

Small but powerful:

Small and Medium Social Enterprises (SMSEs) are efficient providers of social services. They also benefit from investment and grant support

Poor people in developing countries already rely on the private sector for vital services, especially the thousands of small pharmacies, schools and community organisations that proliferate in developing countries (“SMSEs” – Small and Medium Social Enterprises). Many of these enterprises have strong social goals.

Yet few agencies work with SMSEs, focusing instead with a smaller number of NGOs with more developed international presence. Working with SMSEs is a good strategy for an agency – a small investment can have a large multiplier effect. But there are two major constraints to overcome.

First, it is hard to predict which businesses will be a success and returns can be slow. SMSEs need to be complex, since they work in a complex market. There are two, separate markets; urban and rural. Decision making is communal. There is little information or communication, for enterprises or customers. Distribution channels are long and costly. Businesses face more risks. As a result, social enterprises need to spend time making partnerships, educating customers, refining their business model.

Secondly, since businesses are small, funding and supporting SMSEs has high transaction costs. Social investors need to find innovative ways to reduce costs, perhaps working with a local partner bank or focusing on capital intensive sectors. Some banks in developing countries already focus on these markets, with great success. For example, the SANASA Development Bank in Sri Lanka, which focuses on social

sector lending, achieved 39% revenue growth and 113% profit growth last year.

External support is valuable. It can provide investment (capital, consolidation funds, risk reduction funds) or fund business development (training, entrepreneur development or subsidies). The right combination of investment and support can lead to explosive growth. This document gives a number of project ideas for investors and funders.

To be a success, agencies should:

- reduce transaction costs, by working with local banks and networks
- innovate to differentiate from local investors and lenders
- build-up expertise in a sector and invest in experiments
- take a long-term view be willing to fund enterprise development costs
- be prepared to divest from enterprises that are not meeting expectations

This document analyses the SMSEs in one area of Sri Lanka in some detail. It identifies some general characteristics of the markets and details case studies in a few sectors. It should be useful to social investors and funders of SMSEs.

This document can be read as a text document, or you can use the hyperlinks to jump to issues of particular interest.

Please feel pass on the link to anyone who may be interested.

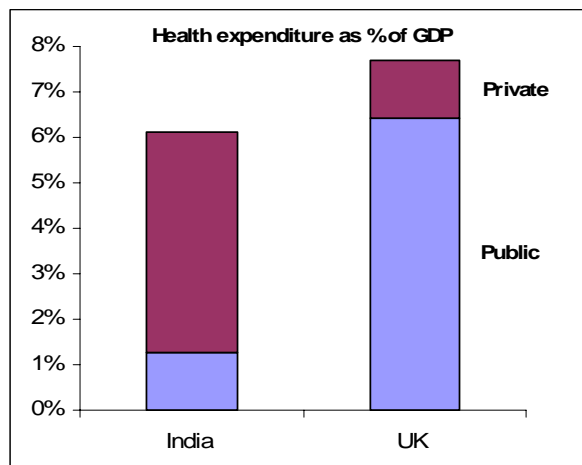
Importance of SMSEs in developing countries

The private sector in developing countries is often the main provider of 'social services', such as health, education, water supply or housing. For example in India 78% of healthcare expenditure is private, 30% of urban children and 50% of rural children go to private schools. Please see [Appendix 4 for details of how the private sector supplies social services to poor in developing countries](#) (education and health in India).

This is not surprising. Developing and developed economies spend approximately the same proportion of income on vital services – for example India spends 6.1% of GDP on health services while the UK spends 7.7%¹. Yet since

the tax take is much lower in developing countries than in developed countries. Public spend on the social sector is 20% of GDP in the UK² compared to 7% of GDP in India³. The difference is made up by the private sector. Private individuals account for 78% of health expenditure in India and only 17% in the UK.

More surprisingly, in developing countries public 'social' expenditure is typically focused on the rich, not the poor. For example in India 32% of public health money goes to the richest fifth, while only 12% goes to the poorest⁴. The rich are better at demanding their rights, both at the hospital door and at the ballot box, and governments often prefer to spend



Source of social services

Rich	Mix Public and Private	Mix Public and Private
	<ul style="list-style-type: none"> • Public is convenient and serves elite need • Private better quality 	<ul style="list-style-type: none"> • Better quality in private • Have choice
Poor	Mostly Private / Communal	Mostly Public
	<ul style="list-style-type: none"> • No access to public • Private offers services the poor need 	<ul style="list-style-type: none"> • Comprehensive service • Access to all
	Less-developed countries	Developed countries

money on 'high-end' services used by the rich, such as heart by-passes and university education, even when there are serious gaps in basic medicine and primary education. The consequence is that the poor in developing countries rely more on the private sector for basic services than anyone else.

The private sector also provides many services vital to the welfare of the poor, in sectors usually not considered 'social'. For example, the private sector provides agricultural inputs, determining farmers' productivity. The efficiency of (private) agricultural product markets determines the farmer's wages.

Most enterprises used by the poor in developing countries are small and part of the 'informal' economy. This survey tries to understand these enterprises and identify how they can be supported. ([Return to summary](#))

Support to SMSEs – an effective strategy for foundations and international agencies

SMSEs receive almost no external support. International agencies focus on state provision of social services, believing private enterprises will not offer good quality and affordable services for the poor. Charities and foundations tend to focus on NGOs.

Yet small, local enterprises provide most social services to the poor. Supporting them either through social investing or by funding grants is a good strategy for a foundation or an agency.

Investment in a social enterprise can have a large multiplier effect. Once started a good business will grow by itself, a good business model will be copied – stimulating a market is a more effective way to ensure a service is provided than funding an institution.

With good project design, investment or grants to social enterprises can be administered easily as success is easy to measure and local partners will work to improve their own efficiency, not rely upon external guidance.

