



hatch.

Supporting startups through the COVID-19 Crisis



June 2020

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Glossary of terms

BOI	Board of Investment
CBD	Central Business District
CBSL	Central Bank of Sri Lanka
CSE	Colombo Stock Exchange
EPF	Employees' Provident Fund
ETF	Employees' Trust Fund
ESOP	Employee Stock Ownership Plan
GoSL	Government of Sri Lanka
ICT	Information and Communication Technology
PPP	Private Public Partnership
SLASSCOM	Sri Lanka Association of Software and Service Companies
SLT	Sri Lanka Telecom
SME	Small and Medium Enterprises
UDA	Urban Development Authority
VRS	Voluntary Retirement Scheme
YoY	Year on Year

Sri Lanka towards a technology driven economy

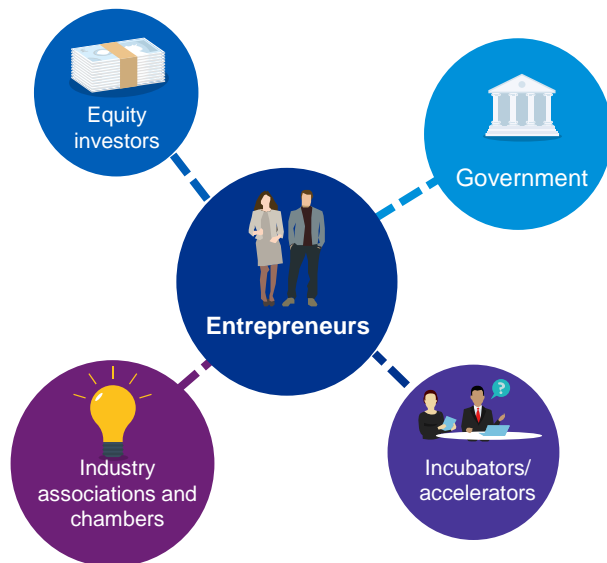
Technology development at a policy level

- Sri Lanka continues to strive towards becoming a technology based economy with the current leadership also placing great emphasis on the sector.
- In the process of attaining the above status, strategic investments are to be carried out to embed technology into every sector of the economy, while encouraging a culture of technological innovation.
- Creating the right ecosystem for startups has been considered vital in achieving this goal. This trend is evident globally as well, where promoting local startups has become one of the key goals of policy makers to achieve sustainable economic growth.

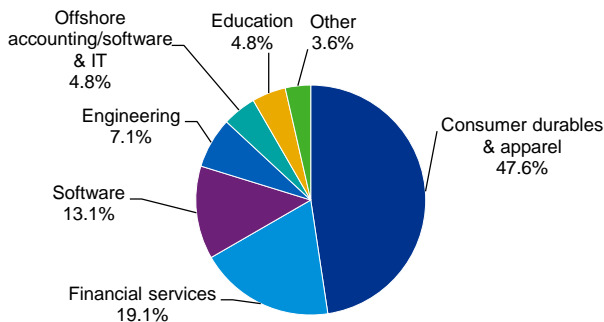
The startup ecosystem of Sri Lanka

- Prior to COVID-19, the startup ecosystem in Sri Lanka was growing in line with the development areas such as communication and IT which have contributed to a rapid growth in the number and scale of startups.
- SLASSCOM estimates 400 registered startups in Sri Lanka in 2019 and estimates that the country will reach its 2022 goal of 1,000 startups.
- The local start up ecosystem benefits from high literacy levels, technical expertise, a well developed internet infrastructure and an advantageous location.
- For the purpose of this document we have considered startups as companies who are less than five years old and are technology focused or technology enabled.
- Incubators and accelerators are growing at an increasing pace which provide the much needed guidance and mentoring for startups in Sri Lanka. In the recent past, there has been an emergence of angel investors and venture capital funds who come in with “Smart Money”. However, with COVID-19, these funds have also dried up for businesses.

