCC's 44 hotel projects indicates an average investment cost per job of Rs 302,900 (US\$13,200). About 30% of the projects were new enterprises, 54% were expansion, and 10% were BMR. The remaining 9% financed cost overruns and for shortfalls in financing plans. The ex-ante financial rates of return for the new projects approved in FY82 ranged from 12% to 48%, with a weighted average return of 19%; the internal economic rates of return (on a sample of four subprojects) ranged from 15% to 47%, with a weighted average of 29%. The domestic resource cost (DRC) estimates ranged from Rs 8.90 to Rs 18.60 (below the exchange rate at the time), indicating that most projects were economically attractive. Annex 12 is a synopsis of the 15 projects above the free limit ("A" projects) financed under IDA Credit 742-CE. The economic indicators show financially and economically viable projects; ex-post economic returns for the 15 "A" subprojects show a range of 12% to 40%, with a weighted average of 22%.

D. Financial Aspects

Portfolio

5.14 Loan Quality. DFCC's loan portfolio was Rs 497.5 million as of December 31, 1982. The quality of this portfolio remains good, although DFCC's arrears have increased in recent years. As of December 31, 1982, arrears of principal and interest amounted to Rs 45.4 million or 9.1% of the outstanding

portfolio compared to 1.8% in June 1979. About 5% of the portfolio in arrears is in companies operating at a loss or in serious technical difficulties, compared to only 0.8% in 1979. During FY79-82, collections as a percent of total dues (overdues plus amounts falling due) fell from 80% in FY79 to 64% in FY82. DFCC's management has taken the following measures to correct the arrears situation: monthly status reports are prepared for all loans in arrears and equity investments which are late in dividend payments; project implementation officers visit problem projects two or three times in a six-month period; legal actions are issued more promptly although progress in the courts is slow; and more realistic evaluations are made regarding the need for reschedulings, which amounted to about 3% of DFCC's loan portfolio in FY82. About 75% of DFCC's arrears are concentrated in three subsectors (ready-made garments, hotels and chemical firms), and in a relatively few companies, indicating that intensive supervision efforts on these companies should remedy most of DFCC's arrears problem.

5.15 Equity Portfolio. As of December 31, 1982, DFCC's investment portfolio amounted to Rs 59.1 million (about 12% of its loan portfolio) in 88 companies. In FY82, the average dividend yield on the equity portfolio was 8.8% compared to 5.4% in FY80. However, 19 of the 31 companies in which DFCC held ordinary shares did not declare dividends in FY82 while 24 of the redeemable preference shares were late in dividend declaration. The real value of DFCC's ordinary share portfolio is difficult to assess, due to the lack of active trading in many of the ordinary shares, while preference shares are not quoted on the equity market. However, if the shares were liquidated, DFCC should make reasonable capital gains on most issues. DFCC intends to continue to make share investments financed from its own resources and from cash generated by selling matured investments.

5.16 Provisions. DFCC's provisions for doubtful loans amounted to Rs 8.7 million or 2.1% of its loan portfolio as of December 31, 1982; provisions for doubtful share investments amounted to Rs 1.2 million or 2% of the equity portfolio at that date. Although the provisions appear low, the real risk of losses arising from bad debts is slight, considering DFCC's liens on the fixed assets of its clients. However, with its increase in profitability, DFCC will be in a position to make larger provisions for doubtful debts.

Financial Performance

5.17 Profitability. DFCC's income statements for FY79-82 (Annex 13) indicate that profit before tax increased from Rs 6.9 million in FY79 to Rs 26.5 million in FY82, primarily as a result of DFCC's increased lending volume. A corporate tax rate of 44% (before investment relief and other deductions) left DFCC with after tax income of Rs 18.3 million in FY82, of which Rs 2.9 million was allocated to dividends, Rs 3.8 million to special reserves ^{1/} and Rs 11.4 million to general reserves. The dividend rate was 12%. DFCC's administrative costs amounted to 1.7% of total assets in FY82, up from 1.4% in FY79, due to higher supervision coefficients of recent years and increased rental costs for DFCC's offices. Return on equity was 31.5% in FY82 compared to 27.8% in FY81,

^{1/} DFCC's Act requires that at least 20% of annual profits be set aside as special reserves and invested in fixed deposits as long as the subordinated GOSL loan is outstanding.

the high percentages reflecting DFCC's small capital base until recently. The debt-service coverage ratio (DSCR) was 1.2:1 in FY82, which is satisfactory. The cash flow statement is shown in Annex 14.

5.18 Capital Structure. DFCC's balance sheets for FY79-82 are shown in Annex 15. Total assets grew from Rs 223.9 million in FY79 to Rs 534.0 million in FY81, at a rate of 34% per annum. Shareholders' equity stood at Rs 66.3 million, of which retained earnings and reserves accounted for 64% and share capital, 36%. DFCC's debt-equity ratio stood at 6.7:1 on December 31, 1982, within the existing 7:1 limit. Under the proposed project, this limit would be maintained.

Operational Forecasts

5.19 Lending Activity. Forecasts of DFCC's lending activity are more difficult than for NDB due to erratic fluctuations in the level of DFCC's operations in recent years. Projections reflect growth of: 20% in net approvals in FY84 (still less than one-third of the FY82 level); 30% in FY85; and 10% in later years. With these assumptions, net loan approvals are expected to reach only Rs 109 million in FY86. About 60% of DFCC's commitments are expected to be for foreign exchange subloans and 40% for Rupee loans. During the period July 1983 to June 1986, DFCC's foreign exchange commitments are expected to total about Rs 250 million (US\$11 million). Due to low returns, further investments in redeemable preference shares are not assumed; a small proportion of ordinary share investments are expected out of DFCC's Rupee resources and the FMO line of credit, which was approved in 1982.

5.20 Pipeline. DFCC's pipeline of projects as of March 31, 1983 consists of 22 manufacturing projects requiring US\$4.4 million in foreign exchange, with total costs of about US\$7.0 million. Manufacturing projects show diversification with increased shares in: plastic products (19% of the pipeline); construction materials comprising 24%; rubber products, 16%; food processing, 15%; printing and packaging materials, 15%; and chemical products, 10%. The expected employment generation of the new projects is estimated to be about 1,100 jobs at a cost per job of US\$7,500. This is higher than the average for DFCC's past projects due to inflation and the reduced number of SMI projects in DFCC's pipeline.

5.21 Resources. By March 1984, DFCC is expected to have fully utilized its US\$10 million loan from ADB. Its only other source of foreign exchange consists of a loan from FMO for US\$3.2 million equivalent, of which US\$0.4 million can be used for equity investments. The proposed credit would provide the majority of DFCC's foreign exchange resources over the next three years. DFCC's Rupee resources will be met by Central Bank refinance funds and by share capital. A means of solving DFCC's Rupee resource problems could be a merger with one of the smaller commercial banks (i.e., Hatton National Bank or Commercial Bank of Ceylon) or a collaborative arrangement with the larger state-owned Peoples Bank or Bank of Ceylon. DFCC has opted for the latter course, manifested by the changes in its capital structure and arrangements to assist BOC and People's Bank in project appraisal and joint financing.

5.22 Financial Projections. Annexes 13-15 show DFCC's projected income statement, cash flow and balance sheets for FY82-FY86. As a result of its increased volume of lending, DFCC's profits before tax are expected to grow from Rs 26.5 million in FY81 to Rs 43.9 in FY86, an annual rate of 23%. After

allowing for corporate taxes of 44% and investment tax relief of about 15% (primarily on DFCC's investment shares), net income before tax is projected to grow from Rs 26.5 million in FY82 to Rs 43.9 million in FY86. However, in FY83, net income after tax is projected to be only Rs 12 million, down from Rs 18.3 million in FY82, as a result of the low lending level during the past year and increased tax liability for FY83. The cash flow projections assume a constant dividend rate of 12%. DFCC's average return on equity is expected to decline from 31% in FY82 to 14% in FY83 as a result of the share capital increase and the drop in net income in FY83. Return on equity is projected to be between 16% and 21% in the FY84-87 period. The debt:equity ratio is expected to decrease from 6.7:1 in FY82 to 4.9 in FY83 and 3.2 in FY87.

VI. IMPROVING EFFICIENCY OF PUBLIC ENTERPRISES

A. Characteristics and Role

6.01 Share and Performance. In 1981, the state industrial corporations, excluding the petroleum refinery, accounted for about 40% of industrial output and employment. The 7% return on capital employed in production, down from about 20% in 1979 and 1980, is particularly alarming since assets are undervalued, at historical, depreciated costs. Annex 16 provides performance data and key ratios for the state industrial corporations operating under MISA. Most corporations are engaged in import-substitution activities. 1/ Several of these firms, which had operated under excessive protection, as virtual monopolies, with preferential access to inputs under the previous Government, have suffered under the liberalized trade and industrial policies operating since 1977. The UNP Government has approached the problem of public enterprises by: (a) reducing budgetary transfers, hoping that the corporations would be forced to take measures to respond to increased competition; (b) improving monitoring in an attempt to increase performance accountability; and (c) introducing some measures to increase private participation in ownership and management of public enterprises.

B. Policy Measures and Government Links

6.02 Investment Policy. The present Government's policy toward public enterprises has been characterized by specific actions to "turn off the tap." Data supplied by MISA indicates that from 1979, budgetary provisions for MISA and related state industrial enterprises have been reduced markedly. 2/ The

1/ In 1981, the Petroleum Corporation, which imports petroleum and re-exports bi-products of its refining operations, accounted for over 90% of the Rs 2.6 billion of exports by state industrial corporations.

2/ The 1983 budget for MISA corporations and departments is Rs 72.4 million compared to provisions of Rs 104.3 million in 1982, Rs 126.2 million in 1981, Rs 741.7 million for 1980, and Rs 1,154.3 million for 1979. The source of these figures is MISA's summary document on "Performance of Public Sector Corporations under the Ministry of Industries and Scientific Affairs, 1982". Central Bank figures on budgetary transfers to all public sector corporations indicate other levels and trends, but disaggregations are not yet available.

1983 budget for corporations and departments under MISA is Rs 72.4 million, or 6% of budgetary provisions in 1979. The main reductions have been in capital expenditures by GOSL for the state corporations, which have fallen from Rs 663.8 million in 1979 to Rs 21.9 million (US\$960,000) budgeted for 1983, of which about Rs 18 million was for capital expenditures for bodies providing services to private industry, e.g., the Industrial Development Board and Bureau of Ceylon Standards. All other capital investments in public sector corporations, mainly for balancing and modernization, are expected to be met from internal reserves, bank loans, or suppliers' credits. However, other measures taken by the Ministry of Finance have dampened prospects for self- and bank-financed investments. During 1981, GOSL instituted a policy requiring the corporations to pay the Treasury an amount equivalent to 10% of the total capital employed prior to making any new investments, regardless of funding sources, size of investments, or profitability of the corporation. If the requirements were rigidly enforced, payment of Treasury "dividends" would leave the enterprises with little or no equity for investment projects; in most cases, this would cause liquidity squeezes affecting availability of needed working capital, which could have a major impact on efficiency, capacity utilization and profitability. ^{1/} This provision also applies to corporations investing in new joint venture companies with foreign or local private partners; thus, GOSL's objective of increasing private involvement in public enterprises has been undermined. While the Treasury should seek dividends on its substantial past investments in public enterprises, dividends should be related to profitability and should make allowances for investments needed to improve performance. During negotiations, this policy was discussed, to ensure that the policy is not enforced in the case of sound BMR investments and when viable joint ventures are proposed.

6.03 While no overall policy on expanding the private sector's role in public enterprise has been established yet, various initiatives have been taken: (a) joint ventures with foreign partners have been established; (b) private management contracts have been instituted with foreign firms for five of the textile mills, with positive results; and the Tyre Corporation has a technical contract with Goodrich for manufacturing radial and other tyres; and (c) private limited or public companies have been the preferred forms for new public enterprise activity, e.g., expanding cement and ceramic tableware capacity, a joint venture for footwear exports, and revamping the Colombo Dockyard. With each of these forms, management autonomy in operating the enterprises has increased, although retention of some government controls is likely to limit potential productivity gains from private management contracts. In the case of joint ventures and other public companies, the changes in ownership eliminate controls over operations of public corporations, at least as long as the venture is succeeding. With the management contracts in textiles, regular tendering procedures for cotton purchases have been replaced by purchases on the spot market, requiring only verbal approval from the Secretary, Ministry of Textile Industries. Over 1000 nonproductive employees have been terminated, with six months to a year of wage equivalents in severance pay.

6.04 Relevant Legislation. While these cases should have useful demonstration effects, they have occurred on an ad hoc, exceptional basis, and changes

^{1/} In fact, most corporations have negotiated lower payments to the Consolidated Fund.

in ownership structure have occurred only in the case of new enterprises. The Industrial Corporations Act specifies that only the Treasury may hold shares, and gives the Government broad, discretionary authority over the operations of the corporations. The Ministry of Finance is considering alternative legislative proposals to increase autonomy and improve performance of public enterprises. These include: (a) a new corporate law for all public enterprises, which could: incorporate increased management autonomy and facilitate more efficient enforcement of profitability norms; (b) legislation to provide for progressive moves from corporation status to the company form; and (c) a case-by-case approach by which enabling legislation could repeal the existing statute which constituted the corporation and transfer all assets and obligations to a new company. The proposed project would include technical assistance to the Ministry of Finance in: drafting appropriate legislation and determining criteria for selecting the initial corporations which would be transformed into companies. This legislation would cover corporations as well as government-owned business undertakings (GOBUs), which are nationalized enterprises which have retained loosely defined features of private industrial operations. Recently, a decision has been taken to convert GOBUs into either public sector corporations or public companies, as GOBUs have no legal status. The preference by MISA and MOFP appears to be public corporation status, resulting in reduced autonomy for the GOBUs, which is disturbing during a period in which GOSL's stated intention is to increase private sector participation in ownership and management of public enterprises. During negotiations, the legal approach to GOBUs was discussed with understandings reached that: (a) their status would not be determined until after firm-level analysis under the proposed project is completed; and (b) GOBUs would be converted to companies when their primary functions are those of commercial undertakings.

C. Programs to Improve Public Enterprises

Ministry of Industries

6.05 Most public industrial activity falls under the purview of MISA. The 16 corporations under MISA constitute 76% of capital investment, 76% of output, 60% of employment and 80% of profits in the public industrial sector. ^{1/} Under the project, the Ministry of Industries and Scientific Affairs (MISA) would have major responsibilities in: helping chairmen prepare corporate plans; channelling firm-level technical assistance to address specific problems; instituting and recommending policy changes affecting performance of the corporations; and initiating pilot schemes altering ownership and management. To implement this program over the period of October 1982 to December 1985, the Ministry of Industries is forming a Public Enterprise Cell, to facilitate coordinated action on corporate planning, progressive decontrol, monitoring, development of effective incentives in line with appropriate valuation criteria, and organization of firm-level assistance. During negotiations, the

^{1/} This pattern is distorted by the major role of the Petroleum Corporation, which constituted: 18% of capital investment, 16% of profits (excluding losses by the Fertilizer Corporation); 9% of employment; and 65% of output by state industrial corporations in 1981. If the Petroleum Corporation is excluded, corporations under MISA constitute about 72% of investment, 76% of profits, 48% of employment, and 65% of output of public sector corporations.

composition and functions of the Public Enterprise Cell was discussed, with agreement reached (Annex 17).

6.06 Corporate Plans. The project would build on the work already begun in instituting corporate plans as the basis for operating public sector enterprises. In 1979/80, the Public Enterprise Division of the Ministry of Finance and Planning, with assistance from the National Institute of Business Management (NIBM) under MISA, took the lead in encouraging corporations to prepare corporate plans. While useful in acquainting public enterprise managers with the concept of corporate planning, the plans had several weaknesses. Most corporate plans reflected confusion between objectives (e.g., public profits) and constraints (e.g., labor relations), and no clear directives were given regarding the treatment and relative priorities of noncommercial vs. commercial objectives. Also, the preparation of the plans was not accompanied by analysis of what constituted good vs. bad performance in achieving various objectives. Most importantly, public enterprise managers did not view corporate plans as the basis of increasing their autonomy; rather, Chairmen saw the plans as a tool for increasing outside controls. Finally, the Ministry of Industries was not directly involved, and thus did not use its leverage to encourage the corporations' management to take the exercise seriously. Due to these weaknesses, the quality of the plans was decidedly mixed.