To work with SMSEs, investors and funders need to identify good enterprise and minimise transactions costs / maintain deal flow.

This paper addresses these two issues. It is based on a series of interviews with SMSEs in one small town in Sri Lanka – Ambalantota. By studying the ‘on-the ground’ operations of SMSEs, it aims to understand the characteristics of the social sector market, the business issues that these enterprises face, ways that these enterprises can grow and ways in which external agencies can support this growth. (See [Appendix 1 for detailed case studies](#) and [Appendix 2 for description of the area surveyed](#))

The paper will be of use to any organization that wants to work with enterprises in developing countries to achieve positive social results. The paper refers to ‘investors’ (organizations such as social investment funds and financing organizations who seeking at least partial cost recovery) and ‘funders’ (organizations seeking to give grants, such as NGOs, foundations and donor agencies). In practice, a project may combine ‘investing’ and ‘funding’, for example supplying loans at the same time as funding skills development. ([Return to summary](#))

Box: Support for SMSEs

[Social investors](#) can:

- Fund banks that invest in SMSEs
- Set up lending companies for capital intensive sectors, such as water
- Provide equity to SMSEs, for expansion, consolidation
- Fund SMSEs networks

[Grant providers](#) can

- Train and support entrepreneurs
- Build capabilities of organisations that help SMSEs, like banks
- Use SMSEs as a channel to provide social services

Most effective organisations may use a combination of mechanisms

[Click here for more examples](#)

‘Social enterprises’, ‘community enterprises’ and ‘enterprises’

Research for this paper interviewed [Rice mills / storage](#), [Agricultural input retailers](#), [Pharmacies](#), [Microfinance organizations](#), [Community water supply organizations](#), [Telecommunications centres and general retailers](#).

Most entrepreneurs said that although they wanted to break even or make money, they also wanted their enterprise to be good for the community.

One third of enterprises surveyed said that they only had social goals – profit was not a motivation for them. In these enterprises, typically rural community enterprises, the leaders of the enterprises did not see themselves as ‘entrepreneurs’, but as community workers. Their objective was cost recovery, not profit, and the whole community jointly owned the enterprise. Community organizations are most effective when they provide a service that many in a community need, such as primary education, microfinance and water supply. They may be the most efficient form of enterprise in these sectors since they benefit from increased loyalty, reduced labour costs (since members provide time for free), better local knowledge and simplified sales (since everyone in the community will know of and trust the enterprise). For example community owned [microfinance organizations](#) have low labour costs and use community pressure to ensure repayment.

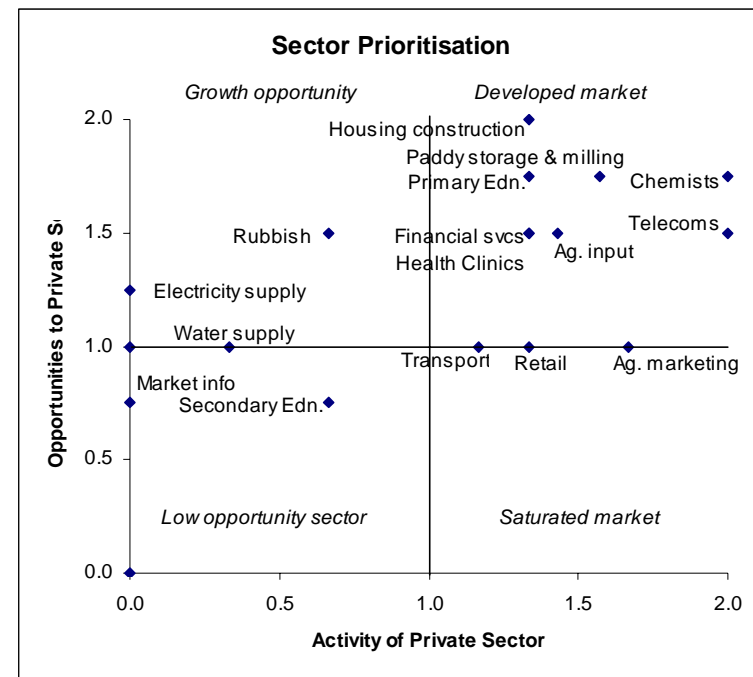
One third of enterprises interviewed had a mix of social and commercial goals; the entrepreneur wanted to make a profit but also wanted to serve the community. Enterprises in developing countries more often have a strong community focus. There may be two explanations for this. Many entrepreneurs have a genuine concern for the social needs of their community. People with social conviction are less likely to join public sector institutions in developing countries, since the public sector is less efficient and jobs in the public sector

Box: SANASA Development Bank’s Sector Prioritization Approach

The SANASA Development Bank is a specialist ‘Development Bank’, owned by the [SANASA cooperative movement](#) of Sri Lanka. It focuses on supporting Social Enterprises, both providing traditional lending (at times using preferential loan schemes) and giving training and advice to entrepreneurs.

In order to determine which social sectors are priority, each branch of the bank has reviewed its local market. The branch starts with a long-list of priority sectors, defined by the National Development Plan. A structured set of metrics then determines which sectors already have many entrepreneurs and which sectors are most likely to grow in future.

Sectors where the private sector is already active and where there are good growth opportunities are targets for lending. Sectors where there are opportunities but no entrepreneurs yet active are priorities for training and mobilization.



are more often obtained as a result of contacts than conviction. This desire to help the community may be enhanced as few people move from their 'home' area. Also, serving the community can be a wise risk mitigation strategy. Few people have access to 'institutional' risk protection (such as insurance) but most face high levels of insecurity, so it is wise to build networks of 'mutual responsibility' for protection against unexpected events. The survey was in a Tsunami impacted area – many said that people started working together more following the Tsunami.