Key enablers



Industries the startups are involved in¹ (2019)



91.7%
Adult literacy rate



44,3%
Digital literacy rate



32.9 Mn
Mobile subscriptions
(c. 150% of population)



11.8 Mn
Broadband connections
(c. 54% of population)



1 – ~96% of the startups are based on some software solution

Sources: SLASSCOM, TRCSL, Department of Census and Statistics, CBSL, World Bank, President's manifesto 2019

COVID-19 pushes a transformation drive

The 'new normal'

- The impact of the COVID-19 pandemic has rippled through every aspect of society, creating various economic and social challenges. As social distancing continues to limit usual human interaction, Sri Lanka is starting to embrace the 'new normal', where lifestyle patterns and the business landscape, has been driven towards a trend of digitalization.

Outlook for startups in a post-COVID Sri Lanka



- During the lockdown, adoption of e-commerce platforms have increased drastically, and this trend is expected to continue in the medium to long term, as the GoSL continues to strictly enforce social-distancing.



- Sri Lanka saw more than 15 delivery related startups emerge from the COVID crisis. While social distancing becomes a norm and online payments become commonplace, these start-ups are poised to grow into enterprises of tomorrow.



- The digitalization drive triggered by the pandemic is likely to continue, giving rise to a need to develop remote working infrastructure, enterprise automation, websites and other relevant systems.



- Telehealth and telemedicine systems have seen new registrations and channeling grow rapidly. Going forward, these platforms are expected to play a huge role in a socially distant community.



- Startups will have to critically re-evaluate their business models, keeping in mind the direction of the business in the short-term. Entrepreneurs should keep an eye out for opportunities, especially in areas where the current status quo is failing to deliver.



- Government support will be required to sustain the momentum towards digitalization, during and after this pandemic. The government has already relaxed a lot of regulations to facilitate some initiatives as discussed in the following pages of this document.

Sources: Hatch, CBSL, KPMG analysis

Local startups gaining global attention

Landmark transactions in the startup space



- Some of Sri Lanka's startups have gained international recognition and acceptance as indicated by some of the transactions outlined above.
- Startups are expected to be a key economic driver going forward for Sri Lanka, which is already a heavily SME based economy. SMEs contribute to 52% of the national GDP and account for 45% of the total employment of the country.
- The growing popularity of Sri Lanka as a destination for business expansion is also reflected through several foreign startups such as Daraz, Ikman, Oyo, Carmudi, etc. However, further regulatory support would be required to position Sri Lanka as a startup friendly economy and attract more foreign capital.

Startups of Sri Lanka during COVID-19

- The lockdown from COVID-19 has accelerated the need for technology driven startups. We can see this through the proliferation of last mile delivery companies during COVID-19.
- Furthermore, Sri Lanka witnessed a multitude of homegrown startups, who are taking the lead to solve issues and contribute in areas where the system has failed to deliver. Some key areas with significant development are as follows:



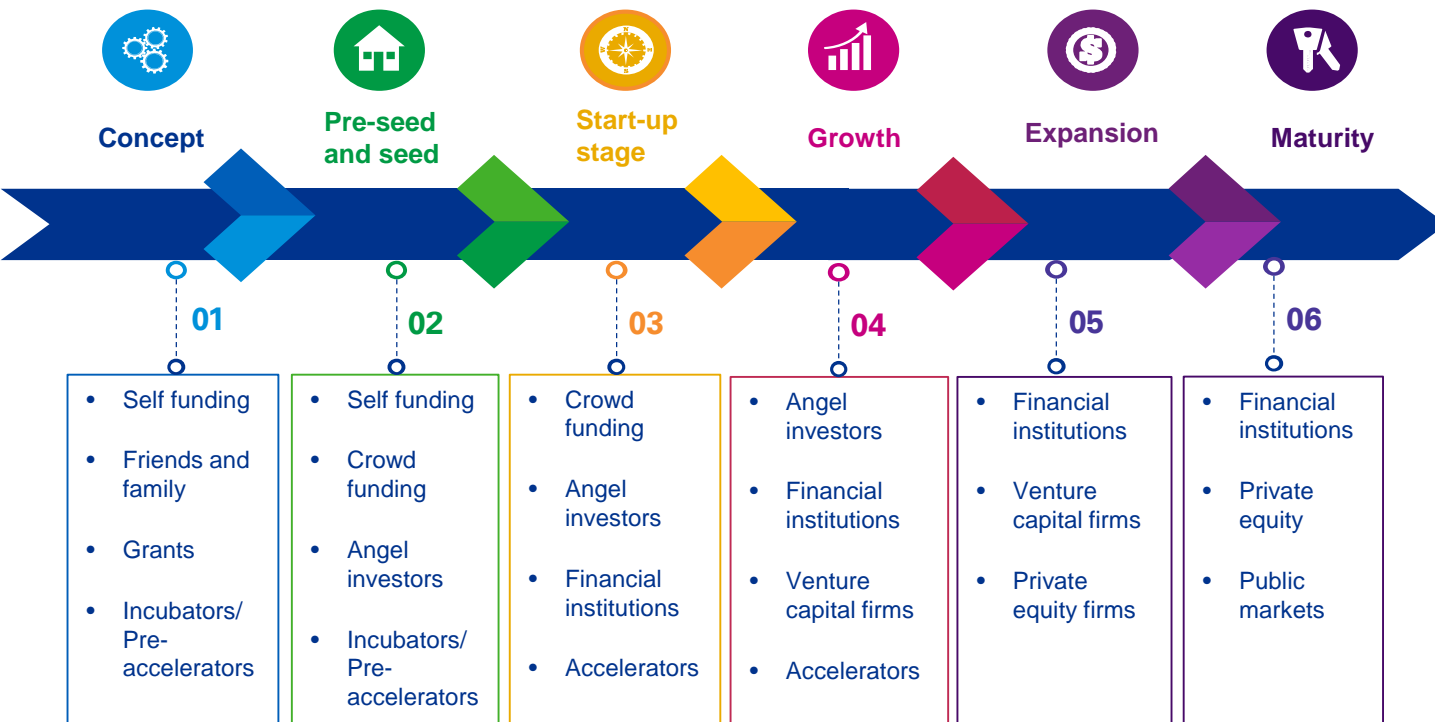
Sources: SLASSCOM, KPMG analysis



Key challenges for startups - Amplified by COVID-19

Difficulties in raising funding (1/2)

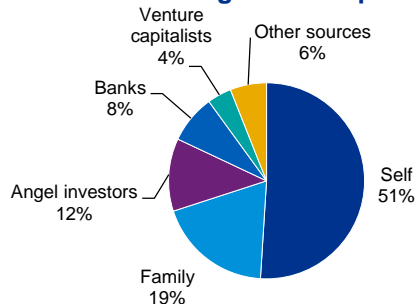
Capital providers in Sri Lanka's startup cycle



Equity

Key challenges

Sources of funding for startups



Debt

Key challenges

- Historically, lending was limited for startups due to being considered high risk ventures with no collateral assets.
- Several startups including tourism, retail and manufacturing face cash flow constraints which worsen the situation.
- GoSL has introduced several relief measures for SMEs, including loan moratoriums and new working capital facilities at concessionary rates. However, most startups have limited access to these facilities mainly due to lack of collateral.

Difficulties in raising funding (2/2)



Equity

- Certain regulations in Sri Lanka place limitations on equity and product crowdfunding, such as the number of people that can invest into a private limited company. Most BOI granted concessions and other tax reliefs have also been removed in the recent past, resulting in very little incentives for potential investors.

Suggestions and recommendations

Medium/long-term

- Promote investments in startups by way of relaxing certain regulations and providing tax concessions on returns. Eg: tax write offs for angel investors in early stage companies or funds.
- Reduce minimum investment requirements to qualify as a BOI venture.
- Restrictions on equity and product crowdfunding to be minimized. The government can work hand in hand with the private sector enabling platforms to source and allocate funds.
- Establishing the framework for a limited liability partnership (LLP) structure to eliminate double taxation for investors/shareholders.



Debt

Suggestions and recommendations

Short/medium-term

- Recognition of startups as a separate sector to SMEs, where banks can be less stringent on the requirement of collateral and instead evaluate the business model and the human capital when providing loans.
- Relief loans to be extended to new startups and not only to existing clients.
- Encourage banks to work with investors/incubators/accelerators to assess risks of providing debt to startups through a separate program or credit line.