6.07 Under the proposed project, the Public Enterprise Cell would assist the chairmen of the corporations and GOBUs under MISA in preparing corporate plans. The corporate planning exercise would be performed with the explicit objective of replacing outside controls over procurement, personnel, pricing, and day-to-day management with greater corporate autonomy, with a contractual system of signalling and rewarding achievement of desired results. At the outset, these plans would be prepared annually covering a rolling two to three year period. Major features of each corporate plan would include: (a) key performance targets, concentrating on improvements in public profits ^{1/} with agreement on criterion values which will constitute acceptable and outstanding performance; (b) measures to be taken by the corporation to achieve these objectives; (c) critical internal and external problems, and their impact on corporate performance; (d) valuation of assets based upon replacement rather than historical costs; and (e) performance incentives for managers who exceed the agreed targets. The phasing of the corporate planning exercise, introduction of performance incentives and successive removal of controls is discussed in Annex 14. Under the project, IDA would finance two full-time advisors to work with the Public Enterprise Cell of MISA, to assist in the installation of corporate plans and changes in the system. The term of these advisors would be from about October 1983 to October 1985; estimated costs are US\$340,000. During negotiations, agreement was reached on draft terms of reference and qualifications (Annex 17); consultants, TORs, and contractual terms would need to be satisfactory to IDA.

6.08 Policy Measures. As an essential complement to the corporate planning exercise, the Public Enterprise Cell, working closely with the Public

^{1/} Excluding from revenues and expenses all public transfers, including taxes, contributions to the consolidated fund, other dividends to the Treasury, cross-subsidization among public corporations, and expenditures for social programs.

Enterprise Division of the Ministry of Finance would analyze changes needed in government policies and procedures which currently constrain the corporations' ability to perform. Major dimensions would include: (a) tendering procedures in purchasing equipment and raw materials; (b) interference and rigidities in hiring, promotions, performance incentives, and salaries; (c) controls over investments and financial decision-making; (d) selection criteria for Boards of Directors; and (e) controls over pricing of products. These controls, which seriously impair the ability of corporation chairmen to operate efficiently, have become entrenched and will be difficult to eliminate. The Secretaries of the Ministries of Industries and Finance have indicated the commitment of their Ministries to gradually replace these day-to-day controls with a system based upon corporate planning, performance incentives and management accountability for results. The project would provide technical assistance in this task.

6.09 Firm-Level Assistance. The project would include technical assistance, provided by foreign and local consultants, to address specific problems at the corporate level. The rationale for this assistance is twofold: (a) in several cases, significant improvements in performance can be achieved by tackling firm-level problems; and (b) by implementing pilot changes in some corporations (accompanied by selective loosening of government controls), improved performance may be demonstrated, providing the basis for making changes in the system. Chairmen of most industrial corporations have expressed a strong need for such technical assistance, particularly if it is combined with changes in the system of controls, to enable greater flexibility in management. Annex 15 contains a summary of key internal and external problems faced by individual public sector industrial corporations. While firm-level needs differ, several common areas emerged from discussion with public corporate managers and analysis of corporate plans and special studies:

- (a) Personnel management, particularly in addressing overemployment and absenteeism; developing incentives which incorporate quality as well as output objectives; and devising effective training programs;
- (b) Market analysis combined with unit costing as the basis for determining those products in which the corporations can be competitive in the liberalized import environment, to enable rationalization of product mix;
- (c) Financial planning and management, which is increasingly important with the closing of the Treasury tap and which several Chairmen felt was the weakest functional area;
- (d) Analysis of balancing, modernization and maintenance requirements to improve production efficiency and cost competitiveness, and to reduce energy and raw material wastage; and
- (e) Development of quality control and management information systems.

6.10 The project would provide about 96 man-months of technical assistance to MISA corporations. The following Chairmen have identified specific needs which are likely to require about one man-year of technical assistance per corporation: Cement, Ceramics, Leather, Hardware, and Mineral Sands. All consultancy would be at the request of the relevant corporation chairmen; the

Public Enterprise Cell, with the chief advisors, would assist in preparation of terms of references and contracts, and selection of consultants, all of which would need to be acceptable to IDA. Estimated costs of this consultancy are US\$670,000. The costs of advisors and consultants would be treated as development expenditures.

6.11 Pilot Schemes. The project would encourage initiatives to increase private participation in ownership and management of public corporations, by providing technical assistance in the preparation and implementation of pilot schemes, which would include: (a) joint venture companies, with local or foreign private partners; (b) private management contracts, in those cases in which outside managerial, technical and/or marketing know-how is needed; and (c) conversion of existing corporations to companies as a means to increase autonomy and to eventually mobilize private financial resources. Formation of companies and joint ventures will continue to be given priority for all new or expanded public corporation activities. In addition to providing firm-level assistance in executing these pilot schemes, the senior advisors under the project would seek to encourage GOSL to maintain its commitment and accelerate actions on increasing private participation in ownership and management of public enterprises.

Ministry of Finance and Planning Committee on Public Enterprises

6.12 The Public Enterprise Division (PED) of the Ministry of Finance ^{1/} has launched several initiatives to improve public enterprise performance. In 1982, under UNDP financing, the Ministry of Finance and Planning invited a team of international experts on public enterprise management to analyze operations of the public sector corporations, and the government systems affecting their operation; particular attention was given to analyzing and making recommendations regarding the role of the Public Enterprise Division of MOFP. Several elements of the technical assistance to be provided to MOFP under the project emanate from the recommendations of this report. Major findings of the team include the following:

- (a) Corporations should be expected to focus on financial objectives; financial performance and social objectives should be demarcated clearly;
- (b) Of the various modes of "privatization" under discussion by GOSL, the favored and most practical options are joint ventures, management contracts, floating of subsidiary companies, and encouraging public enterprises to run as business concerns;

^{1/} A Parliamentary Committee on Public Enterprises (COPE) was established in 1979, to review performance of state corporations and to recommend measures to improve their efficiency. The PED serves as a technical arm of COPE. In 1982, a COPE delegation undertook a study of public enterprises in other countries; a report on their findings and implications for Sri Lankan public enterprises has been prepared; the report illustrates the continued resistance by some officials and MPs to reduce controls and to enable the corporations to focus on productivity and financial objectives.

- (c) There is a clear need to rationalize the capital structure of public sector corporations, revaluing assets and clarifying the structure of loans vs equity;
- (d) Dividends paid to the Treasury should be linked to net profits and sound reserve practices;
- (e) Investment decision-making affecting public sector corporations needs to be streamlined;
- (f) Corporate planning, involving Chairmen and supervising ministries should be utilized as a means of outlining performance evaluation criteria and increasing management autonomy;
- (g) Management information systems need to be improved and streamlined, at both operating and evaluation levels, to increase accountability, enable performance incentives, and justify reduction in central controls; and
- (h) The present structure of controls, affecting nearly every significant managerial decision, needs to be dismantled.

The Group recommended that PED remain the advising arm to COPE, and that it continue to serve as the "focal point" dealing with matters concerning public enterprises which transcend the supervisory work undertaken by line ministries. PED would improve management information and performance evaluation systems; and spearhead corporate planning, financial policy and structural policy issues, working in close cooperation with line ministries.

6.13 The proposed project would support PED in strengthening these functions. About US\$450,000 would be provided in technical assistance and training in the following areas: (a) accounting and management information systems; (b) review and reform of controls affecting all public sector corporation performance; (c) corporate planning and performance evaluation for non-MISA corporations; and (d) structural and legal changes to increase private participation in ownership and management. PED would work closely with the Public Enterprise Cell of MISA to ensure coordinated approaches and maximum decentralization of functions. Coordination meetings between the Public Enterprise Cell of MISA and PED would be held at least monthly, chaired by the MISA Secretary. During negotiations, implementation schedules and coordination were discussed, with agreement reached on composition of the Coordinating Committee (Annex 17).

Organization and Procedures

6.14 Prior to disbursements for their public enterprise programs, the Ministry of Industries and the Ministry of Finance, respectively, would prepare implementation plans and first-year action programs acceptable to IDA. Each agency also would prepare, by November 30 of the prior year, action plans for years two and three of the project. During negotiations, agreement in substance was reached on the implementation plan for MISA's program to improve public enterprise performance. Qualifications, terms of reference, and contractual arrangements for all consultants would need to be acceptable to IDA. For convenience, the Ministries of Finance and Industries would channel

authorization and withdrawal requests and quarterly progress reports through NDB.

VII. THE PROPOSED CREDIT

7.01 Arrangements for the Credit. The proposed IDA Credit of SDR 23.1 million (US\$25 million equivalent) would be made to the Government of Sri Lanka on standard IDA terms and conditions. The Credit provides for a commitment period of three years and disbursement in five years. GOSL would onlend US\$23.0 million of the credit to NDB and DFCC through subsidiary loan agreements with each institution. The amounts available to NDB and DFCC would be determined on the basis of actual commitments, with no preallocation by bank; GOSL would pass the proceeds of the credit to NDB and DFCC in Rupees, with GOSL bearing the foreign exchange risk on repayments to IDA. Repayments to GOSL would be on interest rates resulting in a fixed spread of 3% to NDB and 4% to DFCC (para 7.03).

7.02 Technical assistance funds of US\$2.0 million would be utilized for consultancy and training for the Ministry of Industries, Ministry of Finance and the development and commercial banks. NDB would be responsible for administering technical assistance for the commercial banks (US\$0.4 million) and for channelling authorization and withdrawal requests from the Ministries of Finance and Industries to IDA. Costs of the technical assistance component, which are outlined in Annex 4, would not be repayable to GOSL as they constitute development expenditures. These technical services are expected to result in improved output and profitability over the medium term, which would result in tax and dividend revenue for GOSL, and achievement of employment and output objectives.

7.03 On-lending Terms and Conditions. Given GOSL's recent important modifications in interest rates (paras 2.13 to 2.15), and objectives of rationalizing lending rates the initial onlending rate to be charged to subborrowers by NDB and DFCC would be 14%. As in previous SMI and DFCC credits, the foreign exchange risk would be borne by the Government. The 14% on-lending rate reflects reductions in inflation and is positive in relation to medium term inflation projections (para 2.14). The Government has confirmed that during the disbursement period of the IDP, the lending rate and refinance percentages under the Central Bank's medium and long term industrial refinance schemes would be adjusted as necessary to ensure that final onlending rates for industry are not lower than those charged by NDB and DFCC under the Industrial Development Project. The on-lending rate to industrial borrowers would be reviewed semi-annually, and would be revised if necessary to ensure that rates remain positive in relation to medium term inflation projections and consistent with minimum commercial bank rates for industry. If lending rates are revised, the new rates would apply only to loans not yet approved prior to the revision. Initially, GOSL would on-lend the proceeds of the credit to NDB at 11% and to DFCC at 10%, which would provide them a spread of 3% and 4% respectively, sufficient to cover administrative costs and risks of default on subloans approved under the project. The higher spread to DFCC is justified since it is subject to the corporate income tax of 44%, whereas NDB's income is tax free for 10 years; also the average DFCC subloan size is expected to be lower, with resultant higher administrative costs as a percentage of subloan size. GOSL would pay the standard commitment fee on the undisbursed amount of the credit;

NDB and DFCC would charge their subborrowers a similar commitment fee. The initial framework of the proposed rates and spreads would be:

	<u>Initial Rates and Spreads</u> (per annum)	
	<u>NDB</u>	<u>DFCC</u>
Final on-lending rate	14%	14%
Fixed spread to DFCC and NDB	3%	4%
Rate charged by GOSL	11%	10%
IDA Service charge	0.75%	0.75%

The above rates and spreads were agreed at negotiations. The continued appropriateness of these terms would be monitored during the commitment period.

7.04 Amortization. Repayment from NDB and DFCC to GOSL would be based on a fixed amortization schedule of 18 years including 5 years grace. The repayment periods of subborrowers to NDB and DFCC would not exceed 15 years, including three years' grace; most subloans would be for 7 to 10 years. Repayment from GOSL to IDA would be the standard 50 years amortization schedule, including 10 years of grace.

7.05 Maximum Size, Free Limits and Subloan Review. The maximum size of eligible subloans under the proposed project would be determined by the exposure limits of NDB and DFCC; at present, NDB can provide a loan of up to Rs 100 million (US\$4.4 million) and DFCC a loan of up to Rs 40.0 million (US\$1.8 million). In the case of NDB, prior IDA review and approval would be required for all subloans above US\$400,000 (Rs 9.2 million). Also, since NDB is a new client of IDA in direct lending operations, the first three private and first three public sector subprojects, irrespective of size, would require prior IDA review and approval. It is estimated that 40% of NDB's subprojects by number and 70% by amount would receive prior IDA approval. In the case of DFCC, all subloans above US\$250,000 would be submitted to IDA for prior review and approval; this free limit is expected to result in about 30% by number and 60% by amount receiving prior IDA review and approval.

7.06 Procurement. Limited international bidding would be required for individual contracts above US\$2 million. In these cases, NDB and DFCC would insist that project sponsors contact embassies and trade representatives of IDA member countries; however, they would not be required to advertise in international publications as reflected in the Bank's Procurement Guidelines (section 1.02). For smaller contracts, NDB and DFCC would employ their existing procurement procedures (paras 4.08 and 5.10) which conform to the Bank's standard practices for DFCs. In most cases, machinery and equipment would be procured by obtaining at least three competitive quotations from established sources. Only under the special component for equipment loans to be processed on an accelerated review basis, NDB and DFCC could submit subloan applications with procurement requests based on less than three quotations if the amount of each contract was less than US\$50,000. NDB and DFCC would be expected to maintain records of the method of procurement and to monitor utilization of subloans through regular supervision activities.

7.07 Disbursement Procedures. The estimated disbursement schedule is shown in Annex 19, which reflects the profile of actual disbursements of Bank-wide

DFC projects. IDA would disburse against 100% of the foreign exchange costs for machinery and equipment of eligible subloans and 70% of the costs of imported equipment bought off the shelf, corresponding to the estimated foreign exchange content of these items. As in the case of prior Bank/IDA loans to DFCC, full documentation of expenditures would be submitted to IDA. For the technical assistance component, IDA would finance 100% of expenditures for consultants' services and overseas training.

7.08 Reporting, Accounts and Auditing. As at present, NDB's and DFCC's accounts would be audited by external auditors; NDB would be subject, as DFCC has been, to the provisions of the long-form audit. The accounts of sub-borrowers would be audited according to their established practices and the covenants in the subloan agreements. For public sector subborrowers, accounts of the Auditor General would be submitted to IDA. IDA shall have the right to require that corporations contract the services of auditing firms, as considered necessary. NDB and DFCC would submit quarterly progress reports covering their operations under the loan and related institutional developments; financial statements would be submitted semi-annually. The Ministries of Finance and Industries would submit quarterly reports covering progress under the public sector technical assistance program.

VIII. BENEFITS AND RISKS

8.01 Benefits. The project benefits would consist of incremental investment and improved output and efficiency in private and public industrial enterprises. Direct benefits of the lending component would include US\$41 million in additional fixed and permanent working capital investment, with about US\$35 million in incremental annual output once projects become fully operational. Direct employment creation would depend on the composition of subprojects presented by NDB and DFCC; a rough estimate of jobs to be created would be about 2,500, with fixed assets per job averaging about US\$15,000; in addition, productivity of workers in existing enterprises would be increased through balancing and modernization investments. Technical assistance to improve the development banks' subsector analysis and project promotion efforts are expected to result in an increased proportion of term lending being channelled to subsectors with higher indigenous raw material content and stronger forward and backward linkages (e.g. agro-industries, rubber products, engineering industries, and tourism investments outside Colombo).

8.02 The improvement of consortium lending arrangements involving the development banks, commercial banks, and investment funds would increase the quantity and quality of projects financed, by improving appraisal standards, spreading risks on larger industrial investments, and attracting more funds to industrial finance. Also, the establishment of the new equity fund, to be administered by NDB, will help bridge gaps in the capital markets, addressing equity constraints in larger industrial investment. GOSL and the financial institutions view these measures as important steps in improving term financing instruments.

8.03 The project also is expected to yield direct benefits in improving performance of public enterprises, supporting moves to increase autonomy, introducing performance incentives, tackling firm-level problems, and accelerating the process of increased private sector involvement in ownership and management. Improvements in the tariff structure and industrial export

incentives would encourage increased investment in efficient industrial enterprises based on Sri Lanka's comparative advantages.