Finally, one third of enterprises said their motive was purely profit. However, even in these businesses entrepreneurs understood that it can be 'good business' to be seen to be doing good. Many of the traders we talked to stated that they were successful because of their 'position in the community' and told us that they offered better pricing to poorer customers. Stories of community service travel fast, and can create differentiation in markets with undifferentiated products and pricing. Good 'public relations' can lead to better sales.

Enterprises said they offer cost recovery prices for poor customers when they have excess capacity – for example milling poor farmer's rice when there are no other demands on the machines. Also, some enterprises are happy to bundle advice with product sales – spending more time with a poor customer. For example pharmacies give the poor basic medical advice, microfinance managers give business development advice. ([Return to summary](#))

SMSEs work in complex markets, so their business structures have to be complex

SMSEs face a complex market. Investors and funders need to understand it to identify the most effective enterprises.

Two markets – urban and rural

Unlike in developed countries, in developing countries there is a very big difference between urban and rural markets. A business adapted to one market may well not be appropriate in the other.

Rural businesses face particular problems. Volumes are small. Credit is less often available or is very expensive. Distribution costs are high.

This does not mean, however, that there are no business opportunities in rural areas. Since there are often higher barriers to entry in the rural market, there are fewer entrepreneurs and so prices (and margins) can be higher to cover costs – there can be considerable pent-up demand in rural areas. Put another way, a new rural entrepreneur can have more impact than an urban one. For example, introducing a new credit scheme in an urban area may increase choice or lower prices. In a rural area it may be the only credit available.

Communal thinking

Especially in rural areas, the market is ‘communal’, rather than individual. Whole communities will accept a product, or decide they do not need it. As Ogilvy, the advertising agency, says “We do not try to understand individual consumer psychology. Most decision making in rural India is collective. Village women bathe together at a well or a pond. Family

members and neighbours, usually men or elders, get together over cups of tea and discuss the merits of a tractor”

Community networks can be a powerful tool. Communities can cooperate to buy a new input, like a tractor, or to run an enterprise like a microfinance institution. Villages can decide as a group to invest in new infrastructure, like a water supply, allowing them to use larger and more economic systems. But equally, to convince a whole community of a product’s merits can take more effort.

Complex and costly distribution channels

Long distance and communal purchasing make distribution complex, especially in rural areas. Enterprises that find innovative ways to reduce these costs create a competitive advantage.

One effective way to reduce distribution costs is to create partnerships with existing networks, such as NGOs or community based organizations. [SANASA Development Bank](#) partners with SANASA Primary Societies to reduce the costs of serving rural communities.

Uncertain environments and risk aversion

Businesses in developing countries face more uncertainty. Natural disasters and wars are more common – as Sri Lanka’s record clearly shows. Economic conditions and macro-economic policies can also change fast.

Insurance markets for SMSEs are not well developed and, if a business fails, an entrepreneur is unlikely to find alternative employment. Understandably, many entrepreneurs prefer to

take a 'safe' approach, maintaining a stable business, rather than take risks. As a result, enterprises tend to avoid capital investment and innovation, preferring a secure, steady income stream to an uncertain, if potentially higher one.

This has implications for business planning. Risk needs to be closely evaluated in business plans and mitigation should be costed in. Products should be designed to accommodate variability in customers' fortunes, for example credits should allow more flexibility in repayments, schools should allow parents to delay payments, medical treatments should not assume customers can continue paying, etc.

Lack of role models

Entrepreneurs in developing markets have less information. Mass communication and media are poorly developed, outside of large towns entrepreneurs will rarely interact. Especially in rural areas, entrepreneurs will not be exposed to many new ideas.

This reduces innovation and diversity. Many markets, both for social and other goods, are characterized by a number of enterprises offering similar products, colluding on pricing, rarely innovating or offering new products.

On the flip-side, entrepreneurs are hungry for new ideas. Introducing new technologies or new business models can lead to rapid growth. The young owner of a [farm machinery dealership](#) brought his sales experience gained from work with a larger firm back to his home community, and experienced explosive growth.

Less aware customers

Customers in developing countries, especially poorer and rural customers, have less access to mass media and less

opportunity to communicate outside of their immediate community. Additionally, there are fewer trusted sources of information, less consumer protection regulation, more difficult access to courts and less knowledge of brands – so more opportunities for unscrupulous traders to trick customer. As a result, the poor may be cautious buyers – needing longer to consider a purchase, and a relationship with an enterprise before making a large purchase.

This means distribution channels have a dual role: to bring a product to the customer and to educate customers on a product and its benefits. For example, pharmacy outreach programs will not only have to sell a medicine, but also communicate its benefits. As a result, businesses must create long longer-term relationships with their customers, not only expect to have transactions.

Discontinuous development

Although the markets that social enterprises are working in can appear 'traditional' and 'stable', rapid changes are possible. The most successful innovations lower the cost of a product (such as hand-tractors) or a services (such as communications or credit), allowing mass market expansion and rapid growth. These cost reduction innovations are becoming more common, with new suppliers (China), new technology (wireless telecommunications) and innovative business models (microfinance).