High cost burden



Staff expenses

Cost composition of startups

60%-70%

Staff cost as a % of total costs

Key challenge

- Staff expenses are a significant portion of operating expenses for startups. Especially for those operating in fields which require certain skillsets.

Suggestions and recommendations

Short/Medium term

- Deferral of EPF/ETF payments by at least 06 – 12 months. This will ease the cash flow burden on the companies and also increases the immediate disposable income of employees.
- Creating a separate startup fund from the EPF/ETF payments, which will be reinvested into the business.

Long term

- Providing an option for startups employees to apportion (subject to an upper limit) their EPF/ETF contribution towards ESOPs of the company. This can be structured based on an independent valuation of the company.
- This will also promote greater participation of the employees in the business, a secondary market for this ESOPs can be setup with support from the Colombo Stock Exchange.



Access to skilled personnel

~400,000 direct workers in the apparel industry

~170,000 direct workers in the tourism industry



Key challenge

- Cost of skilled or experienced labor for startup businesses

Current status of employment

- COVID-19 has had a particularly adverse impact on the apparel and tourism sectors.
- Further, significant levels of economic activity throughout the country has come to a stand-still, where most companies have resorted to laying off contract employees and imposing pay cuts on all levels.

Suggestions and recommendations

Short/Medium term

- The startup will provide employment to these individuals and take advantage of their domain expertise to grow their business. GoSL can consider supporting these startups by contributing to some of the salary costs.

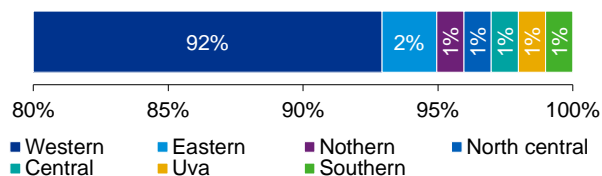
Sources: Hatch, SLASSCOM, KPMG analysis

Taking advantage of COVID related developments



Infrastructure

Regional distribution of startups



Key challenges

- Most startups, especially tech-oriented ones rely heavily on supporting infrastructure such as, physical office spaces, networks, cloud storage facilities, etc. These costs are usually difficult to rationalize.
- High rental rates in the CBD area has made co-working spaces a popular phenomenon.
- As social distancing requirements will continue to be active for the medium term, demand for physical office space will dampen as remote working becomes a norm.

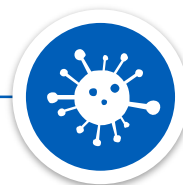
Suggestions and recommendations

Short/Medium term

- The GoSL to provide concessions/subsidies on utilities and infrastructure. Subsidies provided can include:
 - ISPs such as Sri Lanka Telecom and Dialog Axiata PLC to provide infrastructure and other relevant services at subsidized prices.
 - Relief on utility payments (electricity and water) for the next 06 – 12 months, while these companies recover.

Long term

- GoSL, along with the UDA, BOI or any other institution, to setup and provide designated workspaces in properties held by these institutions on a PPP basis at subsidized rates.



Sustaining COVID-driven growth

Booming sectors



Delivery platforms



Online shopping



FinTech



TeleHealth

Opportunity

- New startups have emerged and existing companies operating in the above sectors have seen unprecedented growth, during COVID-19.
- Existing businesses from other sectors are expanding their business models and moving into areas such as deliveries and online sales.
- Not all new ventures will survive. Those with agile business models equipped to operate in the long run will require the necessary support.

Key challenge

- Limited resources and support.

Suggestions and recommendations

Short/Medium-term

- GoSL can identify, co-sponsor and promote startups supplying essential goods during the pandemic. In a bid to promote social distancing, the public can be encouraged to use such platforms as an alternative to traditional outlets such as supermarkets. GoSL has already partnered with privately owned ridesharing apps for deliveries.
- GoSL can also consider incentivizing larger corporates in their respective industries, to work with startups and provide necessary support in terms of infrastructure and expertise.
- Bankers can work with established startups who engage gig-economy workers to monitor credit parameters for these workers.