8.04 Risks. A risk of the lending component of the proposed project is that an adequate number of eligible subprojects might not materialize, due to uncertainties in a recessionary environment. However, the pipelines and projections of NDB and DFCC indicate credit demand well in excess of the amounts provided under the credit given that the Bank Group's lending for the IDP was reduced from US\$35 million to US\$25 million to reflect the current investment climate. It is probable that full commitment of the US\$23 million IDA subloan component will be achieved in less than three years provided under this project.

8.05 Success of the program to improve performance of public enterprises will require strong commitment by the relevant Ministries to: (a) replace controls with a system of accountability and performance incentives; and (b) encourage increased private participation in ownership and management. While strong support for the proposed program has been obtained, implementation will involve a delicate process; many controls are entrenched, and there will continue to be varying views on the appropriate role of public enterprises. A detailed implementation plan, agreed during negotiations, reflects commitment to concrete action in a much needed program to improve public enterprise performance.

IX. RECOMMENDATIONS

9.01 During negotiations, agreements or understandings between IDA and GOSL/NDB/DFCC were reached on:

- (a) on-lending terms and conditions, spreads, and subproject eligibility criteria (paras 3.03 and 7.03);
- (b) administrative arrangements and financing of consultants, including draft terms of reference, with provision that qualification, terms of reference and contractual conditions for the consultants would be acceptable to IDA (paras 3.04-3.09, 4.04 and 5.08);
- (c) the basis for a phased action program for tariff reform incorporating the findings of the Effective Protection Study which the Government would submit to IDA by June 30, 1984, and on which implementation would commence by September 30, 1984 (para 3.08);
- (d) outline of the study of industrial incentives (para 3.09);
- (e) components, institutional arrangements, costs and counterpart financing requirements (paras 3.10, 7.01-7.04);
- (f) staffing of project promotion units in NDB and DFCC (paras 4.15 and 5.07);

- (g) a detailed implementation plan for MISA's program to improve public enterprise performance; contents of annual action plans, acceptable to IDA, to be prepared by MISA and MOFP by November 30 each year; and composition of the MISA cell and (para 6.14); and
- (h) procedures for procurement, disbursement, review, reporting, accounting and auditing (paras 7.06-7.08).

9.02 Conditions of participation for NDB and DFCC in the project would be that:

- (a) The Boards of Directors of these institutions approve their respective Strategy Statements (paras 4.05 and 5.05); and
- (b) that NDB and DFCC establish project identification and promotion units (paras 4.15 and 5.07).

9.03 Conditions of effectiveness for the proposed credit would be that:

- (a) at least one bank had complied with conditions of participation; and
- (b) subsidiary loan agreements, satisfactory to IDA, be signed between GOSL and NDB and DFCC respectively (para 7.01).

9.04 Development of an implementation plan and establishment of a Public Enterprise Cell with adequate staffing (paras 6.05 and 6.13) would be a condition of disbursement of the technical assistance to the Ministry of Industries for its program to improve public enterprise performance.

SRI LANKA

INDICATORS OF PERFORMANCE IN LARGE INDUSTRIES

	Share in % of Total ^{1/}				Ratio in Rupees		
	Number of Firms	Value Added	Fixed Investment	Employment	Fixed Investment per Employee	Value Added per Employee	Value Added per Rupee of Fixed Investment
<u>Food, Beverage & Tobacco</u>	9	32	17	20	21,700	40,300	1.86
(Sugar)	(1)	(1)	(5)	(6)	(16,900)	(4,800)	(0.28)
(Distilling)	(-)	(1)	(3)	(2)	(19,600)	(7,400)	(0.37)
(Tobacco)	(1)	(21)	(3)	(2)	(27,400)	(228,500)	(8.33)
<u>Textile & Garments</u>	45	26	21	41	12,860	15,600	1.21
<u>Wood Products</u>	4	3	5	6	24,400	12,300	0.5
<u>Paper Products</u>	4	5	16	5	80,200	18,200	0.23
<u>Rubber & Chemical Products</u> ^{2/}	13	10	9	7	33,100	39,400	1.2
(Soap)	(3)	(4)	(3)	(1)	(48,200)	(94,000)	(1.95)
(Tyre & Tube)	(1)	(1)	(1)	(2)	(20,300)	(22,200)	(1.09)
(Rubber)	(2)	(1)	(1)	(1)	(30,700)	(27,000)	(0.88)
(Plastic)	(3)	(1)	(1)	(1)	(35,700)	(37,000)	(1.04)
<u>Non-Metallic Mineral Products</u>	7	10	17	11	38,500	21,600	0.56
<u>Basic Metal Products</u>	1	1	5	2	47,900	12,200	0.25
<u>Fabricated Metal Products</u>	16	12	7	7	23,800	44,100	1.85
<u>Other</u>	1	1	2	1	32,700	23,700	0.72
<u>Total</u> ^{2/}	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>24,600</u>	<u>24,900</u>	<u>1.01</u>

^{1/} Figures do not add to 100 due to rounding.

^{2/} Excluding petroleum products.

SOURCE: Dept. of Census & Statistics,
Report on the Survey on Manufacturing Industries, 1979.

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SRI LANKA
INDUSTRIAL DEVELOPMENT PROJECT

Performance and Prospects of the Tourism Sector

1. Sri Lanka has achieved a remarkable success in attracting foreign tourists over the past fifteen years. Until the 1960s, tourism stagnated at a low level with visitor arrivals, on business or pleasure, fluctuating around 20,000 annually. In 1966 it was decided to promote the industry, the Ceylon Tourist Board (CTB) was established and a ten-year tourism plan (1967-76) was adopted. From less than 19,000 arrivals in 1966, visitor numbers more than doubled to reach 46,000 in 1970. Thereafter, despite year-to-year variations, a high growth rate was maintained, averaging 21% annually over the period 1970-80. The growth rate slowed to 12.5% annually in the past two years, reflecting in part the world recession. Total visitor arrivals numbered 407,000 in 1982.

2. The great majority of visitors (about 90%) are recorded as vacationers, and only about 6% as business visitors. The latter figure is probably an under-estimate. Western Europe is the major market for vacation visitors, providing around 60% of all visitors in recent years. Within Western Europe, the Federal Republic of Germany and France are the largest markets, together accounting for about half of all European visitors. However, traffic from the United Kingdom rose sharply in 1980 and 1981, almost equalling the total from France. In 1982, traffic from Europe declined for the first time (by 5.5%) but this was offset by a continued rapid growth in traffic from India which rose from 36,000 in 1980 to 93,000 in 1982. Traffic from Asian countries now accounts for about a third of all visitors.

Government Policies

3. From the mid-1960s, the Government has consistently supported the development of the sector, adopting appropriate air access policies, providing essential infrastructure and granting incentives to encourage private investment in tourism. Because of Sri Lanka's location far from the world's major tourism markets, the Government has supported policies favoring lower air fares by encouraging air charter operations from Europe and by encouraging reduced group fares on scheduled airlines flying to Colombo, particularly by the national airline, Air Lanka. The major incentives for private investors were tax holidays and fast write-offs of capital investments in hotels, but before the change in economic policies in 1977, private investment in the sector was encouraged also by restrictions on investments in other sectors, particularly manufacturing and agriculture. From April 1983, tax holidays for new projects in the hotel sector were withdrawn, but investment relief^{1/} still applies.

4. The expansion of hotel capacity has been financed largely with private capital. Public funds were mobilized to finance the two older 5-star

^{1/} up to one third of assessable income of those investing in the equity capital of hotels is free of income tax.

hotels in Colombo--the Intercontinental and the Lanka Oberoi--and to help in financing the new 500 room Galadari Meridien Hotel. Since the establishment of the NDB in 1979, private investors have sought greater public financing, particularly for larger higher category hotels. Though public share issues to raise equity capital for new hotels have increased significantly in number in the past year, continued financial support from the public sector for investment in hotels will be necessary to achieve the expansion of capacity required to meet future demand growth.

Future Prospects

5. The Ceylon Tourist Board earlier projected that visitor arrivals would grow on average by 15% annually over the period 1979-1984. Projected and actual arrivals are shown in the table below:

Tourist Arrivals
(000)

Year	Projected	Actual
1979	250	250
1980	298	322
1981	348	371
1982	400	407
1983	452	-
1984	506	-

6. Although the overall target for 1982 was achieved, the decline in European arrivals meant lower occupancy rates in hotels, as new capacity was added in the past two years. Hoteliers increased their prices, due to rising costs and the earlier pressure of demand, particularly in the higher category hotels in Colombo and on the beach, and as a result partly of tax increases such as the rise in business turnover tax on hotels and restaurants and the level of taxes on vehicles used by tour operators and some consumer items (e.g. alcoholic beverages), present prices in Sri Lanka appear to be less competitive than formerly as compared with such destinations as Kenya and Thailand.

7. Following the small decline in European traffic in 1982, a recovery was experienced in the early months of 1983. Nevertheless, it is likely that future growth in visitor arrivals from Europe will be slower than in the past. To offset any shortfall in European vacation traffic, greater marketing efforts are to be made in the Middle East, in Japan and Australia, and new market segments such as the incentive tour and convention markets are to be promoted. Business visits from Asian and OECD countries have been increasing in response to the higher level of commercial and industrial activity since 1977, and this trend is likely to continue. The fast growth in traffic from India appears largely motivated by shopping opportunities in Sri Lanka; this market segment is vulnerable to any change in Indian currency or import regulations. Provided that price increases in Sri Lanka are restrained to enable it to remain a competitive destination, and given an upturn in the

world economy, the Ceylon Tourist Board's overall projection of some 500,000 visitor arrivals by 1984 or soon thereafter seems attainable.

Implications for NDB and DFCC

8. The CTB projects hotel capacity requirements at about 11,000 rooms by 1984 as compared with 7,500 rooms existing at the end of 1982. Some 3,900 new rooms in projects approved by the CTB are currently under construction, of which over 2,000 rooms are in Colombo. This is likely to result in an excess supply of hotel rooms in Colombo in the mid-1980s, but further expansion will be needed on the beach and on tourist circuits to meet demand beyond 1984.

9. The investment cost of projects already under way is estimated at some US\$150 million, and of projects expected to begin in the near future at about US\$20 million. The bulk of the financing appears to be assured for projects costing about US\$100 million. The NDB and DFCC have agreed or are expecting to provide about US\$7-8 million equivalent towards these projects. No new commitments for tourism projects have been made by DFCC since March 1982 as a matter of policy, but NDB is in principle willing to continue to assist in financing such projects. A relatively large project in NDB's pipeline for which no commitment has yet been made is the renovation of the Queen's Hotel in Kandy, estimated to cost US\$9-10 million. NDB is also being asked to provide a share of the loan capital of the 5-star beach hotel at Bentota of which the principal sponsor is the Indian Hotel Company (the Taj Group), and in which IFC has approved an equity investment of US\$100,000 and loans totalling \$3.0 million.

Recommendations

10. The NDB (and possibly at a later stage DFCC) should exercise caution in further lending to the hotel sector until trends in the vacation visitor market for Sri Lanka become clearer in the next twelve months. Such caution is more necessary because the sponsors of many hotel projects, stimulated by the prospective withdrawal of the tax holidays from April 1, 1983, hastened to apply for the necessary approvals of the Ceylon Tourist Board and the Ministry of Finance before March 31, 1983. Were all the projects for Colombo which received such approvals to proceed, there would be a still greater over-supply of hotel capacity in Colombo in the mid-1980s. In setting priorities for future lending for hotels, NDB and DFCC should coordinate closely with the CTB, where the prime responsibility for guiding the development of the sector rests. The bulk of the hotel projects on which construction has begun or is expected to begin shortly appear to accord with market requirements in terms of location and standard of amenity. The major exception to this is the proposed expansion of 5-star hotel capacity in Colombo. Hence it is recommended that in the near term NDB and DFCC should not assist in financing any new 5-star hotel in Colombo, except possibly for limited assistance to those hotels whose construction is already well advanced. Under the proposed IDA credit, NDB's and DFCC's withdrawals for tourism subprojects would be possible, provided that such lending does not lead to tourism exceeding 30% of their respective portfolios.

SRI LANKAINTEREST RATE STRUCTURE
(in percent)A. DEPOSIT RATES

	Treasury Bills	Savings Deposits	Fixed Deposits			
			3 months	6 months	12 months	24 months
1. People's Bank	13	10 - 13.5	12 - 14	15	18	20
2. Bank of Ceylon	13	10 - 13.5	12 - 14	15	18	20
3. Hatton Bank	13	10 - 13.5	12 - 14	15	18	20
4. Commercial Bank of Ceylon	13	10 - 13.5	12 - 14	15	18	20
5. DFCC	-	-	-	-	-	-
6. National Savings Bank	-	12	-	15	18	18

B. LENDING RATES

1. Commercial Bank loans (term loans and working capital)	22 - 30 % <u>a/</u>
2. DFCC	17
3. NDB	17

C. REFINANCE LOANS

	Prior to March 1983	After March 1983
1. <u>Export Projects</u> (100% Refinance) <u>b/</u>		
Loans not exceeding		
Rs 5 million: Central Bank to Commercial Bank	10%	9%
Commercial Bank to project sponsor	12%	11%
Loans exceeding		
Rs 5 million: Central Bank to Commercial Bank	11%	10%
Commercial Bank to project sponsor	13%	12%
In April 1983, the refinance percentage was reduced to 70%, which resulted in an effective cost to the project sponsor of 14%.		
2. <u>Regular Medium and Long Term Credit</u> (non-export projects)		
Central Bank Refinance Portion	16%	15%
Equivalent Commercial Bank On-Lending Rate to Sponsor	20% <u>c/</u>	19% <u>c/</u>

a/ Commercial bank lending rates to clients vary by bank, by reputation of the client and by nature of the loan.

b/ In April 1983 the refinance percentage on export loans was reduced to 70%.

c/ Reflects a blend of refinance (60% of loan size lent at 15%) plus loan from bank's own resources (40%) lent at higher rates.

Source: Central Bank of Ceylon, Bulletin, January 83; NDB and DFCC data.

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INDUSTRIAL DEVELOPMENT PROJECT

Estimates of IDA Financing for Technical Assistance Component 1/

Agency	Element	Man-months		Costs (US\$ '000)
		T.A.	Training	
I. Credit Institutions				
(a) <u>NDB</u>	- Chief and Operational Advisors	18		126
	- Subsector Analysis	12		84
	- Training (in SE Asia)		48	70
	- Consulting on consortium financing, equity fund	4		28
	<u>Subtotal, NDB (a)</u>			<u>308</u>
(b) <u>DFCC</u>	- Subsector analysis, promotion, and other	18		126
	- Training (in SE Asia)		24	35
	<u>Subtotal, DFCC (b)</u>			<u>161</u>
(c) <u>Commercial Banks</u>	- Consultancy in MIS, appraisal, supervision	30		210
	- Training (in SE Asia)		48	70
	<u>Subtotal, Commercial Banks (c)</u>			<u>280</u>
<u>Total, Financial Institutions</u>				<u>749</u>
II. Public Sector Enterprises				
(a) <u>Ministry of Industries and Corporations</u>	- Corporation Planning and Controls	48		336
	- Firm Level Assistance, TA for Pilots	96		384 2/
	<u>Subtotal, MISA (a)</u>			<u>720</u>
(b) <u>Ministry of Finance</u>	- Advisor of MIS	24		168
	- Corporate Planning (non MISA Corp.), Efficiency	24		168
	- PED Review	6		42
	- Training and Exposure		35	53
	<u>Subtotal, MINFIN (b)</u>			<u>431</u>
<u>Total, Public Sector Enterprises</u>				<u>1151</u>
III. Policy Work				
(a) <u>MOFP/Pres. Tariff Comm.</u>	- Tariff Reform	6		42
(b) <u>MOFP</u>	- Incentive Study	12		84
	<u>Subtotal, Policy Work</u>			<u>126</u>
<u>GRAND TOTAL</u>		298 3/	155	2026
=====		===	===	=====

1/ Cost estimates are based upon an average of US\$7,000 in man-month costs for foreign consultants. However, in the case of technical assistance from ICICI, the US\$5,000 man-months costs already are known, and are reflected as such. Man-month costs for local consultants are expected to average about US\$1,000. These costs include fees, subsistence allowances, and international travel. Local transport costs would be borne by GOSL.

2/ Assumes that half of the consultants are local.