Need to be both small and big

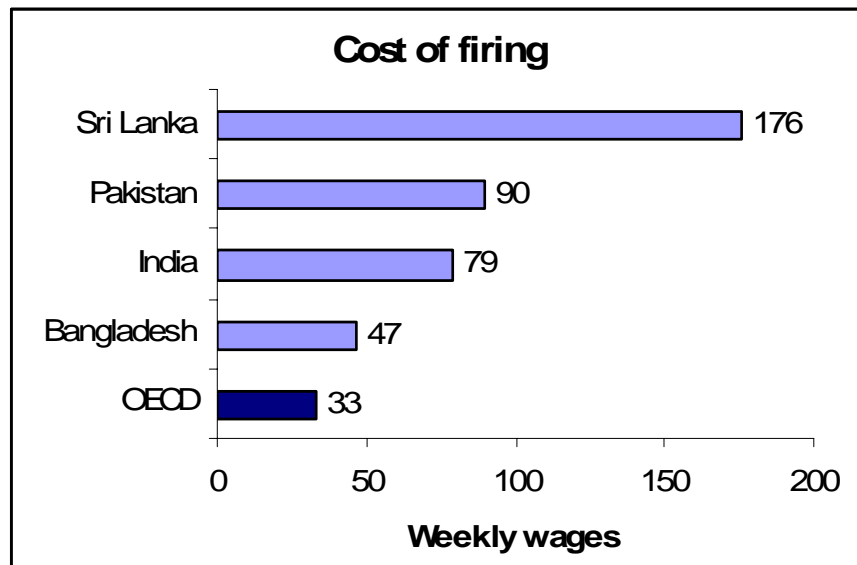
Given complexity, smaller enterprises are likely to be most efficient, since companies need to make local adaptations and communities trust local providers more than external brands. Additionally, remotely managing staff is particularly difficult when communication is slow and there can be many explanations for poor performance.

But there are also disadvantages of being small. Small companies do not learn from others, do not have scale in procurement and have to rediscover best practices.

One solution is to create a network of independent SMSEs. The network provides best practice, skills development and external linkages. The SANASA movement, a network of independent microfinance organizations, is a one example.

Regulation barriers

Government regulations, such as licensing, tax regimes or labour laws are often cited as a major barriers to business development. Sri Lanka is no exception – with large barriers to setting up businesses and hiring staff.



However, discussion with entrepreneurs implies that other issues, such as market instability or lack of role models, may be more important than regulation barriers. All but one entrepreneur reported that they had no problems with government regulations. The only exception, a pharmacist,

said she was unwilling to employ more staff as she was worried it would be expensive to release them if her plans did not work out. Her solution was to rent out facilities to free-lance doctors rather than employ them.

Consequences

The overall result of the above is that business models in developing countries, especially for social enterprises, tend to be complex.

Complexity may not, however, indicate lower profitability. All enterprises in the market face the same barriers, so finding a solution can create a step-change in profitability.

It does, however, require more creativity, experimentation and perseverance to design an effective business, which can mean a long delay between start-up and profitability.

However, once a good business model is identified, since it can tap pent-up demand, growth can be explosive. ([Return to summary](#))

The challenge of transaction costs

Microfinance institutions learnt that they needed to reduce transaction costs to serve the poor - traditional banking models are too expensive to handle small transactions in remote areas. Microfinance lowered costs by designing a new delivery mechanism.

Investing in SMSEs faces the same problems. Enterprises are too small for traditional analysis or oversight. Additionally, agencies located far from the SMSEs will not understand local market realities. New delivery mechanisms are needed. Some models already exist, more experimentation is needed.

[SANASA Development Bank](#) is a local bank in Sri Lanka specialist in lending to smaller social enterprises. By specializing in particular social sectors it creates 'rules of thumb' in each sector that indicate which SMSEs are most likely to be a success, allowing an initial screening of loan applications. Additionally, since it is well known for focusing on social sectors, it is able to channel funds from the government and international agencies that contribute to its costs. Finally, it works hard to minimize its costs. It uses low-cost systems, small branches and keeps all processes simple. As a result, its cost income ratio is 57%.

Equity investment carries additional costs as more analysis is needed. [Aavishkaar](#), an innovative supplier of private equity to SMSEs in India has tried to reduce its costs by only using local staff and locating its offices in low cost areas.

Creating networks of SMSEs can allow increased scale and support channelled through the network will reach a large number of SMSEs. SANASA societies have created a network which owns companies that support the SMSE microfinance organizations. An investor could create similar networks in other sectors, for example pharmacies or schools.

Sector	SANASA's Rule of thumb
Small-scale energy projects	<ul style="list-style-type: none"> • Need reliable technical assistance • Hydro-power better than solar
Community water supply projects	<ul style="list-style-type: none"> • Tube wells are better than long pipes – more reliable
Tea producer loans	<ul style="list-style-type: none"> • Work with known company or National Tea Board for marketing efficiency
Small-scale agriculture	<ul style="list-style-type: none"> • Ensure regular income stream • Look to different crops with less competition, such as medicinal plants
Agricultural machinery	<ul style="list-style-type: none"> • Promote leasing • Work with dealers
Fisheries projects	<ul style="list-style-type: none"> • Marketing and sales are good business • Fishing nets and boats covered by post-Tsunami funding
Micro-finance organisations	<ul style="list-style-type: none"> • Regularity of meeting as a community is best indicator of security of institution
Small-scale retail	<ul style="list-style-type: none"> • Growth area, especially repair of technology and re-cycling
Tourism (boutiques, etc.)	<ul style="list-style-type: none"> • Position of company is very important

Given the positive social impacts of social investments, a 'blended value' model may be possible, whereby some of an investor's costs are covered by a funding agency. Some social investors, including Aavishkaar, have resisted any external support believing it breeds lax practices and undermines long-term financial sustainability, but others find external funding helps so long when it is used to develop organisation capabilities or fund expansion.

Partnerships, using local staff and increasing scale will all reduce transaction costs of supporting SMSEs, but more experimentation is needed to find a business model with acceptable transaction costs. ([Return to summary](#))

Methods of support 1: Social investing

On-the-ground investigation proves there are a number of ways investors can support SMSEs, while securing a return.

Lending

Most of the entrepreneurs we talked to said they wanted loans for expansion.

But not all enterprises planned to borrow to fund their expansion. Some sectors are able to pay for their expansion from retained earnings ([agricultural machinery](#) case study), especially where they have small capital needs. Utilities (such as [water supply](#) or local energy suppliers) or housing projects are more likely to need credit.

While there is no shortage of credit for SMSEs in Sri Lanka in urban areas (see the [milling](#) and [pharmacy](#) case studies), credit is generally not available in rural areas where fewer banks have penetrated and customers do not have formal documentation ([water supply case study](#)). Even in Sri Lanka, which has a high banking concentration, there are opportunities for specialist providers of SMSE credit for rural areas.