Sources: Hatch, SLASSCOM, KPMG analysis

Other considerations



Other recommendations and suggestions

Key challenge	Suggestions and recommendations
Short term	
Import restrictions <ul style="list-style-type: none">— In a bid to control the pressure on the exchange rate, the GoSL restricted all imports except those of essential products.	<ul style="list-style-type: none">— For any startups involved in essential services, which require the use of specialist equipment to be imported, the government to consider providing special permission to import these products.
Extending better credit for gig economy workers <ul style="list-style-type: none">— In addition, the need for physical collateral, has made it difficult for gig economy workers to access credit.	<ul style="list-style-type: none">— The GoSL can consider making these changes permanent and provide opportunities for startups that have already established themselves as business enablers for gig economy workers (i.e. plumbers, electricians, cab drivers, etc.).
Difficulty in bidding for government tenders <ul style="list-style-type: none">— Startups face difficulties in competing for government tenders with established suppliers.	<ul style="list-style-type: none">— Provide opportunities for startups to provide disruptive solutions for legacy systems in addition to the 10% procurement requirement.
Medium term	
Mismatch between the business and tax timelines <ul style="list-style-type: none">— Due to the time bar restrictions on claiming loss allowances and capital allowances, most startups are unable to receive the full benefit of these allowances as these businesses usually take a long time to become profitable.	<ul style="list-style-type: none">— Measures to be introduced specifically for startups to effectively claim tax reliefs and consider adjusting time-bound restrictions to be more in line with the business cycles of the startups.

Sources: Hatch, KPMG analysis

Supporting startups - a policy matter

Several countries have taken measures to promote startups to drive sustainable economic growth. Furthermore, governments have offered several relief packages to support the startups as a COVID-19 policy response.

India



- India's IT industry is one of the key drivers for new startups.
- Startup India is a flagship initiative of the government. The ecosystem is supported by over 250+ accelerator-incubator systems, ~500 institutional and 2,000 active investors.
- *Government incentives for COVID-19 affected SMEs (inclusive of Start ups) include, USD 13 Bn stimulus package, reduction of corporate tax and other funding mechanisms. The business community has requested further incentives for startups due to inherent issues in the industry.*

China



- The Chinese government provides startups with funding as means of generating new opportunities for the slowing economy.
- China's Ministry of Science and Technology has been conducting the nationwide "Torch" program for over 30 years which finances and consults services for hi-tech firms.
- *The government policy initiatives for startups during COVID-19 include tax and fee reductions, exemptions, financial support, social security benefits, energy cost reduction and incentives for medical supply donations.*

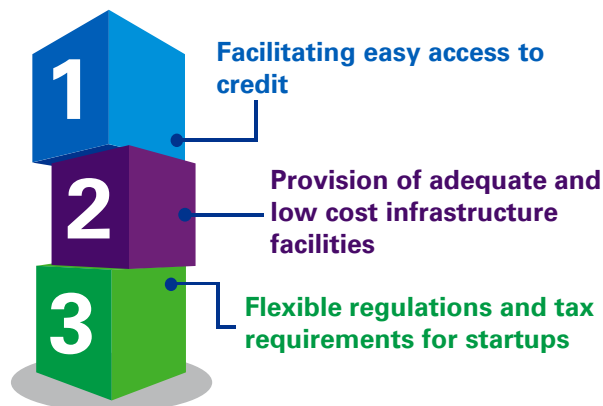
Vietnam



- Vietnam has risen to be one of the largest startup economies in South East Asia owing to support from the government to develop its young and digitally-savvy population.
- Funding for startups is easily accessible through established government avenues such as the National Technology Innovation Fund which provides preferential loans and grants.
- *As measures towards battling COVID-19, the government is issuing incentives in the form of tax breaks, delayed tax payments, delay in land-use fees, lower bank rates and support to obtain loans.*

How Sri Lanka can facilitate startup development

- The key areas of focus to support startups are credit, infrastructure and conducive regulations.
- Sri Lanka can take examples from these larger players and setup a framework of its own to develop the startup ecosystem in the country.
- This document discusses some of the key challenges faced by startups in Sri Lanka which have amplified during the pandemic. Certain policy recommendations have been outlined based on our analysis.





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