High growth companies and how to fund them – a real driver of economic growth?

Corporate Acquisitions and Joint Ventures Commission

Prague, 2014 – Working Session 04

National Report of Sri Lanka

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The working session in Prague is entitled “High growth companies and how to fund them – a real driver of economic growth?” In the working session we plan to address funding alternatives for high growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high growth companies. This questionnaire mainly concentrates on these two topics in relation to high growth companies, but will also cover commercial and regulatory opportunities and constraints.
1. CORPORATE FINANCE – FUNDING ALTERNATIVES

1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

There is no publicly available information in regard to the manner in which investments are typically made in High Growth Companies in Sri Lanka.

In terms of the Companies Act No. 7 of 2007, a company can issue ordinary shares and if the Articles so permit, preference shares and other instruments such as convertible debt and stock options could also be issued.

In the recent past a well known listed company issued warrants in connection with large rights issues but regulatory action was subsequently taken by the securities and Exchange Commission.

It is also possible for companies to raise funds through debt instruments such as corporate bonds and participating debentures.

In the case of corporate bonds, a number of policy measures have been implemented to develop the corporate bond market in Sri Lanka. The measures include the mandatory requirement of credit rating and publication of such rating for all varieties of debt instruments, a registration requirement for all corporate bonds, the entrusting of regulatory functions in respect of corporate bonds to the Colombo Stock Exchange (CSE) and the provisions of facilities to trade corporate bonds.

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

Tax treatment of dividends and interest payments can and does change from time to time. Pending legislation to implement the provisions in the Budget Speech of late last year, it would be premature to comment on tax issues.

It should be noted that in Sri Lanka there is no capital gains tax.

There is however a share transfer levy chargeable at the rate of 0.3% based on the values of stock market transactions which is collected at both sale and purchase points. From 1st April, 2007, profits and income from the sale of shares of any persons or partnership are exempt from income tax.

It should also be noted that is a requirement of exchange control rules that in the case of non resident investors, the particular type of security, (equity based or debt based or hybrid type instruments), would have to be a category which a non resident investor is permitted to invest in. Thus the shares of companies carrying

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on business in certain areas such as money lending, pawn brokering, retail trade with a capital of less than US$ one million, costal fishing and provision of security services are not open to non resident investment. The issue of shares of companies to non residents proposing to carry on certain businesses are restricted upto 40% of the issued capital of company. Some of such restricted areas are, production of goods where Sri Lanka’s export are subjected to internationally determined quota restrictions, timber based industries using local timber, deep sea fishing, mass communications, education etc. The Exchange Control rules applicable to certain categories of debentures are referred to in brief in the answer to question 1.3 which follows.

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

Under and in terms of the Extraordinary Gazette No. 1681/11 notification dated 22nd November 2010 of the Controller of Exchange, there are several requirements that must be satisfied when issuing and transferring convertible or non-convertible, redeemable or non-redeemable debentures denominated in Sri Lankan Rupees in a company classified as a specified business enterprise in terms of the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, to foreign institutional investors, corporate bodies incorporated outside Sri Lanka, individuals resident outside Sri Lanka and Sri Lankans resident outside Sri Lanka. These requirements are as follows:

- All debentures issued under the said gazette should be listed on the Colombo Stock Exchange, and such issue may be made either by way of private placement or initial public offer.
- The period of redemption or conversion to ordinary shares, of the debentures issued under the said gazette should not be less than two years and such conversion would be subject to the exclusions and limitations stipulated in the Government Gazette Notification No. 1232/14 dated 19th April 2002 (referred to previously).
- The debentures issued should have a current credit rating from a local rating agency or international rating agency acceptable to the Securities Exchange Commission of Sri Lanka.

1.4 Is crowd funding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

Please note that crowd funding is not, as far as we are aware, used as a funding mechanism in Sri Lanka.

2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL
2.1 Who are typical investors into a high growth company in your jurisdiction? 
Sources of funding (i.e founders-family-friends, angel investments, venture capital investments, private equity)

Private equity/venture capital is not highly developed in Sri Lanka and while data or statistics are not readily available, it is likely that High Growth Companies would be funded by investors who are family/friends or by bank loans.