For example, credit is rarely available for agriculture inputs, such as seed and fertiliser, especially for paddy farmers ([microfinance case study](#)). This is because banks are wary of lending when there are no regular repayments and when all the borrowers in the sector are likely to fail when there is a bad season – it creates to large a systemic risk for the bank.

Social investors need to determine the best way to support the lending market. Generally it is better to work with established banks, helping them innovate and address

markets not yet covered, rather than create new institutions. Local banks will have lower costs, will continue after the investor decides to move to another country and will be more trusted by customers.

Given the complexity and insecurity of SMSEs in developing countries, banks may need to find new ways to evaluate a loan that takes account of the many risks and allows the lender to keep innovating. Few of the entrepreneurs we talked to could estimate the returns on their investments, but were confident that when a market was making money and growing, they would be able to also get a return. Perhaps banks' loan evaluations should take the same approach, analysing the overall market dynamics and a borrower's record. This analysis can be backed up in most cases by collateral – contrary to expectations, many of the entrepreneurs who we talked to were happy to provide collateral.

Start-up funding

As predicted by SANASA's evaluation of the [market potential](#), most of the sectors we investigated had a significant number of entrepreneurs already active. There was little need for start-up funding.

SANASA's prioritisation did identify some sectors where there appeared to be significant opportunities, but few entrepreneurs. Often these were in more capital intensive sectors where market entry barriers are higher, such as the [water sector](#), rubbish collection or small-scale energy production. Investors could supply start-up funding in these sectors and funders could provide business development assistance.

Also, there is a shortage of companies that provide inputs for SMSEs. New suppliers could help SMSEs overcome their small scale, by sharing experience, reducing risk or spreading investment across many different enterprises. For example, a company that rents medical equipment to [pharmacies](#) on a daily basis would allow the pharmacies to trial a new business and also avoid the risk of expensive equipment not being well utilized. Similarly, there may be opportunities to support networks or associations that serve existing SMSEs, perhaps through a franchise model.

Consolidation funding

There may well be opportunities for investment funds that consolidate existing sub-scale enterprises. Currently, there is little funding available for consolidation and in many sectors there is little dynamic competition, leading to a large number of sub-scale enterprises. A 'merger-fund' run in partnership with a local bank could create more efficient industry structures in a number of sectors where SMSEs predominate, such as [milling](#). It could be implemented in partnership with a funder who could supply technical assistance and training support, and may have lower transaction costs than other forms of equity investment.

Risk reduction instruments

Business in developing countries is risky, especially for SMSEs. Profits are often determined by forces outside of their control, such as weather, government intervention or conflict.

This creates demand for risk reduction mechanisms, either insurance or derivatives. International agencies could again work with local banks to implement these instruments. Risk reduction products could be sold directly to [farmers](#), or to other enterprises that rely upon agricultural product prices such as [rice mills](#).

Project ideas

- Provide long-term liquidity loans for on-lending to local banks. While local banks often have access to ample short-term capital, they may not be able to raise long-term deposits, creating a matching issue. Bundling a loan with technical assistance will also allow the external agency to ensure that quality is protected.
- Set up or provide liquidity to a bank focused on SME lending to rural areas in countries where these loans are not available, using simple risk evaluation processes to reduce transaction costs
- Support a specialist fund for a sector that banks do not currently lend to, such as education
- Create a consolidation fund focused on a sector where there are many sub-scale SMSEs such as milling, local water supply systems or rural buses.
- Provide equity finding to set up a network of water supply companies, which can then act as a vehicle to lend for water system renovation
- 'Buy the risk' of seasonal farming from local banks, allowing them to on-lend to paddy farmers. Alternatively, sell price fluctuation insurance directly to farmers giving banks more security in lending

Pointers

- Work with local banks and institutions wherever possible, as they have lower costs
- Focus on services that allow an external investor to leverage its scale, for example by sharing best practice and sharing risks
- Blend investment with non-financial support, such as training, best practice sharing, international contacts, etc.
- Expect to experiment and work with a client company before identifying a winning business model
- Focus on capital intensive sectors which need investment
- Consider your costs – costs of independent lending and equity investment to SMSEs may outweigh any returns. Use networks where possible
- Consider changing market structure through investment. This may release considerable value

[\(Return to summary\)](#)



Methods of support 2: Grant funding: to support SMSE development, or using SMSEs as a channel to supply social services

Grant funding can either directly support the operations of a SMSE, or use the SMSE as a channel to reach the poor. The SMSEs we talked to in this survey requested both forms of assistance.

Subsidizing loans

As discussed above, many SMSEs want to take out loans, but plan to get these loans from banks. A simple way to help social enterprises 'scale-up', while not distorting the market, would be to partner with a bank to subsidize these loans.

There are, however, dangers to this approach. When borrowers get to know that their loans are partially funded by an international funder, they tend to be less committed to repayment, feeling that the international agency will bail out the bank. Often they are right, and so banks tend to be less active in debt collection. To reduce this risk, credit decisions and debt collection should be clearly the responsibility of a local partner bank, and the bank should provide the majority of the loan with a funder only providing 'top-up' grants.

Additionally, a funder could only subsidise loans that induce a borrower to provide a social service they otherwise would not be willing to provide. For example, opening an outreach centre in a remote area can be a condition for a pharmacy to get a subsidized loan. Offering scholarships could be a condition for schools. As a result, taking the subsidised loan becomes a business decision for the SMSE, not a hand-out., as well as creating more impact.

Loan subsidy schemes have much greater impact than grants. They reach more institutions, do not distort the incentive structure of the recipient and can be much easier to implement than a grant. The effort required to maintain one

school, for example, could lead to a large number of schools getting lower interest loans and hence improving the education opportunities of many more students.