3/ The project includes 298 man-months of local and foreign advisory and consultancy services and 155 man-months of foreign training; for purposes of estimation, 250 man-months are assumed to be foreign and 48 man-months would be local consultancy. Training costs are expected to average about US\$1,500 per month.

NATIONAL DEVELOPMENT BANK OF SRI LANKA

STRATEGY FOR 1982 - 1986

A. STRATEGY

1. RELEVANT CONSIDERATIONS

1.1 The Bank's operational strategy for the period 1982 - 1986 should:

- implement the Bank's objectives as stated in the NDB Act;
- provide support for the Government's development strategy as regards business, industry and the capital market;
- take into account the needs and capacities of a relatively new institution;
- provide for orderly co-operation with other financial institutions in the country; and

1.2 These considerations are examined in detail and relevant strategies set forth in the following sections.

2. THE BANK'S OBJECTIVES

2.1 The broad objectives of the Bank as stated in the Act, are to promote the industrial, agricultural, commercial and other development of the economy of Sri Lanka.

2.2 Given the size of the Bank's capital, its potential resource capability, the structure of its ownership and Board, the powers given to it by the NDB Act, and its history to date, the Bank is well placed to play a leading and distinctive role in development financing.

2.3 The Act mentions the following as NDB's basic purposes:

- providing credit and other forms of assistance;
- stimulating the further development of the capital market;
- mobilizing capital; and
- engaging in project promotion.

The Bank expects to address these purposes as follows:

(a) Providing Credit and Assistance

2.4 The principal aims of the Bank will be to:

- become a significant source of term financing and equity. The Bank would do so by setting its cumulative target for direct loan commitments upto 1986 at around Rs 2.4 billion and its cumulative equity investment commitments at Rs 100 million;
 - by setting its target for the number of clients to total 150 by 1986; and
 - by setting its target of refinance credit for its SMI operations at 6,000 clients by 1986, representing an amount of around Rs 1,000 million.
- In addition to SMI refinance, diversify its refinance operations for larger projects. The Bank would do so by offering a new refinance scheme in respect of which it would bear part of the risk, and keep itself open to devising new refinancing schemes to support priority sectors. In this way the Bank hopes to strengthen its role as a potential "apex" institution to other sources of investment finance.
- Strengthen its service activities. The Bank would do so by increasing substantially the number and value of its syndications, underwritings and co-financing activities. In particular, the Bank will seek to tap sources of investment finance not so far available for industrial investments (see Section 5).

(b) Promoting Development of the Rural Sector

2.5 The Bank's main strategy to achieve this objective will be through an extensive refinancing program in support of small and medium-scale industries (SMI). The Bank will also seek, to the extent possible, to encourage the location of viable larger industries in rural areas to spread economic benefits. The Bank's specific goals in these regards are mentioned in section 3.4 below.

(c) Stimulating the Capital Market

2.7 The Bank's main strategies to fulfill this obligation will be to:

- buy unseasoned equities from client enterprises, hold them for seasoning and sell them in the open market in due course;
- encourage client companies to seek quotations for their shares;
- restrict the finance provided to individuals, partnerships and private limited companies and accord priority to quoted or potentially quotable companies;

- strengthen its underwriting function; initially by increasing the number and volume of such transactions, but over time, by developing a distribution mechanism for the shares in its portfolio, to facilitate primary issues, and secondary issues;
- help increase the supply of shares potentially available, through sponsoring the establishment of an equity fund or investment company in association with other sources of finance; and
- as the opportunity develops, promote or join with others in the promotion of specialized financial institutions needed to support a rapid development of the capital market.

In support of this, NDB will establish and manage an Equity Fund called the Capital Development and Investment Company (CDIC) incorporated under the Companies Act. NDB will provide upto Rs 100 million in equity to the CDIC and will seek to mobilize a further Rs 200 million of equity capital from the Government and other financial institutions.

(d) Mobilizing Capital

2.8 In order to enable mobilization of loan finance, the Bank will protect its creditworthiness by pursuing prudent lending and investment policies (without prejudice to its development goal). The Bank hopes to attract further loan funds from international and bilateral sources.

2.9 When the cost of local capital reaches a point at which borrowing with a reasonable margin for onlending is possible, the Bank will try to place appropriate securities on the local market to mobilize medium and long-term resources.

2.10 The Bank thus hopes to have borrowed the equivalent of Rs 1.2 billion by 1986.

2.11 The Bank will conserve its earnings in order to increase the funds needed for its operations and will have a well-formulated reserve and dividend policy. The Bank's equity is expected to increase by 1986 to Rs 1.6 billion.

(e) Project Promotion

2.12 The Bank will give special emphasis to project promotion to build its pipeline and diversify its areas of assistance by subsector and project size. The bank will seek to develop new viable private sector clients and will focus its financing of public sector projects on balancing, modernization and replacement investment for viable existing enterprises, and expansion projects.

2.13 The Bank's modus operandi for project promotion will comprise:

- developing a stronger client base through improved client contacts and more active business and entrepreneurial promotion;

- identifying on a selective basis industrial subsectors that have potential for growth on sound economic lines; undertaking studies of such projects in association with potential sponsors to the stage of financing by the Bank and other sources;
- further action to identify projects suitable for the Project Development Facility (PDF), assisted by a grant of US\$ 500,000 from UNDP;
- flexible use of the Bank's own contribution of US\$ 250,000 equivalent to the PDF; and
- embarking on a program to prepare project profiles which would be of use to entrepreneurs, and seeking sponsors to implement such projects with financial support from the Bank.

To carry out these activities, the Bank will establish a project promotion and business development unit with initial staffing of at least three officers.

3. SECTORAL PRIORITIES

(a) Expanding Private Sector Investments

3.1 The Bank's direct financing, both by way of loan and equity, is available for private enterprises. As mentioned earlier, the Bank aims to become a significant source of investment finance to such enterprises. It expects to provide a flexible and speedy service to its clients. (See also Section 5 as regards co-ordination with other financial institutions).

(b) Improving Public Enterprise Efficiency

3.2 An important purpose of the Bank is to finance worthwhile projects of public enterprises, with particular attention to BMR. In light of the government's objectives to improve public enterprise efficiency, the Bank would promote viable balancing and modernization investments through its lending operations and would utilize the equity fund to encourage increased private participation in public sector enterprises.

(c) Attracting Foreign Investment

3.3 The Bank will actively encourage, whenever desirable, the close association of foreign sources of finance and know-how with its projects. In pursuit of this aim:

- the Bank would locate and canvas sources of funds and know-how for individual projects;
- invite foreign financial institutions to co-finance or joint syndication groups for suitable projects;

- encourage local entrepreneurs or public sector corporations that are weak in management or marketing expertise to seek association with foreign sources to strengthen their expertise; and
- seek to protect domestic interests through monitoring carefully all proposed arrangements for transfer of know-how, know-how fees, transfer pricing, procurement and related matters.

(d) Encouragement of Small and Medium Industries

3.4 The Bank attaches great value to the development of entrepreneurship, diversification of ownership, geographical decentralization, employment and other benefits of small-scale enterprises, and recognizes the importance of small and medium scale industries, particularly agro-processing industries, in promoting the development of the rural sector. In pursuit of this goal: the Bank would seek to continue for several years the program of refinancing started in 1979 with IDA funds, through supplementary financing for this purpose from appropriate sources.

(e) Subsector Priorities

3.5 NDB will focus on the following industries in implementing its strategy:

- (i) The Bank will place special emphasis on financing agroindustries given the indigenous raw material supply and the inadequate attention given to this area in the past. Product groups of particular interest will be rubber-based and coconut-based industries, fruit and vegetable processing and canning, edible and non-edible oils, and wood products;
- (ii) Engineering products, as a means of deepening the manufacturing base of the economy by financing engineering enterprises which are efficient in import-substitution or have promising export prospects;
- (iii) Chemical products which have significant foreign exchange savings and where the technology and skills are available or can be obtained from abroad;
- (iv) Export-oriented industries, with high local value added and net foreign exchange earnings will be encouraged;
- (v) Hotels and tourism-related projects, up to a maximum of 30% NDB's loan portfolio at the end of each fiscal year. Projects for construction of "five-star" hotels will not be financed if there is a strong likelihood that excess capacity is emerging (e.g. in Colombo);
- (vi) Industrial Services which are crucial to the growth of the economy, such as repair facilities used for transportation; and
- (vii) Equipment requirement in manufacturing enterprises, which might not form part of a larger project.

(f) Employment Generation

3.6 The employment-generating aspects of projects would be a subject of careful attention by the Bank. To implement this goal, the Bank would:

- continue support for the SMI Program as already mentioned;
- support medium-scale industries not eligible under the SMI program through direct financing;
- support the tourism sector which has a high direct and indirect employment content; and
- use capital/employment ratios as an appraisal tool.

(g) Foreign Exchange Generation:

3.7 The Bank will accord high priority to projects that generate or save foreign exchange. Accordingly, the Bank will apply tests relating to Domestic Resource Costs as a proportion of foreign exchange earned/saved, as an appraisal tool (para 3.10).

(h) Efficiency of Public Sector Enterprises

3.8 In support of the Government's aim to restore the efficiency of public sector enterprises, the Bank would, with direct support from the controlling Ministries:

- encourage Government enterprises to map out appropriate corporate investment plans and priorities and select projects for financing; co-operate with technical assistance staff expected to be assigned for this purpose.
- insist on well-prepared projects before financing them; where needed, provide funds and assistance under the Project Development Facility to undertake feasibility studies or studies on specific aspects;
- discourage expansion while major tasks of rehabilitation remain unattended to; consider viable rehabilitation projects where needed;
- encourage the formation of new mixed companies sponsored or co-owned by public corporations, jointly owned by private sources of know-how and finance, and competently managed, to undertake large expansions;
- insist on reasonable equity contribution to support the debt finance sought; and
- assist whenever requested experts obtained by Government enterprises to help in their rehabilitation/modernization efforts.

(i) Quick-gestation Projects

3.9 The interest of the Bank in financing projects in the medium size range will have in part the effect of supporting the Government's strategy to achieve quick results. The Bank will carefully limit its financing of long-gestation projects to those that are clearly supported by the Government in the national interest.

(j) Economic and Financial Merit of Assisted Projects

3.10 The Bank, as already mentioned, will use appropriate measures and techniques to appraise and monitor the economic merit of the projects it finances. In regard to large projects, (those involving loans of more than US\$400,000 equivalent) it will calculate the economic rate of return and will not normally accept any project with a rate of return of less than 10%. For all projects, where possible, the financial rate of return will be calculated and projects with a rate of return of less than the opportunity cost of capital will not normally be accepted.

4. ORGANIZATION

4.1 The Bank will strengthen its organization to cope with the growth and other tasks arising from the strategy chosen for 1982 - 86. The Bank will do so by:

- increasing the number of full professional positions;
- strengthening its senior and mid-development; and
- creating specialized departments as needed to handle specialized functions.

4.2 Arranging training facilities for new existing staff:

- the Bank will, besides conducting in-house training for its staff, provide specialized training outside Sri Lanka for a substantial proportion of its professional staff including most of its engineering staff.

4.3 Articulating and implementing systematic appraisal, supervision and loan collections procedures:

- the Bank will do so by prescribing in near final form the Manuals of Operations now available in draft form; refining the manuals and procedures as it gains more experience; strengthening its project follow-up procedures and organization for directly financed projects; and instituting a more intensive follow-up and evaluation system for the SMI refinance scheme.

4.4 Moving cautiously toward a role of leadership in the investment financing community, avoiding an excessive spread of its human resources over a wide area.

5. CO-OPERATING WITH OTHER FINANCIAL INSTITUTIONS

5.1 The Bank is enjoined by its charter "whenever it is feasible and desirable to act in participation or co-operation with approved credit institutions." The Bank accords priority to such co-operation and has developed the following modes for doing so:

- (a) Consortium financing, by organizing formal meetings of the four indigenous commercial banks and DFCC, to streamline loan application and review procedures, spread risk, and provide feedback to other lenders;
- (b) purchasing participatins in term loans made by other financial institutions for new projects, provided the underlying appraisal meets the Bank's normal criteria;
- (c) syndicating loans with other financial institutions, including merchant banks, whether as leader or participant;
- (d) refinancing term loans made by other financial institutions for new projects, provided the underlying appraisal meets the Bank's normal criteria; sharing a part of the risk of such loans through partial recourse arrangements as opposed to the full recourse arrangements now offered by the Central Bank.

5.2 The Bank recognizes that sources of term funds such as the Employee's Trust Fund, the Insurance Corporations and the State Mortgage Bank might, if supported by the Bank's appraisal capability, be persuaded to co-finance the Bank's projects. The Bank would initiate well structured co-operative arrangements with those institutions in pursuit of this objective.

6. GENERAL

6.1 The above strategies will be considered flexible, and will be adjusted and supplemented in the light of prevailing circumstances from time to time.

SRI LANKA
NATIONAL DEVELOPMENT BANK OF SRI LANKA
OPERATIONS: ACTUAL AND PROJECTED, FY80-FY86
(in millions of Rupees)

Actual			Year ending December 31	Projected			
FY80	FY81	FY82		FY83	FY84	FY85	FY86
1. NET APPROVALS							
- Direct Operations:							
			Loans in Foreign Exchange	144.0	166.0	191.0	219.0
			Rupee Loans	216.0	248.0	286.0	329.0
			Equity Investments	360.0	414.0	477.0	548.0
			TOTAL DIRECT	18.0	20.0	22.0	24.0
				378.0	434.0	499.0	572.0
- Refinance Operations							
			SMI 1/	175.0	250.0	114.2	150.0
			Other 2/	30.0	34.5	39.0	43.5
			TOTAL REFINANCE	205.0	284.5	153.2	193.5
			Other - Purchase Participation	25.0	28.7	32.5	36.2
			TOTAL NET APPROVALS	608.0	747.2	684.7	801.7
				-----	-----	-----	-----
2. COMMITMENTS 3/							
- Direct Operations:							
			Loans in Foreign Exchange	170.6	159.1	183.3	210.6
			Rupee Loans	337.0	238.7	274.8	316.0
			Equity Investments	507.6	397.8	458.1	526.6
			TOTAL COMMITMENTS	19.7	19.4	21.4	23.4
				527.3	417.2	479.5	550.0
				-----	-----	-----	-----
3. DISBURSEMENTS							
- Direct Operations:							
			Loans in Foreign Exchange	92.5	143.2	170.6	192.7
			Rupee Loans	257.3	262.5	270.2	295.9
			Equity Investments	349.8	405.7	440.8	488.6
			TOTAL DIRECT	10.6	15.6	20.5	22.0
				360.4	421.3	461.3	510.6
- Refinance Operations							
			SMI	151.8	217.4	225.6	-
			Other	9.0	28.3	35.3	40.0
			TOTAL REFINANCE	160.8	245.7	260.9	40.0
			Other - Purchase Participation	12.5	26.9	30.5	34.4
			TOTAL DISBURSEMENTS	533.7	693.9	752.7	585.0
				-----	-----	-----	-----
4. COLLECTIONS							
			Direct Loans	57.2	67.7	81.2	97.4
			SMI Refinance	47.7	69.9	95.9	109.9
			Other Refinance	-	1.3	6.1	13.7
			TOTAL COLLECTIONS	104.9	138.9	183.2	221.0
				-----	-----	-----	-----

1/ Projections include SMI II through 1985, for 1986 SMI III is assumed.
2/ NDB has not as yet commenced other refinance operations.
3/ In refinance operations, approvals are equivalent to commitments.

NATIONAL DEVELOPMENT BANK OF SRI LANKA

Action Program and Timetable

Project Identification and Promotion Unit

A. NDB Unit

1. NDB will establish by end June 1983 a Project Identification and Business Promotion Unit as a key element in developing its pipeline and in carrying out its strategy of portfolio diversification. Initially, the unit would consist of at least three officers, including the unit chief, with work experience in, or a knowledge encompassing the following subsectors: agroindustries, light engineering, chemicals, rubber-based industries, coir industries, textiles and garments, and leather products. The final number and composition of the unit would be determined with assistance from the promotion advisor. Initially, an economist and an engineer would constitute adequate staffing. The unit would be headed by an officer experienced in project promotion and business development. Staffing of this unit would be completed by March 31, 1984. The technical assistance under the Industrial Development Project will include assistance in determining project promotion, subsector analysis, and business development including a detailed work program for the unit (below).