2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?

It is not possible to answer this question in the absence of publicly available data or statistics.

2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)

The process of documenting the investment would depend on the nature of the investment.
In the case of an equity investment in the shares of a company, it would be usual to enter into a shareholders’ agreement.
The Articles of Association of the company would have to be amended appropriately.
It should be noted that in the case of companies listed under the Securities Exchange Commission, the provisions of the listing rules and takeovers, Mergers Code may be relevant.

2.4 Are there incentive schemes for investing into high growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)? No.

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

If an investor invests in a company by lending and security for the loan is issued by way of a secured debenture this may be preferable as opposed to an equity investment since a secured debenture would have priority over the claims of a mere shareholder of a company when it comes to distribution of assets upon liquidation. In the case of a non-resident investor, compliance with the provisions of the Exchange Control Act would have to be ensured.

3. ENTREPRENEUR’S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

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3.1 **Which company form is most popular?** (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)

The most popular type of company (whether high growth or any other category) is the limited liability company which can be divided into two categories: private and public limited liability companies.

These types of companies protect an investor from personal liability. The shareholder’s liability is limited to the amount which remains unpaid on any shares which the investor has acquired; (NB: most shares are now issued fully paid so this is less and less common).

The framework for the management of a company consists of a board of directors and shareholders. Shareholders holding the majority of shares ultimately control the company through the exercise of their votes at annual general meetings. For certain decisions, a super majority would be needed.

3.2 **What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?**

In the absence of readily publicly available information it is not possible to answer this question. However it should be noted that of the top fifteen companies in Sri Lanka (by net profit) in the year 2012, five companies were from the banking sector. In terms of growth, certain companies in the fields of tile production, local aerated beverages and consumer goods have seen spectacular growth in recent years.

3.3 **Are there incentive schemes for entrepreneurs incentivising high growth companies** (e.g accelerators/incubators? Other?)

There are no specific incentive schemes applied for high growth companies. However the following tax concessions are applicable for the following categories of businesses.

- **Medium Scale - New Enterprises** (investments of Rs. 50 Mn and above)

<table>
<thead>
<tr>
<th>Activity**</th>
<th>Qualifying Criteria</th>
<th>Tax Exemptions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amount of Investment</strong> (Rs. Mn)</td>
<td></td>
<td>(No. of years)</td>
</tr>
</tbody>
</table>

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*Please note that the above data is taken from the BOI website which has been updated in 2014.*
<table>
<thead>
<tr>
<th>Category</th>
<th>Qualifying Criteria</th>
<th>Tax Incentives</th>
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<tbody>
<tr>
<td></td>
<td></td>
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<tr>
<td><strong>01.</strong></td>
<td>Agriculture or Forestry</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cultivation of food crops or industrial crops, Horticulture, Forestry, Animal Husbandry (Dairy, poultry, Swine, Goat etc.)</td>
<td>Same amounts as for the Manufacturing category.</td>
</tr>
<tr>
<td></td>
<td>None</td>
<td>Same periods as for the Manufacturing category.</td>
</tr>
</tbody>
</table>

* Amount of investment means the cost of any land, plant, machinery, equipment and other fixed assets.

* It is a requirement that products manufactured shall have a minimum of 35% value addition if more than 50% of the production is to be sold in the domestic market.

* For BOI approved projects, Customs import duty would be exempted on imports of Project related capital goods (plant, machinery and equipment) and, Input (raw materials) for export oriented projects.

- Large Scale – New Enterprises

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2 ibid.