Training and information to SMSEs

Few of the entrepreneurs we talked to asked for business development assistance, since they felt they already knew how to run a business. But most asked for technical inputs, such as trends in [world market prices for rice](#), or how to maintain [medical machines](#). This type of advice is easily given, perhaps just by setting up an information board in a local town or supporting information centres for SMSEs. But technical expertise is required.

More advanced advice may be required for some enterprises, for example on how to complete a merger, or how to market to rural communities. The most effective 'advisors' will be other enterprises who have been successful (in another region). Advisory programs could ask successful 'graduates' to train others, in return for pay or reduced interest rates.

Sharing business information is particularly important in rural areas, given the difficulty of communication. Training can share best practice, or just show how a business model works. For example, SANASA has developed a program of [village motivators](#) who travel through rural areas helping to set up new SANASA societies and develop the professionalism of existing societies. Similar programs could motivate mothers to start community schools, or introduce new crops. This motivation can be packaged with credit, as in the [orchid growers](#) case study.

Advice could also show how to create linkages to increase sales. There are often existing community networks that could

be made more effective through a partnership with a private sector enterprise. These networks could, in time, become sales agents for the private enterprise. One example is [Ayurvedic medical practitioners](#).

Networks to maintain quality

A concern is often expressed that the quality of provision from private sector enterprises is not as good as in state institutions. Data is mixed on this, with better quality provision from private companies in some sectors (such as education) and worse in others (such as healthcare).

Both ethical private companies and consumers will gain if good quality is maintained. Quality inspections of private facilities could be a requirement of grant or investment assistance. In time these quality inspections could become an established brand and help consumers choose which private provider was best, as well as give guidance to the SMSEs on how to develop their product offering. Taken a step further, this quality audit could transform into a set of best practices and approaches, allowing a recognised 'approach', with training and on-going guidance, which could transform a network of independent SMSEs into a network or franchise.

Help lenders

There are already specialist lenders to social enterprises. This can be profitable, but additional investment and support may be needed to help the lenders develop their institutions.

There is a wide range of possible support to an institution, including staff development, process reform, product development, etc. The priority will depend upon the bank's situation and is best identified through the bank's planning process. For example, the SANASA Development Bank has identified [IT development](#) as a priority, to reduce costs,

increase customer confidence and enable the roll-out of new products. It has started a project to replace its core banking system and will roll a system out to village based societies.

Contracting SMSEs to serve the poor – voucher schemes etc.

In addition to helping SMSEs to develop, they can be used as a 'client' channel to implement a funding agency's project objectives. For example, if a funding agency wants to increase the number of immunisation shots delivered to young children, it can either deliver these shots through the existing state infrastructure, set up its own infrastructure or contract the private sector to deliver these shots. Given that private sector providers of most social services are already present in most areas where the poor live, usually in higher concentration than government services, using the private sector will reach the most number of people. Additionally, small private sector companies can be more nimble than public institutions and projects can be set up faster.

In sectors where no private sector enterprises are working, it may be more effective in the long-run to help a private sector enterprise enter the market, rather than to set up a separate institution via a project. For example, if an agency wanted to promote a new agricultural innovation, it would be most efficient to work with existing agricultural machinery retailers.

There are as many ways to use the private sector to implement a social service as there are potential social services. However, all approaches should follow a set of basic principles. Pricing of services is critical. Funders should provide sufficient financial incentive for a SMSE to conduct the desired business, but not so much so that it over-pays – calculation of the variable cost to provide existing services is the easiest way to judge a good price. Implementation should be designed to ensure services are only provided to target

groups, i.e. people who would not have received service before. For example, providing subsidies to educate primary school children will not increase enrolment if these children were already in school. However, the targeting mechanisms should not become a major cost – in an area that has low levels of maternal health care, it could be simpler to just provide (basic) care to all, rather than try to target people who do not have sufficient funds. Richer people will, in any case, want to pay for better care. Finally, many of the ‘typical’ requirements of projects, such as identifying a target group, or creating a fixed budget, may not be appropriate for these projects and funders may have to change their project preparation procedures.

Project ideas

- Subsidize loans to pharmacies or schools on condition that they comply with regular quality inspections
- Subsidize loans to schools on condition that they offer scholarships to gifted poor students.
- Set up technical advisory services for SMSE sectors. These advisory services could themselves be private enterprises, with revenues from a funder based on voucher schemes.
- Pay successful entrepreneurs from one area to give training to new entrepreneurs in another area
- Fund motivators of community based organisations to help communities to set up new enterprises
- Fund quality audits of SMSEs in particular sector. In time, these audits could develop into a franchise model for provision of more complex social services, such as private doctors or secondary education

- Provide support to banks and micro finance institutions that in turn help set up new SMSEs
- Fund private schools to take in street children in inner city areas, private pharmacies to give nutrients to pregnant mothers and health care to infants, private small shops to give left-over food to destitute old people or water supply companies to provide sanitation in slums.

Pointers

- Focus on one sector and gain real expertise of the economics and good project ideas in that sector
- Ensure assistance does not disrupt the market by favouring one social enterprise over others – offer assistance to all in the market and limit provision through pricing, not rationing
- Aim to keep assistance simple and low cost. Targeting should be achieved through program design rather than explicit decision making, reporting should be minimized
- Use local skills where possible. If a new organisation is to be set up, make it local and (preferably) with a plan for later commercialisation.
- Expect that normal project preparation techniques will not apply. Instead, start small with a pilot and if it is successful, scale up. Funding should be ‘self-regulating’, with less effective mechanisms not being popular

[\(Return to summary\)](#)

Appendix 1: Case studies

Rice milling and storage

Most of the villages around Ambalantota are dependent upon paddy cultivation (rice growing). All sell their product to privately owned rice mills, located on the outskirts of the town. These mills process the rice, process it and sell it to local shops and traders before the next harvest. Their efficiency, along with the local market price for rice, ultimately determines the price that the farmers get for their produce.