B. Project and Business Development Advisor

2. Qualifications. The advisor to NDB will have a degree in business administration or industrial economics and have at least eight years work experience, in project promotion, subsector analysis in business development in situations similar to Sri Lanka. The advisor will have experience in developing and implementing project and business promotion programs in other countries. Experience in agroprocessing and light manufacturing is desirable.

3. Responsibilities. The following main tasks will be undertaken in accord with a work program to be agreed by NDB and IDA during the advisor's first month on the job:

- (a) Review NDB's project portfolio to gain a detailed knowledge of the subsectors and type of projects financed and operational constraints;
- (b) Review the capacity within NDB to undertake promotional work and recommend staffing numbers and qualifications for the unit, whether any NDB staff members are suitable, and what are the qualifications of staff to be recruited from outside NDB;

- (c) Contact major industrialists and ascertain the type of new, expansion, and modernization projects which are under consideration;
- (d) Liase with investment promotion bodies (FIAC, LIAC, Export Development Board, and the Industrial Development Board) to determine projects of current interest to investors;
- (e) Provide in-service training to staff of the Project Identification, Business Promotion and Economics Department on project identification, business promotion, and subsector analysis; and
- (f) Assist NDB in strengthening its pipeline, in accordance with objectives outlined in its Policy and Strategy Statements.

4. Assignment Duration and Reporting. The advisor will remain with NDB for a 12 month continuous period, and will prepare quarterly progress reports, and an interim and final report.

SRI LANKA

NATIONAL DEVELOPMENT BANK OF SRI LANKA

Summarized Income and Cash Flow Statements
(in millions of Rupees)

Actual			Year Ending December 31	Projected			
FY80	FY81	FY82		FY83	FY84	FY85	FY86
			1. INCOME				
4.3	32.6	73.5	From project lending	126.5	206.3	298.1	371.6
84.9	86.2	78.4	From term deposits	75.5	52.6	46.1	58.8
1.1	1.3	2.5	Other project related	3.4	4.3	4.7	5.5
-	-	-	Other	0.2	0.2	0.3	0.3
90.3	120.1	154.4	TOTAL INCOME	205.6	263.4	349.2	436.2
			2. EXPENSES				
5.8	8.4	10.5	Administrative Expenses	17.8	22.1	26.9	32.7
0.5	7.0	18.5	Interest on borrowings	35.4	71.4	124.0	171.0
0.3	0.4	0.5	Depreciation	0.5	0.6	1.7	1.9
0.2	-	0.2	Other	-	-	-	-
6.8	15.8	29.7	TOTAL EXPENSES	53.7	94.1	152.6	205.6
83.5	104.3	124.7	3. NET PROFIT	151.9	169.3	196.6	230.6
80.0	90.0	110.0	Less Appropriations: General Reserves	-	109.5	125.5	145.0
3.9	10.3	10.3	Bad Debts Reserve	16.4	20.4	23.3	24.6
-	-	-	Equity Fund	100.0	-	-	-
-	-	-	Dividends	22.5	22.5	22.5	22.5
(0.4)	4.0	4.4	Earnings retained in previous year	13.0	16.9	25.3	38.5
3.9	3.7	7.7	RETAINED EARNINGS	25.1	42.0	67.3	105.8
3.5	7.7	12.1					
-----	-----	-----		-----	-----	-----	-----
			4. CASH INFLOW				
111.3	143.1		Net profit before interest	187.3	240.8	320.7	401.6
0.4	0.5		Add: non-cash adjustment	0.5	0.6	1.7	1.9
111.7	143.6			187.8	241.4	322.4	403.5
21.3	50.6		Collections ^{1/}	105.0	139.4	185.1	224.3
133.0	194.2		Net cash generation	292.8	380.8	506.5	627.8
101.2	132.0		Borrowings	220.0	347.6	537.2	296.0
118.2	(64.2)		Draw-down of term deposits	75.4	90.0	(105.1)	(20.2)
-	1.1		PDF: Grant from UNDP	0.7	2.0	3.3	3.5
352.4	263.2		TOTAL CASH INFLOW	588.9	820.4	942.9	907.1
-----	-----			-----	-----	-----	-----
			5. CASH OUTFLOW				
-	-		Debt Service: Principal	25.0	38.8	48.3	112.1
-	0.9		Interest	41.5	33.0	48.9	195.1
-	0.9			66.5	71.8	97.2	307.2
314.1	263.0		Disbursements	536.4	698.3	757.7	588.9
0.5	0.4		Capital expenditure	2.1	1.0	10.5	2.3
-	-		Equity Fund Investment	-	50.0	50.0	-
40.7	(1.2)		Other: Change in Net Current Asset	(16.1)	(0.8)	27.6	8.6
352.3	263.1		TOTAL CASH OUTFLOW	588.9	821.3	943.0	907.0
-----	-----			-----	-----	-----	-----
-	-		DEBT SERVICE COVERAGE RATIO ^{2/}	3.8	4.2	3.9	2.0
0.8	0.9	0.8	Administrative Expenses/Total Assets (%)	1.1	1.1	1.0	1.0
11.4	13.3	13.9	Net Profit/Average Equity (%)	14.7	14.5	14.9	15.2

^{1/} Assuming full collection of overdues.^{2/} Based on full collection. The ratio reflects the general nature of NDB's borrowings--unmatched repayments permitting the revolving of funds.

ANNEX 9

SRI LANKA

NATIONAL DEVELOPMENT BANK OF SRI LANKA

SUMMARIZED BALANCE SHEET

(in millions of Rupees)

<u>Actual</u>			<u>Year ending December 31</u>	<u>Projected</u>			
<u>FY80</u>	<u>FY81</u>	<u>FY82</u>		<u>FY83</u>	<u>FY84</u>	<u>FY85</u>	<u>FY86</u>
<u>PORTFOLIO ASSETS</u>							
72.5	267.0	462.6	Direct Loans	779.5	1175.1	1596.8	2048.2
42.2	133.8	149.6	Refinance Loans	256.5	409.6	544.9	431.7
4.4	11.4	13.3	Equity Investments	23.8	39.4	59.9	81.9
<u>119.1</u>	<u>412.2</u>	<u>625.5</u>		<u>1059.8</u>	<u>1624.1</u>	<u>2201.6</u>	<u>2561.8</u>
<u>INVESTMENTS</u>							
481.8	399.7	455.6	Term Deposits	366.0	255.0	362.5	382.1
-	-	-	Equity Fund	-	50.0	100.0	100.0
<u>481.8</u>	<u>399.7</u>	<u>455.6</u>		<u>366.0</u>	<u>305.0</u>	<u>462.5</u>	<u>482.1</u>
<u>OTHER ASSETS</u>							
150.0	150.0	150.0	Pro Notes from shareholders	150.0	150.0	150.0	150.0
2.0	2.1	2.0	Fixes assets net of Depreciation	3.6	4.0	12.8	13.2
4.3	6.0	12.4	Net Current Assets	(14.9)	(22.7)	(25.6)	(35.7)
<u>156.3</u>	<u>158.1</u>	<u>164.4</u>		<u>138.7</u>	<u>131.3</u>	<u>137.2</u>	<u>127.5</u>
757.2	970.0	1245.5	TOTAL ASSETS	1564.5	2060.4	2801.3	3171.4
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<u>Financed by:</u>							
<u>SHAREHOLDERS' EQUITY</u>							
600.0	600.0	600.0	Share Capital	600.0	600.0	600.0	600.0
128.9	229.3	349.6	General and Special Reserves	466.0	595.9	744.7	914.3
3.5	7.7	12.1	Retained Earnings	25.1	42.0	67.3	105.8
732.4	837.0	961.7	SHAREHOLDERS' FUNDS	1091.1	1237.9	1412.0	1620.1
-	-	1.1	PDF Grant from UNDP	1.8	3.7	6.3	8.7
<u>732.4</u>	<u>837.0</u>	<u>962.8</u>	TOTAL EQUITY	1092.9	1241.6	1418.3	1628.8
<u>LONG TERM DEBT</u>							
-	-	38.0	Foreign Exchange for: Direct Operations	115.7	256.0	430.5	634.6
24.8	133.0	206.8	SMI Refinance	288.9	488.7	763.3	643.0
-	-	37.9	Central Bank Refinance	67.0	74.1	89.2	105.0
-	-	-	Other Loans	-	-	100.0	160.0
<u>24.8</u>	<u>133.0</u>	<u>282.7</u>	TOTAL DEBT	<u>471.6</u>	<u>818.8</u>	<u>1383.0</u>	<u>1542.6</u>
757.2	970.0	1245.5	TOTAL FUNDING	1564.5	2060.4	2801.3	3171.4
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1:29	1:6.2	1:3.4	DEBT: EQUITY RATIO	1:2.3	1:1.5	1:1.0	1:1.0

DEVELOPMENT FINANCE CORPORATION OF CEYLON

Financial and Operational Strategy of the DFCC
For Period 1982 - 1986

BACKGROUND

1.0 The last statement of strategy for the DFCC was formulated in 1975. The environment in which the DFCC operated changed drastically in 1977/78 with the new economic policies of the Government, in particular, the ready convertibility of Rupees into foreign currency together with liberalization of imports. On the one hand the construction, trade and service sectors expanded very much more than the import-substitution oriented manufacturing sector, which was the traditional area of DFCC operations. On the other hand, the financial environment within which DFCC operated changed greatly with the creation of the National Development Bank of Sri Lanka and the availability of long term finance and other financial services from the commercial banks. All these factors resulted in the DFCC losing the near monopoly of foreign currency resources for the private sector, which it enjoyed hitherto. Stated here is the revised strategy based on the changed circumstances.

1.1 Given below is the operational and financial strategy of the DFCC for the next 3 to 4 years. This strategy has been influenced among others by:

- (a) Plans and policies of the Government for economic and social development;
- (b) Reasonable estimates of the scope of activities including investments possible by a development bank such as DFCC; and
- (c) A realistic estimate of the competitive business environment in the financial sector and the resource possibilities for the DFCC.

MARKET STRATEGY

2.0 Efficiency of Service. The overall marketing strategy of the DFCC would be to strive for an advantageous market differentiation vis-a-vis other larger financial institutions based on factors of speedy and efficient service, flexibility and greater technical know-how and expertise in project based lending, and simultaneously exerting its development banking orientation. At the same time, greater emphasis will be laid on cooperation with other financial institutions both local and foreign through consortium arrangements. Also DFCC will continue to concentrate its lending operations almost exclusively in supporting the expansion and development of the

private sector. In this respect, DFCC is in an advantageous position due to the special relationships and understanding it has developed over the last 25 years of successful involvement with the private sector. It will strive to improve the present speed of operations and decision making.

2.1 Project Promotion. In order to diversify its portfolio and identify new projects, DFCC will expand its project promotion efforts and will create a project promotion unit adequately staffed to actively seek out project proposals and identify promising ones in accordance with the priorities stated in para. 3.0. The officers will contact potential sponsors, and support institutions, screen project approval lists of the approval agencies such as FIAC and LIAC and with the appraisal department, recommend attractive projects for incorporation into the DFCC pipeline. DFCC will also assist in the promotion of joint ventures between local and foreign entrepreneurs.

2.2 Economic and Sectoral Analysis. As an integral feature of its promotion efforts, DFCC will undertake more detailed economic analysis of sectors and subsectors and will undertake selected sector and subsector studies in areas of importance to DFCC operations and potential for future projects. Light engineering, agro-industries, rubber-based industries are possibilities for analysis. The economic and sectoral analysis would complement DFCC's promotion efforts and improve its understanding of the policy environment within which DFCC operates. Project briefs covering a range of subsectors will be prepared drawing upon the sectoral analysis and DFCC's project experience.

2.3 Diversification of Services. While project based lending would remain at the centre of operations, DFCC will make an effort to diversify its services to the private sector clients in keeping with their needs. DFCC will undertake equipment term-financing with accelerated appraisal to compete with equipment leasing and services provided by other financial institutions. Provision of advisory services, investment banking and related services and equipment leasing are also some areas under consideration.

2.4 Manpower. Since the primary requirement for such a market strategy is qualified, competent and highly motivated staff, DFCC will strive to train its existing staff on an on-going basis, and effectively motivate them with a competitive package of incentives. DFCC will continue to place high priority on training, particularly, on project development, assessment of development aspects, economic analysis of projects and project supervision.

SECTORAL PRIORITIES

3.0 Industry sectors which would receive special attention from the DFCC may be broadly enumerated as under:

3.1 Export-Oriented Industries. Viable export-oriented industries, in particular those making use of Sri Lanka's labour and raw material advantages with high value added. DFCC will encourage foreign private collaboration in those projects where technological know-how, product quality and marketing channels are key factors in performance.

3.2 Resource-Based Industries. Projects utilizing local raw materials such as mineral resources, rubber, coconut, wood products, essential oils, etc. In pursuance of this, DFCC will support projects in the agricultural and livestock sectors ungradas a means of producing the raw materials needed.

3.3 Import Substitution. Efficient import substitution industries considered essential to the economy are those in which there is a comparative cost advantage, those which have considerable forward and backward linkages and those with high employment potential. Engineering projects would be given priority as they utilize DFCC's relatively strong technical appraisal skills and have strong links to other industrial developments.

3.4 Pioneering Projects. DFCC with its well established capabilities in the technical evaluation of projects and with experienced engineering staff, will make a special effort to identify, sponsor and support pioneering type ventures, both in terms of technology as well as product/services.

3.5 Modernization. Investment in modernization, expansion, energy conservation, etc. of existing projects which would result in their technological upgradation, increasing of efficiency in terms of cost and quality. The DFCC considers modernization vital for the survival of existing industries in view of the open economic policies and competition from imports. If appropriate, DFCC will also endeavour to apply technologies which are adapted to the circumstances.

3.6 Replacements with more modern equipment, balancing of equipment, improvement in energy utilization and equipment to ensure continuity of production will yield substantial benefits at minimal investments and in the least gestation periods. However, DFCC will not finance the creation of new capacity in those sectors where existing units have significant under-utilization of capacity except in cases where there is special justification.

3.7 Service Industries. Viable service type industries which are important to the needs of the economy in as far as the absence of them will hamper the growth of other sectors, will also be assisted by the DFCC. One of the main criteria for selection of service industries will be high employment potential.

3.8 Tourism. In tourist-sector projects DFCC assistance in terms of percentage of the portfolio is already somewhat high; therefore, tourism loans will be limited to maintain a maximum of 30% of DFCC's loan portfolio. The main priorities will be to finance the capacity expansion, upgrading and increasing the efficiency of the large number of existing clients. New hotel projects assisted by DFCC would be very few and mainly those in the medium-class and those which are clearly profitable with a high ratio of equity. Even in such cases the emphasis will be on joint-financing with other financial institutions.

3.9 Criteria of Project Appraisal. DFCC would employ the standard guidelines for project appraisal for development banks. Calculations of the financial rate of return, which should be at least equal to or above the opportunity cost of capital, should be performed for all projects. For all projects involving foreign exchange subloans of above US\$250,000 equivalent, DFCC should calculate economic rates of return. DFCC would not normally finance any projects with rates of return of less than 10%. Where these rates cannot be calculated (e.g. BMR projects investments which cannot be separated from the existing company) DFCC will calculate the domestic resource cost ratio (DRC) as a key element of the project's economic justification. Where possible, DFCC should calculate both the ERR and the DRC.

PRIORITIES ACCORDING TO SIZE, OWNERSHIP, DISPERSION

4.0 Small Industry Sector. The DFCC has so far financed about 10% of its portfolio in the small and medium scale industries (SMI) sector. This ratio is presently considered appropriate taking into account that financing of the SMI sector is also largely done by the commercial banks through their branch networks and considering that the DFCC has no branches outside Colombo and is unable to provide sufficient working capital and other banking services. These factors inhibit wide-spread assistance by DFCC to this sector. Despite these constraints, DFCC would continue to assist its sizeable number of existing clients numbering about 200 to expand and make the projects more viable and also be prepared to consider new avenues for SMI financing. While future lending to SMIs will be mainly to the larger end of the spectrum, special emphasis will be given to identify new but viable schemes and to support new and small entrepreneurs especially those with technical expertise. DFCC will also strive to develop schemes for subcontracting, franchising, servicing, etc. in association with larger businesses, whereby market and technical assistance would be assured.