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| 02. | 1. Manufacture, Production or processing of non-traditional goods for export, including deemed exports;  
2. Manufacturing for domestic and/or export market Boats, Pharmaceuticals, Tyres and Tubes, Motor Spare Parts, Furniture, Ceramics, Glassware or other mineral based products, Rubber based products, Cosmetic products, Edible products manufactured out of locally cultivated agricultural products, Construction materials, Electrical/Electronic items | 90% (60% for Apparel & Ceramic) | 70% of turnover should be in convertible foreign currency as applicable. | 6  
7  
8  
9  
10  
12 |>300 and ≤500  
>500 & ≤700  
>700 & ≤1,000  
>1,000 & ≤1,500  
>1,500 & ≤2,500  
>2,500 | Same amounts as for the manufacturing category. | Same periods as for the manufacturing category. |
| 3. Services | Provided to a person or partnership outside Sri Lanka  
Tourism or Tourism Related Projects,  
Providing Hotel Services, Guest Houses or Similar Services,  
Infrastructure Projects including Construction of Commercial Buildings,  
Development of any warehousing or storage facility,  
Power Generation using Renewable Resources  
Establishment of Industrial Estates, Special Economic Zones or Knowledge Cities,  
Urban Housing or Town Centre Development,  
Provision of Any Sanitation Facility or Waste Management | | | |
<table>
<thead>
<tr>
<th>Systems,</th>
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</thead>
<tbody>
<tr>
<td>Development of Water Services,</td>
</tr>
<tr>
<td>Development of internal water ways or related transport (goods or passengers)</td>
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<tr>
<td>Construction of Hospitals and provision of Health Care Services,</td>
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<tr>
<td>Repair of aircrafts or maritime vessels or ship breaking</td>
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<tr>
<td>Sporting Services (eg. Motor Racing or Golf Course)</td>
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<tr>
<td>Information Technology</td>
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<tr>
<td>Software development</td>
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<tr>
<td>Business/Knowledge Process Outsourcing</td>
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<tr>
<td>Any Project in Light or Heavy Engineering Industry,</td>
</tr>
<tr>
<td>Artificial insemination for cattle (Dairy development)</td>
</tr>
<tr>
<td>Educational services</td>
</tr>
</tbody>
</table>

* Amount of Investment means the cost of any land, plant, machinery, equipment and other fixed assets.
* For BOI approved projects, Custom duty will be exempted in respect of certain imports of certain project related capital goods (plant, machinery and equipment) and in respect of inputs (raw materials) of export oriented projects. In addition please refer category No 6 below for exemptions during the project implementation period.

Note – the above information is subject to change depending on any amendments to the Inland Revenue Act which may be passed in 2014.
• Strategic Import Replacement – New Enterprises³

Any new enterprise established on or after 01.04.2012 and engaged in the manufacture of any of the products referred to in the table below will be eligible for the following tax incentives.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Minimum Investment* (USD. Mn.)</th>
<th>Tax Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fabric</td>
<td>5</td>
<td>5 years Tax holiday followed by a concessionary tax rate of 12% thereafter</td>
</tr>
<tr>
<td>Pharmaceutical</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Milk Powder</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Cement</td>
<td>50</td>
<td></td>
</tr>
</tbody>
</table>

* Amount of Investment means the cost of any land, plant, machinery, equipment and other fixed assets.

Note – the above information is subject to change depending on any amendments to the Inland Revenue Act which may be passed in 2014.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

See the answer to question no. 2.5 above.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

a. Anti-dilution measures

Commonly in the case of an equity investment, a shareholders’ agreement would be entered into which would contain provisions such as

³ ibid.
requiring the consent of all directors/shareholders to certain important matters – for example in the case of a decision taken in regard to the issue of shares, that such a decision would require the consent of all directors.

NB - Under and in terms of the standard Articles of Association the board of director has the power to issue shares to such persons as the Board thinks fit in accordance with the provisions of the Companies Act No. 7 of 2007. Before issuing shares it is the directors who will decide the consideration for which the shares will be issued.

Where the shares confer rights other than the following rights: one vote on a poll at a meeting of the company on any resolution, the right to an equal share in dividends paid by the company and the right to an equal share in the distribution of the surplus assets of the company on liquidation, or where the shares impose any obligation on the holder, it is the board of directors that has the authority to approve terms of issue which set out the rights and obligations attached to those shares.

b. Shareholders agreements commonly contain provisions in regard to rights of first refusal, pre-emption rights, drag and tag along provisions etc.

Any such provisions in a shareholders’ agreement would have to be incorporated into the Articles of Association.

c. Protective provisions/ Information rights/Dead-lock resolution

The Companies Act of Sri Lanka is flexible enough to allow safeguards to be built in when drafting Articles of Associations to provide for matters such as protection of investors, (shareholders), for a right of information to directors/shareholder, for what happens in the case of dead lock.