Profit is largely determined by the sales price. When market prices are high profits are 4 times greater than a bad year, so millers watch the prices carefully. The biggest risk is that prices rise too high, leading the government to buy rice from overseas and reduce prices.

Rice mills are often criticized for the large margin between buying price and sales price, and for insufficiently investing in storage so spoiling a large proportion of the product. At least to some extent this is a response to the price fluctuations. Margins reflect the risk premium. Underinvestment is a consequence of concerns over repayment ability.

Nilantha's Rice Mill & Storage

Current business

Mr Nilantha buys paddy from about 1000 villagers around Ambalantota. His business is stable: it has been running for 10 years, always operating out of the same 600ft² shed and mostly using the same machinery – only his polishing machine needs regular replacement. He employs 2 workers, although he can manage by himself for most of the year. His turnover is growing slowly, especially when there is a good harvest.

Although the last few years have been good, Mr Nilantha would like more security in pricing – perhaps by buying some form of insurance against price fluctuation. This would allow him to plan his future. But no one offers this type of insurance in Sri Lanka.

Paddy cultivation is not profitable – farmers get Rs 15-17/kg (15-17c/kg) so there is very little income for the farmer, especially once they repay their loans. Although different rice mills compete for trade, Mr Nilantha tries to give a better price for poor farmers. He explains that although he is running a commercial business and needs to make money, he is also part of the local community and needs to maintain his position in the community. He says that customers want to come to him as he is well known and respected in the community.

Plans for future business

Mr Nilantha has a plan to expand his shed – it is currently too small and can fill-up at the end of the season. To finance this, he would take out a loan from the bank, which he is confident he could get. He has a good relationship with the bank and has collateral.

However, he is wary of taking out a loan as, if he has a bad year, he may not be able to repay. So these are not urgent plans – he can work without the new shed and is happy to continue in a safe environment.

After 10 years, Mr Nilantha is confident he understands his business and how to maintain his machinery. The only external assistance he would like is more information on pricing, and some mechanism to reduce fluctuations.



Sunil Jayanthe's Rice Mill & Storage

Current business

Mr Jayanthe's business is located about 1 kilometer away from Mr Nilantha's, and is strikingly similar. While he has been in operation about 20 years, his revenues are about the same, he has the same machinery and same size shed. He also takes great pride in his position in the community.

Price fluctuation is also Mr Jayanthe's main concern. To reduce his exposure, he has started selling building materials

(concrete, piping, etc.) "a good, steady business". He also would like more information on market pricing, and could pay for some form of insurance to reduce price fluctuation risk.

Plans for future business

Mr Jayanthe wants to buy a truck, to allow him to travel to villages and to deliver rice to stores. He has approached a bank to buy the truck on a lease, and also has collateral if that is required. But, like Mr Nilantha, he is worried that if he has a bad year, he may not be able to make repayments. As he says "prices are not in my control – if they go against me, what can I do?"

Social investing

Lending and risk reduction

While there are clearly some opportunities for lending, the entrepreneurs we met were justifiably worried about their ability to repay loans if prices fell. A loan with a repayment schedule based on market price for rice would be more attractive. There is also demand for an on-going risk reduction mechanism, perhaps insurance or a derivative. Reducing risk should ultimately increase farm-gate prices for farmers. Partnership between a risk mitigation specialist and a local bank could be the best mechanism.

Consolidation fund

There are (at least) three mill & storage enterprises within a kilometer of each other outside Ambalantota. Yet all appear to be sub-scale. Machinery and trucks are not well utilized, storage space is not consolidated. There would be efficiency gains from merging. For example, rather than Mr Nilantha taking out a loan to buy more storage space and Mr Jayanthe leasing a truck, perhaps they should merge – Mr Nilantha has a truck and Mr Jayanthe has spare storage. But neither owner

is likely to get funding for a merger. A consolidation fund managed through a local bank, coupled with advice on pricing and how to manage a merger, could lead to improved efficiency. There are many other mills in the area so monopoly pricing should not be possible. Indeed, with additional scale, one mill may be able to offer higher prices, allowing it to build volume and hence increase profitability. This could start a price war that ultimately would favour the larger mills and create a more efficient market structure.

Funding support

Pricing information

Both entrepreneurs asked for assistance in pricing information. Better information would lead to less fluctuation in the price of rice, the staple diet of the poor. This could be simply provided through a local message board, local communications centres or a local bank.

Agricultural inputs

Agricultural innovation, especially the application of new seeds, fertilizers and machinery, is the most effective way to increase productivity of the majority of the poor in the Ambalantota region. Considerable changes are already underway, with many more farmers using two wheel tractors and mechanized threshers, driven in part by lower prices – tractors are now produced in China and Pakistan, rather than Japan. Additionally, local sellers of agricultural inputs are becoming more competitive – new stores are opening up and existing stores are having to innovate.

S. B. Damith Chaminda – Dealership for Haley’s Farm Machinery

Current business

Mr Chaminda sells tractors (2 wheel and 4 wheel), three-wheeler goods transporters and small threshing machines. His business is growing fast. He only opened 8 months ago and he plans to turn over Rs25m (\$250k) in his first year.

He learnt the trade from previous employment with Haley’s. This experience is vital – it showed him how to market to rural buyers. He says it is most important to go to villages to explain the product. He has created leaflets, runs demonstration days and holds local meetings – spending time



with the customers. His main problem to date has been getting sufficient supply.

The level of his success indicates pent-up demand in rural areas. “As soon as we went there people wanted to start buying” says Mr Chaminda. “I am already Haley’s best seller in the South. They are sending me on holiday to Italy and France as recognition.”