4.1 Broad-Basing of Ownership. With a view to ensure the growth of a healthy private sector which has long term growth prospects and in accordance with the policies of the Government to develop a capital market, the DFCC will accord priority to assisting public-quoted and broad-based companies as compared to closely-held private companies and partnerships. DFCC will therefore strive to encourage existing close-held companies to become broad-based and publicly quoted. With respect to the financing of joint-ventures, DFCC will pay attention to an adequate participation of the local entrepreneurs in the ownership of those projects.

4.2 Geographical Dispersion of Industry. Although geographical dispersion has been a consistent objective of every government, industry still tended to concentrate in the Colombo District. The reasons have been mainly economic and operational. Radical changes to this pattern cannot be expected in the next 3 years, however, DFCC will accord high priority to those viable projects which are located outside the Colombo Region.

ADVISORY SERVICES AND MERCHANT BANKING

5.0 DFCC in the past has assisted clients in the formulation of projects through its appraisal process and in solving some operational problems through its implementation process. With the "open economic policies" and consequent competitive business environment, as well as the rapid expansion and diversification that takes place, several of its clients are faced with problems which they find difficult to tackle on their own. In such cases DFCC will be called upon to provide advice and guidance on financial, technical, managerial and organizational matters. This would also be in the interest of the DFCC, considering that some of those projects would likely be in arrears and may have inadequate returns from share investments. DFCC will strive to rehabilitate weak units as well as assisting clients to expand, diversify and increase efficiency.

5.1 With the passing of the new Companies Law, establishment of a stock exchange, incentives to businesses to become quoted public companies, rationalization of the interest rate structure, and the paucity of rupee resources, it is expected that there will be an increasing need for public share issue management, underwriting, assistance in mergers and corporate advice.

5.2 DFCC will draw on the experience of all departments, as well as from outside consultants, particularly in project development.

RESOURCE MOBILIZATION

6.0 DFCC expects that one of the major problems it will face in the next three years will be the problem of obtaining financial resources appropriate for the needs of its clients. This will be particularly, important with respect to local Rupee currency resources. A further constraint will be the debt/equity ratios it is expected to maintain. DFCC has increased its ordinary share capital from Rs 24 million to Rs 100 million, which effectively increases its exposure limits for investment in a given company, as contained in the Policy Statement.

INVESTMENTS

7.0 DFCC is conscious of the fact that it will have to pay a reasonable dividend to shareholders on its after tax profits in order to expand its equity base, on which depends its scale of lending. Consequently, it will need to ensure an adequate spread between lending and borrowing rates and also actively seek profitable investments, within the overall developmental objectives. It will invest its "free" funds in such a way as to ensure maximum returns as well as compensate for the erosion of the equity base due to inflation, keeping in mind its overall development objectives.

7.1 DFCC will not normally invest in preference shares. DFCC's investment strategy will continue to be prudent at all times and will reflect its exposure limits contained in the statement of Business Policies.

ARREARS REDUCTION PROGRAM

8.0 DFCC is concerned about its increasing level of arrears and has created a special problem projects cell in the Implementation Department to focus attention and efforts in this area. More frequent plant visits and greater analysis of repayment capacity of clients will be a regular feature of the work of this cell. Problem cases will be considered for rehabilitation by the Advisory Division. DFCC will be more firm in calling up loans and taking legal action, when legal action is appropriate.

8.1 DFCC will formulate an annual collection program with recovery targets and will monitor its collection performance in light of these targets. DFCC will place the highest priority on project supervision in order to prevent increase in its arrears situation.

SRI LANKA
DEVELOPMENT FINANCE CORPORATION OF CEYLON
SUMMARY OF OPERATIONS, FY78/79 TO FY82/83
(Rs million)

	<u>Local Currency</u>		<u>Foreign Currency</u>		<u>Share Investments Local</u>		<u>Share Investments Foreign</u>		<u>Total</u>	
	<u>No. of Projects</u>	<u>Amount</u>	<u>No. of Projects</u>	<u>Amount</u>	<u>No. of Projects</u>	<u>Amount</u>	<u>No. of Projects</u>	<u>Amount</u>	<u>No. of Projects</u>	<u>Amount</u>
<u>Gross Approvals</u>										
FY78/79	83	33,034	71	105,723	12	8,418	11	10,591	177	157,766
FY79/80	43	18,039	33	53,655	7	4,680	5	7,950	88	84,324
FY80/81	90	114,137	16	65,500	10	7,025	1	2,000	117	188,662
FY81/82	93	199,510	18	39,965	3	5,000	-	-	114	244,475
FY82/83	12	27,507	16	22,625	12	5,923	-	-	40	56,055
<u>Cancellations</u>										
FY78/79	+3	+5,257	19	33,842	-	+200	4	5,113	26	44,412
FY79/80	6	+2,780	22	34,681	2	775	2	2,615	32	40,851
FY80/81	7	+3,383	2	254	1	956	-	-	10	4,593
FY81/82	+4	+15,050	13	47,943	1	750	-	-	18	63,743
FY82/83	8	6,392	1	1,690	-	-	-	-	9	8,082
<u>Net Approvals</u>										
FY78/79	86	38,291	52	71,881	12	8,618	7	5,478	157	124,268
FY79/80	6	20,819	11	18,974	5	3,905	3	5,336	25	49,034
FY80/81	83	110,754	14	65,246	9	5,069	1	2,000	107	183,069
FY81/82	97	214,560	5	-7,978	2	4,250	-	-	104	210,832
FY82/83	4	21,115	15	20,935	12	5,923	-	-	31	47,973
<u>Net Commitments</u>										
FY78/79	75	35,062	39	62,069	9	7,618	8	7,134	131	111,883
FY79/80	26	17,239	27	31,593	1	-650	-	1,500	54	49,682
FY80/81	70	79,296	16	38,892	6	4,443	1	4,000	93	126,631
FY81/82	83	166,698	19	32,493	3	?	-	-	105	?
FY82/83	15	37,905	14	20,873	12	5,923	-	-	41	64,701
<u>Disbursements</u>										
FY78/79		16,024		37,207		10,118		7,874		71,223
FY79/80		30,590		53,393		7,657		3,850		95,490
FY80/81		57,755		51,022		5,860		1,915		116,552
FY81/82		110,790		41,834		7,076		2,000		161,700
FY82/83		111,046		30,231		5,447		-		104,711
Undisbursed Commitment		141,061		12,642		1,877		-		155,580

April 1983
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DEVELOPMENT FINANCE CORPORATION OF CEYLON
SYNOPSIS OF 15 "A" SUBPROJECTS FINANCED UNDER CREDIT 742-CZ

<u>Sector</u>	<u>Project Type</u>	<u>Subproject Number</u>	<u>Capital Cost US\$</u>	<u>Subloan Amount US\$</u>	<u>Share Investment US\$</u>	<u>Market</u>	<u>Breakeven Point</u>	<u>Economic Rate of Return</u>	<u>Direct Employment</u>	<u>Investment per Job (US\$)</u>	<u>Domestic Resource Cost Rs/\$</u>
Food	Biscuit Factory	A-8	1,247,000	705,128	-	Domestic	44%	17%	109	11,000	- /1
Electrical Equipment	Replacement Machine	A-6	81,793	81,793	-	Domestic	- /1	31%	-	-	-
Rubber	Thread Factory	A-7	991,000	450,077	158,477	Foreign	42%	28.5%	110	8,638	8.56
Printing	Replacement Machines	A-5	171,000	126,966	-	Domestic	- /1	50%	-	-	- /1
Textiles	Expansion	A-12	408,000	246,859	48,077	Domestic	38%	45%	50	8,200	9.5
Textiles	Expansion	A-11	8,422,000	516,462	129,115	Domestic	- /1	19%	597	14,000	8.5
Garments	New Factory	A-1	874,000	398,047	130,292	Foreign	36%	46%	305	1,710	6.7
Auto Engineering	Expansion	A-2	132,600	92,680	32,510	Domestic	- /1	16.9% /2	10	12,500	- /1
Textiles	Expansion	A-3	275,000	31,684	32,510	Domestic	59%	- /1	- /1	- /1	- /1
Engineering	Spring Factory	A-4	303,699	111,411	56,426	Domestic	28%	37%	70	3,040	8.91
Food	Soft Drink Plant	A-9	1,628,000	704,143	-	Domestic	66%	28% /2	- /1	- /1	- /1
Chemicals	Polythene Sack Plant	A-10	119,000	107,484	-	Domestic	- /1	26% /2	- /1	- /1	- /1
Tourism	New Hotel	A-13	3,730,000	370,000	255,000	Foreign	41%	21.5% /2	200	18,650	11.35
Textiles	Expansion Spinning Mill	A-15	5,196,000	512,800	128,200	Domestic	47%	32%	204	25,400	10.55
Agroindustry	Activated Carbon Expansion	A-14	1,730,000	655,731	-	Foreign	40%	29%	40	43,250	10.08

1/ Not calculated.
2/ Financial rate of return.

SRI LANKA

DEVELOPMENT FINANCE CORPORATION OF CEYLON

Actual and Projected Income Statements, FY79-87
(Rs million)

Actual				Year ending March 31	Projected				
FY79	FY80	FY81	FY82		FY83	FY84	FY85	FY86	FY87
INCOME									
7.3	25.8	38.1	62.9	Interest Income:					
8.8	-	-	-	Rupee Loans	91.6	99.4	103.3	109.2	116.5
				Foreign Currency Loans	-	-	-	-	-
0.5	0.5	1.3	2.9	Dividends:					
1.6	2.0	3.4	2.7	Ordinary Shares	3.4	3.9	4.8	5.7	6.7
				Preference Shares	2.7	2.2	1.7	1.2	0.7
1.3	0.6	1.5	1.4	Appraisal Fees	0.5	9.8	0.9	1.0	1.0
0.2	0.3	0.5	0.5	Legal Fees	0.7	0.4	0.4	0.4	0.4
1.9	2.1	1.9	1.4	Fixed Deposit Interest	3.3	3.9	4.3	4.8	5.3
0.1	0.1	0.1	0.2	Staff Loan Interest	0.2	0.3	0.3	0.4	0.5
0.2	0.3	0.4	0.9	Miscellaneous Income	0.2	0.2	0.2	0.3	0.4
<u>21.9</u>	<u>31.7</u>	<u>47.2</u>	<u>72.9</u>		<u>102.6</u>	<u>111.1</u>	<u>115.9</u>	<u>123.0</u>	<u>131.5</u>
EXPENSES									
3.4	3.3	4.6	12.5	Interest Expenses:					
-	-	-	-	Refinance Loans	21.3	28.0	29.7	29.5	28.9
0.2	0.9	0.9	0.8	N.D.B. Loans	0.7	0.6	0.5	0.4	0.3
1.1	2.0	2.4	2.9	N.S.B. Loans	2.4	2.0	1.6	1.2	0.8
0.7	0.5	0.3	0.2	Bank of Ceylon Loans	0.2	0.1	0.1	-	-
3.6	6.8	9.5	10.8	IBRD Loans	10.5	9.0	7.4	5.7	4.3
2.3	3.7	5.2	8.8	IDA Loans	12.2	14.5	14.7	12.8	10.7
-	-	-	0.1	ADB (1) Loan	-	-	-	-	-
<u>11.3</u>	<u>17.2</u>	<u>22.9</u>	<u>36.1</u>	ADB (2) and other Future Loans	0.2	0.2	0.3	0.3	0.4
10.6	14.5	24.3	36.8		<u>47.5</u>	<u>55.2</u>	<u>61.7</u>	<u>61.6</u>	<u>62.5</u>
-----	-----	-----	-----	GROSS PROFIT	55.1	55.9	54.2	61.4	69.0
Less:									
2.8	3.6	5.0	7.0	Overheads	7.5	9.4	11.7	14.7	18.3
0.2	0.2	0.2	0.3	Depreciation	0.3	0.3	1.0	1.0	1.1
0.9	1.5	2.4	3.0	Provision for Doubtful Loans					
<u>6.9</u>	<u>9.2</u>	<u>16.7</u>	<u>26.5</u>	and Investments	22.5	2.7	1.6	1.8	2.1
2.5	2.8	4.2	8.2	Profit Before Tax	24.8	43.5	39.9	43.9	47.6
4.4	6.4	12.5	18.3	Income Tax	12.8	19.5	18.2	19.8	21.5
----	----	----	----	NET INCOME	12.0	24.0	21.7	24.1	26.1
APPROPRIATIONS									
0.9	1.3	2.5	3.8	Share Issue Expenses	-	-	-	-	-
2.0	3.7	7.7	4.4	Special Reserve	1.8	-	-	-	-
1.2	1.5	2.3	2.8	General Reserve	1.0	17.0	15.0	16.0	19.0
				Dividends (Gross)	3.1	7.2	7.2	7.2	7.2
RATIOS									
1.3	1.2	1.2	1.2	Debt Service Coverage Ratio	1.3	1.1	1.2	1.4	1.3
1.4	1.4	1.6	1.6	Administrative Expense/Average					
16.7	18.8	27.5	31.2	Total Assets (%)	1.3	1.4	1.8	2.1	2.6
7.5	8.0	9.6	12.0	Net Profit/Average Equity (%)	13.9	21.1	16.8	16.6	16.0
27.2	23.4	18.5	15.7	Rate of Dividends (%)	12.0	12.0	12.0	12.0	12.0
				Dividends as Percentage Net					
				Earnings (Payout Ratio)	25.8	30.0	33.1	29.9	27.6
				Debt Service Coverage Ratios					

SRI LANKADEVELOPMENT FINANCE CORPORATION OF CEYLONActual and Projected Cash Flow Statements, FY82-87
(Rs million)

<u>Year ended March 31</u>	<u>Actual</u>	<u>Projected</u>				
	<u>FY82</u>	<u>FY83</u>	<u>FY84</u>	<u>FY85</u>	<u>FY86</u>	<u>FY87</u>
<u>Sources:</u>						
<u>Operations:</u>						
Profit before Tax & Depreciation & Provision for Loans	22.8	43.7	46.6	42.5	46.5	50.7
<u>Rupee Sources:</u>						
Loan Repayments	31.0	60.9	68.5	81.8	89.8	86.8
Redemption of RCP Shares	3.3	6.5	6.5	6.5	6.5	6.5
Sale of Ordinary Shares	1.0	1.0	2.0	3.0	4.0	4.0
Staff Loan Repayments	0.1					
Refinance from Central Bank	107.7	95.8	47.1	3.0	4.0	4.0
Share Issue	-	30.0	-	-	-	-
Decrease in Bank Balance	1.0					
Increase in Sundry Creditors	2.1	(0.2)	2.1	1.9	0.2	0.7
Withdrawals from IDA/ADB	97.9	35.2	49.3	52.3	60.3	64.3
	<u>266.9</u>	<u>272.9</u>	<u>222.1</u>	<u>216.3</u>	<u>238.8</u>	<u>245.8</u>
<u>Uses:</u>						
<u>Disbursements:</u>						
Loans	201.0	173.7	102.9	79.7	91.4	97.3
Ordinary Shares	5.4	3.4	7.2	10.3	10.5	10.8
RCP Shares	7.3					
Share Issue Expenses	-					
<u>Repayment of Borrowings:</u>						
IBRD	1.2	1.0	0.7	0.4	0.2	0.1
IDA	12.0	18.8	19.4	21.0	20.3	16.5
ADB (1)	7.7	11.6	11.4	11.0	9.6	6.7
ADB (2) and Future Borrowings	-	-	7.5	15.0	15.0	15.0
Central Bank Refinance	10.0	21.4	22.2	35.0	40.6	44.0
Other Local Borrowings	3.7	4.3	3.9	3.9	3.9	3.9
Loan from Government	1.1	1.1	1.1	1.1	1.1	1.1
Capital Expenditure	0.3	0.3	12.5	0.5	0.6	0.7
Staff Loans	1.0	0.6	0.8	0.9	1.1	1.5
Special Reserve Fund	2.5	3.8	1.9	-	-	-
Tax Paid	8.2	15.0	17.3	18.8	19.2	20.8
Dividends	2.3	2.9	3.1	7.2	7.2	7.2
Increase in Debtors	3.0	5.0	8.6	2.1	4.4	5.0
Increase in Bank Balance	-	10.0	1.6	9.4	13.7	15.2
	<u>266.9</u>	<u>272.9</u>	<u>222.1</u>	<u>216.3</u>	<u>238.8</u>	<u>245.8</u>

April 1983

SRI LANKA

DEVELOPMENT FINANCE CORPORATION OF CEYLON

Actual and Projected Balance Sheets, FY79-87
(Rs million)