However, it should be noted that in terms of the Companies Act No. 7 of 2007, one or more shareholder(s) holding 75% or more of the shares could pass a resolution to amend the Articles.

d. Board seats / observer rights

The Companies Act is flexible and such provisions as desired could be incorporated into the shareholders’ Agreement and Articles of Association.

e. Any other terms specific/important in your jurisdiction?

Any such terms would be subject to being complaint with for a applicable law including but not limited to the Exchange Control Act.
5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

It is not possible to comment on what types of exit are most common given the lack of readily available information. Initial public offers are commonly used in addition to sales to other investors/venture capital parties and private placements.

It is not possible to comment on a typical transaction length since there are many factors which may alter typical time lines.

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders’ agreements/shareholders’ agreements upheld in the next round, or new agreement is entered into?

Typically a new shareholders agreement would be entered into. In some cases the shareholders’ agreement may provide for the new shareholder to execute a deed of adherence.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?

Foreign (non-resident) investors would be liable to pay taxes on income and profits arising in or derived from Sri Lanka.

In the case of dividends, unless there is some special exemption from taxation on dividend income in the hands of a foreign investor in terms of an agreement entered into by the local project company with the Board of Investment of Sri Lanka, the local resident company would deduct withholding tax at source. The impact of any applicable double taxation treaty which Sri Lanka has entered into would have to be considered.

As for the high growth company, if it has entered into an agreement with the Board of Investment of Sri Lanka in terms of section 17 pursuant to which it has been granted incentives such as tax exemptions; or qualified for such exemptions pursuant to provisions contained in the Inland Revenue Act, the tax treatment of its profits and income may be favorable.

Other taxes which a high growth company would likely be liable to collect/pay include VAT and Economic Service Charge (ESC).
Sri Lanka has entered into bilateral Double Tax Avoidance Agreements with 38 countries. The tax implications of these Agreements in connection with investments from these countries would vary depending upon the provisions contained in each such Double Tax Avoidance Agreement.

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.

Under and in terms of the Extraordinary Gazette No. 1733/19 mentioned above, there are certain terms and conditions that should be satisfied by the Debenture-Issuing Companies. These terms and conditions are as follows:

- The Board of Directors of the debenture issuing company should ensure that cash inflows of its business operations are adequate to service the repayment of interest payments on the debentures, so as to prevent any material liquidity risk to the company.

- The Board of Directors of the company should establish a risk management process that ensures the company addresses the possible risks arising from the foreign investment in the debentures of the company and/or the contagion risk of any default and the other risks to the company in the case of such an eventuality.

- Funds for the investment in debentures and the payment for debentures by the nonresident investor should be made only out of funds received as inward remittances through a “Securities Investment Account.”

- A commercial bank or any other person entrusted with the payment of the capital amount, coupon, interests and commissions in respect of any transaction permitted under the said Gazette should make such payment only into or out of a Securities Investment Account.

- Moreover such companies are required to furnish a report to exchange Control Department within 30 days of receipt of remittances for investment in debentures providing the following details:
  
  - The total amount received through SIAs.
  
  - The names and addresses of the Authorized Dealers through whom the remittances were received.

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4 Australia, Italy, Qatar, Bangladesh, Japan, Romania, Belgium, Korea, Russia, Canada, Kuwait, Saudi Arabia, China, Malaysia, Singapore, Denmark, Mauritius, Sweden, Finland, Nepal, Switzerland, France, Netherlands, Thailand, Germany, Norway, UAE, Hong Kong, Oman, United Kingdom, India, Pakistan, USA, Indonesia, Philippines, Vietnam, Iran, Poland.
• A certificate from the Company Secretary confirming that the provisions of the exchange Control Act and the directions issued under the Act with regard to the issuance of debentures have been duly complied with.

It should be noted that the above terms and conditions provided for in Extraordinary Gazette No. 1681/11 should not be construed as affecting or having a bearing on enterprises as defined in the Board of Investment of Sri Lanka Law No. 4 of 1978 in respect of which exemptions has been granted from the Exchange Control Act, to the extent of such exemptions.

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).

NA