Actual				Year ending March 31	Projected				
FY79	FY80	FY81	FY82		FY83	FY84	FY85	FY86	FY87
				ASSETS					
164.5	227.6	314.9	436.5	Loans	549.3	603.7	601.6	613.2	633.7
13.5	16.9	17.5	22.8	Ordinary Shares	25.2	30.4	37.7	44.2	51.0
28.9	35.0	37.9	39.1	Preference Shares	32.6	26.0	19.5	13.0	6.5
206.9	279.5	370.3	498.4	Less: Provisions	607.1	660.1	658.8	670.4	691.2
4.1	5.6	7.4	9.9		28.4	31.1	32.7	34.5	36.6
202.8	273.9	362.9	488.5		578.7	629.0	626.1	635.9	653.6
3.5	4.4	5.7	8.2	Special Reserve Fund	12.0	13.9	13.9	13.9	13.9
1.0	1.1	1.8	2.4	Loans to Staff	3.0	3.8	4.8	5.9	7.4
0.8	0.8	0.9	1.2	Fixed Assets	1.2	13.3	12.8	12.4	12.0
5.3	6.3	8.4	11.8		16.2	31.0	31.5	32.2	33.3
				CURRENT ASSETS					
5.8	11.7	13.6	22.6	Debtors Deposits and Accrued Income	27.6	36.2	38.3	42.7	47.6
10.0	5.0	4.0	4.0	Temporary Investments	4.0	24.0	24.0	14.0	4.0
-	-	(3.4)	6.8	Cash/Bank Balances (Net)	16.8	18.5	27.9	41.6	56.8
15.8	16.7	14.2	33.4		48.4	78.7	90.2	98.3	108.4
223.9	296.9	385.5	533.7	TOTAL ASSETS	643.3	738.7	747.8	766.4	806.3
16.0	23.5	24.0	24.0	Share Capital	60.0	100.0	100.0	100.0	100.0
4.4	5.7	8.2	12.0	Special Reserve	13.9	13.9	13.9	13.9	13.9
7.1	10.8	18.5	23.0	General and Building Reserve	30.0	47.0	62.0	78.0	85.0
0.4	0.2	0.2	0.3	Profit and Loss Balance	1.3	1.1	0.6	1.6	1.5
28.0	40.2	50.9	59.3	TOTAL EQUITY	105.2	162.0	176.0	193.5	212.4
16.0	16.0	16.0	14.9	Loan from Government	13.9	12.8	11.7	10.7	9.6
45.8	43.7	73.6	139.2	Central Bank Refinance	213.6	238.5	231.8	222.4	211.3
11.3	28.6	28.7	26.5	Bank Loans	21.9	18.0	14.2	10.2	6.2
10.0	7.1	3.8	2.8	IBRD Loans	1.8	1.1	0.7	0.4	0.3
64.8	106.0	126.6	141.2	IDA Loans	122.4	103.0	81.9	61.6	45.1
35.1	46.8	70.6	119.5	ADB First Loan	143.2	165.8	148.4	123.8	102.1
-	-	-	-	New Foreign Currency Loans and ADB Second Loan	-	-	-	-	-
183.0	248.2	319.3	444.0	TOTAL LONG-TERM DEBT	516.8	539.2	488.7	429.1	374.6
2.9	3.6	4.2	7.7	Taxes Payable	5.6	7.8	7.3	7.9	8.5
6.5	4.2	8.8	12.8	Sundry Creditors	12.6	14.7	16.6	16.9	17.5
1.2	0.7	2.3	2.9	Dividends	3.1	7.2	7.2	7.2	7.2
2.3	-	-	-	Bank Overdraft (Net)					
12.9	8.5	15.3	23.5		21.3	29.7	31.1	32.0	33.2
223.9	296.9	385.5	533.7	TOTAL LIABILITIES	643.3	738.7	747.8	766.4	806.3
6.53:1	6.17:1	6.27:1	6.7:1	Debt:Equity Ratio	4.91:1	4.48:1	3.96:1	3.52:1	3.19:1

SRI LANKA

INDUSTRIAL DEVELOPMENT PROJECT

Characteristics and Performance of MISA Corporations, GOBUs, and Companies (1981)

<u>Name of Corporation</u>	<u>Capital Invested in Production (Rs '000)</u>	<u>Employment (No Jobs)</u>	<u>Production (Rs '000)</u>	<u>Sales (Rs '000)</u>	<u>Exports (Rs '000)</u>	<u>% Local Raw Materials</u>	<u>Commercial Projects (Rs '000)</u>	<u>Return on Capital in Manufacturing (%)</u>
Ceylon Leather Products	29,528	1,062	41,542	31,674	2,490	60	2,590	8.7
Ceylon Plywoods	77,503	3,519	14,359	135,137	-	80	9,146	11.8
National Paper	376,060	4,383	432,933	419,971	-	40	41	0.01
Paranthan Chemicals	27,604	531	34,712	34,712	-	19	1,142	4.2
State Fertilizer ^{1/}	N/A	963	-	-	-	-	517,960	-
Ceylon Petroleum	216,300	5,809	10,004,643	11,569,625	1,634,726	-	165,300	-
Sri Lanka Tyre	58,205	1,888	232,378	269,848	612	22	11,120	19.1
Ceylon Ceramics	190,763	6,136	199,079	219,085	2,840	60	34,097	18.0
Ceylon Cement	728,179	7,610	932,854	879,946	-	39	7,405	-
Ceylon Steel	290,611	2,214	477,589	449,479	-	2	5,501	1.9
State Hardware	40,565	1,439	46,955	44,443	-	36	-3,048	-
National Salt	54,980	1,489	43,824	44,020	489	100	23,893	43.5
State Mining and Mineral	97,024	2,430	169,625	114,840	100,918	100	44,286	45.6
Ceylon Mineral Sands	130,830	509	111,683	51,114	32,174	100	18,548	0.1
Subtotal, Corporations	<u>2,318,092</u>	<u>39,982</u>	<u>12,742,176</u>	<u>13,814,715</u>	<u>1,773,799</u>		<u>320,026</u>	
<u>Public Sector COS and GOBUS ^{3/}</u>								
Leyland, United Motorways		532	N/A	N/A	-	N/A	17,681	N/A
Lanka Porcelain	30,360	709	74,713	79,713	64,047	41	14,112	0.5
Ceylon Oxygen	26,527	381	12,538	64,613	-	8	4,315	16.0
Lanka Walltiles		-	N/A		-	19		-
Sri Lanka Tobacco	7,433	959	77,708	88,792	-	26	-1,923	-
National Packing	3,009	455 ^{2/}	1,849	13,995	-	N/A	-5,705	-
Gas and Water Co.	14,368	412	42,002	68,229	-	100	-1,547	-
SLIDC		N/A	N/A	1,593	-	N/A		
Vijaya Tiles		272	N/A	N/A	-	N/A	- 214	
Noorani Tiles		398	N/A	N/A	-	N/A	2,637	

^{1/} The Fertilizer Manufacturing Corporation commenced operations in December, 1981.

^{2/} Reduced from level of 5,190 in 1981.

^{3/} Not totalled because of amount of data not available.

Sri Lanka

Industrial Development Project
Ministry of Industries and Scientific Affairs (MISA)
Program to Improve Public Enterprise Performance

Outline of Implementation Plan
(July 1, 1983 - December 31, 1986)

Major Actions

Dates

Organization and Staffing

- Form Public Enterprise Cell in MISA (Composition in Attachment 1) July 1983
- Recruit chief advisors for MISA (Attachment 2 contains terms of reference). August-September, 1983
- Arrival and stay of Chief Advisors October 1983-October 1985
- Establishment and first meeting of the Coordinating Committee (Composition in Attachment 1). by September 31, 1983
- Preparation of year 1 Action Program by November 31, 1983

Corporate Plans

- Preparation of skeletal corporate plans by all Corporations and GOBUs 1/ July-December 1983
- Preparation of detailed corporate plans 1/ July-December 1983 by at least five corporations probably: Cement, Mineral Sands, Ceramics, Hardware and Tyre

1/ Major elements of the corporate plans (covering a rolling two year period) will be: (a) key performance targets, concentrating on improvements in public profits, and isolating social objectives; (b) criterion values which constitute acceptable and outstanding performance; (c) major internal problems and analysis of impact of the various controls on corporate performance; (d) valuation of assets based on replacement rather than historical costs; and (e) operational plans to achieve objectives and targets, including modifications in staffing, balancing and modernization investments, restructuring of capital or management.

Major Actions

Dates

- Preparation of full corporate plans for all corporations and GOBUs, for CY85-CY86 period, with performance incentives for managers who exceed agreed targets. January-July 1984
- Release of some controls on trial basis for selected corporations. January-December 1984

Signalling System

- Detailed review of key controls and systems (done in close cooperation with Public Enterprise Division of MINFIN) analyzing modifications which would improve performance of MISA corporations and GOBUs. Systems to be reviewed include:
 - investment approval procedures and controls on financial management
 - tendering procedures for purchasing equipment and raw materials
 - personnel policies including hiring, promotions, salaries, performance incentives
 - selection criteria for management
 - controls over pricing
- Preparation and discussion with relevant GOSL and IDA officials of report with analysis and recommendations on means to reduce controls and replace them with a system based upon corporate planning, performance incentives, and management accountability for results July-September 1984
- Preparation of, and agreement on, phased program for implementing such a system, with incorporation of steps in CY85 action program September-November 1984

Major Actions

Dates

Firm-Level Assistance

- . Canvassing of corporation management to determine priorities in firm-level technical assistance in: personnel management, marketing; financial planning and management; balancing and modernization requirements; quality control and management information systems; and increasing private participation. July-December 1983
- . Preparation by at least four corporations, with assistance by MISA Public Enterprise Cell, of proposals for technical assistance, with purpose of TA being (a) firm-level improvements; and (b) serving as demonstrations of how performance can be improved if key controls are reduced or removed. October-December 1983
- . Outline of likely firm-level TA requirements for CY84 in annual action program by November 1983
- . Utilization of about 20, 36 and 40 manmonths of firm level technical assistance in CY84, CY85 and CY86 respectively. January 1984-December 1986
- . Quarterly review by coordinating committee of impact of firm-level TA and implications for policies affecting public corporations beginning March 31, 1984

Pilot Schemes

- . Identification of pilot projects to encourage private participation in corporations and GOBUs 1/ October 1983-March 1984

1/ In case of GOBUs, will do corporate planning and asset valuation prior to taking decision re conversion to public corporations or public companies, with GOBUs with dominantly commercial functions to be converted to companies.

Major Actions

Dates

- Launching of at least three pilot projects in management contracts, transformation, joint ventures, and/or selling of shares March 1984 - December 1984
- Firm-level technical assistance to about five firms in preparing pilot schemes March 1984 - December 1984
- Based upon corporate planning and asset valuation analysis, prepare program to encourage appropriate modes of private participation in MISA corporations, with phased actions in annual action programs July-December 1984

Monitoring, Reporting and Accounting

- Quarterly reports presented to coordinating committee and IDA, through NDB beginning December 31, 1983
- Coordinating committee to meet monthly until December 1984, and at least quarterly thereafter beginning September 1983
- Audited accounts for this program to be submitted six months after end of calendar year July, 1984, 85, 86, 87
- Authorization and withdrawal requests to be submitted through NDB, for convenience

Probable Composition of Public Enterprise Cell MISA

- . Chairman, Coordinating Committee for Public Enterprise Program: Secretary, MISA
- . Head of MISA Public Enterprise Cell: Director, MISA to be appointed in consultation with IDA.
- . Members in MISA:
 - Director, Finance
 - Director, Prices and Tariffs
 - Director, Personnel
 - Director, Project Evaluation Division
 - Director, Tender Board
- . Members in Corporations: rotating membership composed of 2-3 chairmen or designates, of involved corporations, probably beginning with cement, ceramics, leather.

The Coordinating Committee on the Program to Improve Public Enterprise Performance to meet monthly, at least from October 1983 - December 1984, and at least quarterly thereafter, will be established by October 1983 with the following minimum membership:

- . Chairman - Secretary, MISA
- . Members
 - Director of Public Enterprise Division of Ministry of Finance (MINFIN)
 - Head of MISA Public Enterprise Cell
 - Director, Planning, MINFIN or designate
 - Chairman, NDB or designate
 - Chief Advisors, Public Enterprise Cell, MISA
 - Rotating memberships of Chairman of 2-3 involved public sector corporations.
 - Director, Project Evaluation, MISA.

SRI LANKA

Industrial Development Project
Ministry of Industries and Scientific Affairs (MISA)

Program to Improve Public Enterprise Performance

Draft Terms of Reference for Chief Advisors

A. Advisor on Corporate Plans and Firm-Level Assistance

Qualifications. The advisor will have a degree in industrial economics or corporate finance and management, and will have at least ten years of experience working in or on public sector enterprises in countries similar to Sri Lanka. The advisor will have strong experience with corporate planning in public enterprises, and will be well versed in the various functional areas of industrial management e.g. finance, marketing, production, personnel, and investment. Good knowledge of specialists who could assist individual corporations in resolving firm-level problems would be desirable.

Responsibilities. The advisor will work for the Ministry of Industries and Scientific Affairs, under the general direction of the Secretary, MISA, and on a daily basis with the head of the Public Enterprise Cell of MISA. The advisor will assist in carrying out the activities outlined in the Implementation Plan (attached) with particular attention to the following aspects:

- (a) assisting MISA corporations and GOBUs in completion of corporate plans, monitoring of implementation of actions, and compliance with objectives and meeting of targets;
- (b) development of criterion values on adequate and outstanding performance, and appropriate systems of performance incentives for management;
- (c) analysis of means to address firm level problems, and assistance to management in developing technical assistance proposals, and locating suitable consultants;
- (d) development and installation of management information systems to help management and MISA better monitor performance, enabling movement to a system of performance monitoring, rewards, and accountability with increased autonomy to corporation management; and

(e) working closely with the Cell and other advisor, development of pilot scheme program to encourage appropriate private participation in ownership and management of public sector corporations, GOBUS, and other enterprises. In performing these tasks the advisor will help ensure strong coordination with the Public Enterprise Division of MINFIN, by participating in regular meetings of the Coordinating Committee and maintaining strong operating-level liason.

Reporting. The advisor will assist in preparation of Quarterly Progress Reports, and will prepare an interim and final report on work, findings, and conclusions.

B. Advisor on System of Controls, Signalling and Private Participation

Qualifications. The advisor will have a degree in industrial economics or business administration, and will have at least ten years of experience in analyzing systems affecting enterprise performance and efficiency, in situations similar to those of Sri Lanka. The advisor also will be well versed in asset valuation and alternative modes of increasing private participation in ownership and management of public enterprises including: management contracts; joint ventures; transfirmation into companies; selling of shares. Preferably, the advisor will have experience both at enterprise and ministerial levels.

Responsibilities. The advisor will assist the Ministry of Industries and its Public Enterprise Cell in undertaking actions and meeting objectives outlined in the Implementation Plan for the Program to Improve Public Enterprise Performance (attached). The advisor will give particular attention to the following aspects:

- (a) Analysis of the existing system of controls over operation of public corporations and GOBUS including tendering procedures; personnel hiring, promotion, and remuneration; pricing policies; financial management and investment approval; and make recommendations, if necessary, to MISA, on the selection of management, to improve public enterprises;
- (b) Recommendations on modifications in the system and phased replacement of controls with a system of performance incentives and management accountability; and assistance in implementing these changes;
- (c) Analysis of optimum means to encourage increased private participation in ownership and management of public corporations, GOBUS and other enterprise forms.

Monitoring and Reporting. The advisor will: assist the MISA Public Enterprise Cell in preparing quarterly progress reports; prepare an interim and final report on work, findings and recommendations; and will help coordination with MINFIN through participation in the coordinating committee and regular operating level contacts.

Duration. Both advisors will be hired for a period of two years, beginning about October 1983.

INDEX - PROBLEMS

- 1 = Marketing
- 2 = Production
- 3 = Inputs
- 4 = Finance/Accounting
- 5 = Personnel

SRI LANKA

INDUSTRIAL DEVELOPMENT PROJECT

PROBLEMS OF SELECTED STATE INDUSTRIAL CORPORATIONS: A. FIRM-LEVEL PROBLEMS

Name of Corporation	Problems					Principal Problems
	1	2	3	4	5	
National Paper Corporation	X			X		<p>Difficulty in competing with imports, with resultant low capacity utilization of about 60%; need to do market and cost analysis to determine lines in which can be competitive, and to upgrade quality.</p> <p>Need to reduce product varieties, rationalize product mix overall and between the two plants to achieve economies of scale; most imports are from plants with 300 MT capacity vs. 25 MT per day in Sri Lanka.</p> <p>Heavy burden to repay major KfW loan for second plant; would preclude making necessary balancing and consolidation efforts.</p> <p>Overstaffing, by about 50% in unskilled, allied trades, clerical, and junior executive levels, combined with high turnover and non-availability in skilled and professional grades; high number of mandays per metric ton produced; low motivation.</p> <p>Escalating costs of imported wood pulp and fuel; desire to substitute indigenous raw materials but Embilipiliya plant not equipped with adequate pulping equipment and local wood not available.</p> <p>Serious problems with sporadic and prolonged power cuts; since continuous process plants, high start-up costs and losses with downtimes.</p> <p>Low return on capital (6.1%).</p>
Ceylon State Hardware Corporation	X	X		X		<p>Losses in 1978; notional profits in 1979 and 1980; extremely low return on capital (about 4%).</p> <p>Need to adapt products and rationalize product mix on the basis of unit cost and market analysis; at present, corporation makes 122 products; in the case of 50 items, fewer than 20,000 units are made annually, averaging less than 100 units per day. Many could be made by private sector.</p> <p>Quality control improvements and reduction in the percentage of rejections are needed.</p> <p>Need to reduce wastage in raw material utilization, particularly in view of escalating input costs.</p> <p>Insufficient internal controls; weaknesses in working capital and liquidity management and budgetary controls (variance from budget is about 40%); and high accrued liabilities.</p> <p>Difficulties in attracting and retaining skilled staff due to low salaries and relatively distant location from major city or town; high percentage of non-production workers to total work force; high absenteeism (20%).</p> <p>Poorly balanced plant with some obsolete machinery.</p> <p>Lack of funds for investment; considering joint venture with Chillington for mammothies.</p>
Ceylon Leather Products Corporation	X					<p>Dwindling market share with competition from private sector; in 1977, CLPC represented 62% of market share in footwear sales vs. 39% in 1978.</p> <p>Need for production incentives which reflect both quality and quantity objectives; at present piece rate incentives combined with poor quality control have resulted in 20-30% increase in output but with high percentage of defective products.</p> <p>Virtually no market intelligence in determining designs and sizing in product mix.</p> <p>Poor maintenance and spare management, resulting in frequent machine breakdowns and losses with downtime.</p> <p>High rate of absenteeism, ranging from 16% to 30%; less of an over-employment problem than in other corporations; low labor productivity averaging 3.4 to 3.8 pairs daily per worker.</p> <p>Inability to retain qualified supervisory and technical manpower.</p> <p>Lack adequate reserves to finance new investments.</p> <p>Limited and dwindling supply of local hides and skins and increased competition to get these inputs since CLPC no longer has monopoly on purchase of hides and skins; better raw material inventory management could result in savings.</p> <p>Questionable comparative advantage vs private sector in recent diversification move in rubber soling.</p>

Name of Corporation	1	2	3	4	5	Principal Problems
Sri Lanka Tyre Corporation		X X	X		X X	Weaknesses in quality control; QC needed at four stages, performed only at two. Low technology for curing; obsolete equipment for vulcanizing; poorly balanced plant. Difficulty in purchasing spares since 40% of the equipment is Russian, with limited servicing. High percentage of non-productive labor force, accounting for nearly half of the Rs 16 million total wage bill; excess employment even in managerial and technical grades; actual cadre about 40% above approved level and about 30% above needs; attempting to address through attrition but this approach is slow and difficult due to pressures from community and union. Quantity-oriented incentive system results in high percentage of rejects. Difficult competition from imports and local tyre rebuilding industry; changing demand for new tyres with corporation slow to analyze and react--production scheduling done only once a year. No pricing strategy: see low prices as an objective, which reduces profits, reinvestment, and response to changing market requirements. Location poor, in residential area, with no room for expansion.
Ceylon Ceramics Corporation		X X X	X	X	X	Problem with quality of sanitary ware. Quantity incentives result in speeding up machines with resultant high percentage of defects. Excess materials used in glazing stage. Need to do unit costing exercise to determine optimum product mix and product costing. Have installed Rs 100 million chinaware plant which is not viable unless have solid export marketing arrangements; negotiating with Royal Dalton to make it a joint venture.
Ceylon Mineral Sands Corporation		X		X		Improvements needed in loading material handling, testing, improving processing efficiency (UNIDO assistance received and on-going in addressing these problems). Substantial amount of untapped high quality mineral sands, synthetic rutile and ilmenite; trying to find foreign partner to establish joint venture company.
National Salt Corporation		X			X	Involved in variety of small industries which could be done by private sector; plan other small investments in epsom salt, gypsum, magnesium sulphate. Need managerial and technical training.
Ceylon Cement Corporation		X	X	X	X	Have taken major steps in improving performance: seek technical assistance under the project in: (a) developing personnel management, including incentive systems; (b) accounting and financial management; and (c) selected production problems.

INDEX - PROBLEMS

- 1 = Tendering
- 2 = Protection
- 3 = Personnel Management
- 4 = Pricing
- 5 = Investment
- 6 = Cross Subsidies

SRI LANKA

INDUSTRIAL DEVELOPMENT PROJECT

PROBLEMS OF SELECTED STATE INDUSTRIAL CORPORATIONS: B. PROBLEMS WITH THE SYSTEM

Name of Corporation	Problems						Principal Problems
	1	2	3	4	5	6	
National Paper Corporation	X						<p>Government tendering procedures are lengthy and inappropriate in pulp and chemical purchases; large stocks need to be held due to long lead time in going through tendering, and procurement costs are higher than if Paper Corporation were to negotiate directly when prices are low. Makes competition with imports difficult.</p> <p>As a result of problems in competing, Paper Corporation has succeeded in getting import duty on paper increased from 25% to 50%.</p> <p>Salaries are determined by government grades; would need to increase salaries of technical and managerial personnel by two to three times to attract and retain adequate numbers of competent key staff; incentives for management would be strong inducement and improve performance.</p> <p>Prices Commission set prices but real problem is market.</p> <p>Regular and unanticipated power cuts are imposed by government on NPC and other corporations.</p>
Ceylon State Hardware Corporation	X						<p>Cumbersome tendering procedures (taking three to five months) have meant that need to order nine months-worth of inputs; took 1.5 years to get decision on procurement of induction furnace.</p> <p>Claim Prices Commission is problem, with prices set being out of date; however, have difficulty selling at these low prices.</p> <p>Made to use old rails which create 20% reject problem; could improve quality if could import billets.</p> <p>Need to use Job Bank for all grades except executives; need approval by Ministry before advertising for any vacancies.</p> <p>Have lost about 50% of engineers and skilled workers during last three years.</p> <p>Have called for tenders for expansion project, but will not be possible until government approves, which is questionable since Corporation does not have equity financing.</p>
Ceylon Leather Products Corporation	X		X				<p>Clear contrast between CLPC and its joint venture with Korean firm on CGEC for canvas shoe manufacture (Korean firm has controlling interest): with joint venture are able to attract technical and managerial staff as can pay higher salaries and are free to select most qualified staff.</p> <p>Profits of CLPC deceptive as cross subsidization of inputs since purchase from own tannery; transfer price is about half the price of leather sold on open market. Management fears that could not sell shoes if costed leather correctly.</p>
Sri Lanka Tyre Corporation	X						<p>Forced to purchase rubber from Department of Commodity Purchase; rubber, which is surplus from China rubber-rice bilateral trade, is of higher quality and price than the Tyre Corporation requires.</p> <p>Tendering procedures, required for all input and equipment procurement in excess of Rs 1 million, result in large inventories and higher purchasing costs than if negotiated.</p> <p>Forced to employ people from the local community, who object to pollution and waste.</p> <p>Prices Commission and public corporation ethic result in many items being priced too low.</p> <p>Have entered into technical services contract with Goodrich (25% of total net sales) to improve performance and set-up radial tyre production.</p> <p>Value assets at historical prices, as dictated, with no efforts to revalue assets.</p>

Name of Corporation	1	2	3	4	5	6	Principal Problems
Ceylon Ceramics Corporation					X		Received Rs 100 million from Treasury for new chinaware factory as bridge loan until could make arrangements with NDB. To make factory operational, would cost another Rs 60 million. Also, project unviable unless establish strong export marketing relations. CCC now want Treasury to alter terms of loan, with 10 year repayment including two years grace at 10% annual interest. Are negotiating with Royal Dalton for joint venture company, with Royal Dalton to hold 49% share and Royal Dalton would purchase from company at agreed price. Still need additional funds and not in position to put in more equity financing.
Ceylon Mineral Sands Corporation			X			X	Board, with mixed qualifications, involved in day-to-day operations through working directors which creates unclear decision-making responsibilities. Excellent expansion prospects in ilmanite and synthetic rutile but technical expertise by foreign partner required; need feasibility study.
National Salt Corporation		X				X	Have monopoly on salt mining and distribution; lends itself to small, labor intensive industries. Public pressure to keep salt prices low, claim that sell at subsidized prices. Forced to sell salt to other corporations at below cost.

SRI LANKAINDUSTRIAL DEVELOPMENT PROJECTESTIMATED DISBURSEMENT SCHEDULE

IDA Fiscal Year and Quarter	<u>By Quarter</u>	<u>Disbursements</u>	
		<u>Percentage</u> (US\$ millions)	<u>Cumulative %</u>
<u>FY84</u>			
To December 31, 1983	0.2	0.8	0.8
March 31, 1984	0.3	1.2	2.0
June 30, 1984	<u>0.6</u>	<u>2.4</u>	<u>4.4</u>
	1.1	4.4	
<u>FY85</u>			
To September 30, 1984	0.7	2.8	7.2
December 31, 1984	1.0	4.0	11.2
March 31, 1985	1.2	4.8	16.0
June 30, 1985	<u>1.3</u>	<u>5.2</u>	<u>21.2</u>
	4.2	16.8	
<u>FY86</u>			
To September 30, 1985	1.7	6.8	28.0
December 31, 1985	1.8	7.2	35.2
March 31, 1986	2.0	8.0	43.2
June 30, 1986	<u>2.2</u>	<u>8.8</u>	<u>52.0</u>
	7.7	30.8	
<u>FY87</u>			
To September 30, 1986	2.4	9.6	61.6
December 31, 1986	2.5	10.0	71.6
March 31, 1987	2.3	9.2	80.8
June 30, 1987	<u>2.0</u>	<u>8.0</u>	<u>88.8</u>
	9.2	36.8	
<u>FY88</u>			
To September 30, 1987	1.3	5.2	94.0
December 31, 1987	0.9	3.6	97.6
March 31, 1988	0.4	1.6	99.2
June 30, 1988	<u>0.2</u>	<u>0.8</u>	<u>100.0</u>
	<u>2.8</u>	<u>11.2</u>	
	<u>25.0</u>	<u>100.0</u>	

April 1983
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INDUSTRIAL DEVELOPMENT PROJECT

Supporting Documents Available in Project File

A. Industrial Sector and Economic Setting:

1. Central Bank of Ceylon, Review of the Economy, 1981; subsequent monthly bulletins.
2. Report on the Survey on Manufacturing Industries, 1979. Department of Census and Statistic.
3. Cuthbertson and Khan, Effective Protection to Manufacturing Industry in Sri Lanka, 1981.
4. Survey of Projects Approved by the Foreign Investment Advisory Committee, 1977 - 1982, Ministry of Finance and Planning.
5. Performance and Prospects of the Tourism Sector, J. A. Simmons. (Mission Working Paper). February 1982; revised in April 1983.

B. Lending Component

1. National Development Bank of Sri Lanka:

- Various financial, operational and institutional data on NDB;
- Policy Statement and Strategy Statement (1983 - 1986).

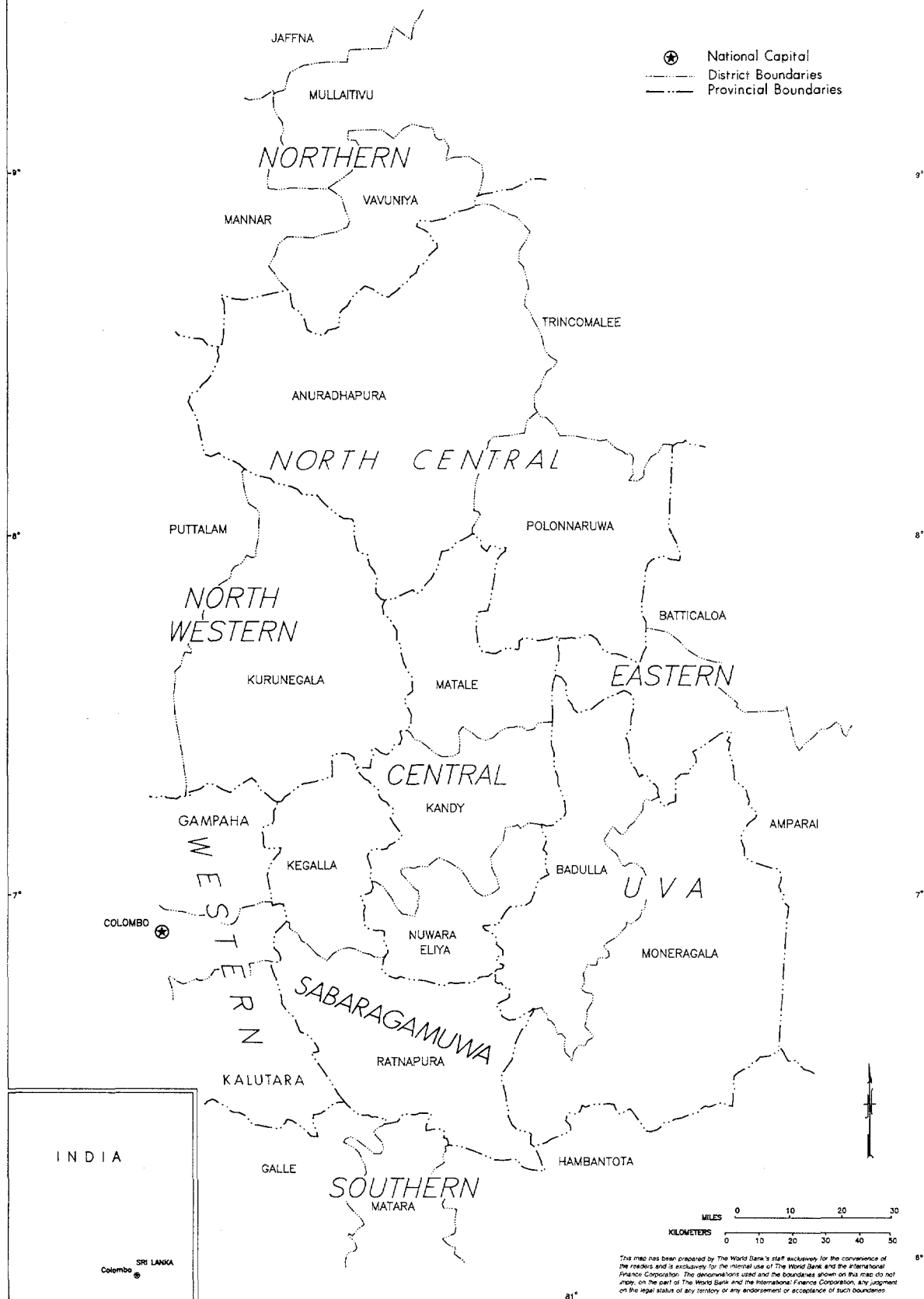
2. Development Finance Corporation of Ceylon:

- Various financial, operational and institutional data on DFCC.
- Statement of Policies and Strategy Statement (1983 - 1986).
- Operational Plan, 1983.

C. Public Enterprises Component

1. Annual and Performance Reports on Public Corporations under MISA.
2. Corporate Plans and Special Studies of Selected Public Industrial Corporations.
3. Parliament and Public Corporations, Report by the Committee on Public Enterprises (COPE).
4. Report on Public Enterprises in Sri Lanka, Mr. Praxy Fernandez et March 1983.
5. Review of Activities, 1981, Ministry of Industries and Scientific Affairs.

SRI LANKA INDUSTRIAL DEVELOPMENT PROJECT



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