One of the reasons for Mr Chaminda’s success is that the price of agricultural machinery has fallen rapidly. For example, Japanese made hand-held tractors previously cost Rs300,000 (\$3,000). Chinese produced tractors are now available, which cost only Rs140,000 (\$1,400).

Leasing is popular, but banks do not appear to do a good job of selling. Government banks require a number of documents, such as land title deeds and birth certificates, which poor farmers do not have. Private banks are simpler, since they only ask for a bank card and a bank book. But there are opportunities to improve the sales process of these banks too – few give Mr Chaminda leaflets that explain their product to potential customers, none join him on his sales trips to villages.

Future business

Mr Chaminda wants to grow his facilities, build an office, a workshop, buy a compressor, so he can also service and mend machinery. Although he could get a bank loan, he does not think it will be necessary – his current profits should be sufficient to cover the investment.

Project to introduce orchid farming

The region around Ambalantota is well suited to orchid farming – it is very hot and humid. There is also good demand

from the tourist industry, both in Sri Lanka and in the Maldives.

Many village women already grow orchids as decoration. The Government, in partnership with the SANASA Development Bank, is now helping them to grow commercially. The Government has given training to the first women in the scheme and is supplying advice on commercialization. SANASA Development Bank is supplying a Rs25,000 (\$250) loan, which is sufficient to buy a frame, nets, 300 seedlings and fertilizer. The loan is for 3 years, with a 6 month grace period. Interest is just 9%, since the loan funds are provided by a subsidised from a Government program (the Perennial Crop Development Scheme) which lends to SANASA at 3%. An officer from the bank will visit the participating villages



regularly to collect repayment.

Orchid farming should be good business. A local cooperative will pay Rs5 per flower. Each plant grows a new stem of 10 flowers every few months, creating a maximum annual revenue of Rs300 per plant, or Rs 90k (\$900) per person. The rural women can do this business from their own home and it does not take much of their time so they can combine it with existing work or child-raising.

The initial government pilot project will be rolled out to 60 women. If it goes well, others should copy and the SANASA Development Bank will supply more loans. The Government hopes the industry will grow and Sri Lanka will export orchids to Japan, the Middle East and eventually Europe.

Social investing

Lending and leasing opportunities

There appears to be considerable innovation in the agricultural sector in Ambalantota. The SANASA Development Bank has seen fast growth in agricultural lending over the past year – lending for agricultural machinery has more than doubled.

There should be opportunities to increase leasing. Although a number of banks offer leasing, their marketing and sales capabilities may not be well developed. A joint venture or management agreement with an external leasing company could help an individual company and help transform the market.

Funding support

Promote linkages

The core of the success of all the companies visited was outreach to village communities. While they are clearly having success, there may be opportunities to increase this success

by linking with established community based organizations, such as cooperatives or microfinance networks.

Training and expertise assistance

Agricultural input retailers provide a vital service to farming communities, increasing productivity so increasing farmers' incomes. External funding could help this process in a number of ways. For example, funders could subsidize trainers to work along-side the salesmen to introduce new techniques or products. Funders could also introduce a new technology or crop by providing a coordinated 'package' of advice, inputs (such as seeds) and initial subsidies to create a new market, along the lines of the Government orchid program.

Pharmacies and medical clinics

While the government of Sri Lanka has an impressive record of health provision, there is still a thriving private sector healthcare market in Sri Lanka (and even more in other developing countries such as India – [click here](#) for more details).

There are few government pharmacies and these are all located in larger towns. Outside of these towns, everyone, both rich and poor, buys medicines from private retailers.

These retailers also often provide diagnostic services – doctors from the government hospitals have private surgeries behind the pharmacy where they work in the evenings. People often prefer these services to the government hospitals, since they are more convenient and faster. A visit to a general doctor costs Rs80-100 (\$0.80-\$1), a visit to a specialist costs up to Rs350 (\$3.50). Even poor often use these services, as they may not be able to lose a day's pay to see a government doctor.

In Ambalantota, there are a number of private pharmacies and medical clinics along the road that leads to the government hospital. According to the manager of the local SANASA Bank branch, these are good customers – they have a good and growing business.

Suwa Setha Pharmacy – Ms Samantha

Current business

Ms Samantha has a successful pharmacy. It has been going for about 3 years, her turn-over is about Rs3m per year (\$30k) and her business is growing.

Social service is clearly important to Ms Samantha. She went into training as a pharmacist so that she could serve the

community and she tries to assist the poor through her business. She says that she offers 'at-cost' medicines to people who clearly cannot afford the normal retail cost. Although she is not a Christian, she also donates medicines to a local church which distributes them to the poor who attend the church clinic. Most of these people were made destitute by the Tsunami – Ms Samantha's own mother was also killed by the Tsunami.

Plans for future business

Ms Samantha has a bank loan, secured by her building. Once she pays that off – which should be in about a year, she hopes to get a new loan to convert the back-rooms of her shop into a 'Channelling Centre' – she will let out the rooms to independent doctors who run private surgeries. This is a good business – a number of other pharmacies have done this and she is confident she can cover the investment.

She is concerned, however, that the doctors who work in the Channelling Centre are good and registered. She asks us if we know how to check if a doctor's certificates are real.

Another business opportunity, which she is less certain about, is to hire medical equipment on a daily basis and offer, for example, ECG scans and x-rays one day per week. ECG machines can be rented for Rs600 per day (\$6) and people with heart complaints often ask her if she can give them a check-up. This is popular in Hambantota (a larger nearby town) and Ms Samantha has the required training – but this is a longer-term plan.

Suwasala Pharmacy – Mr M. G. A. Nilantha Surada

Current business

Just 50m away from Suwa Seta Pharmacy is Suwasala, a similar pharmacy with two doctor's rooms behind. When we visited there is a long line of people waiting to see the doctor – mostly with infants. Business at the pharmacy was brisk.

Mr Surada runs the pharmacy with his wife. He has been going for about 3 years and his turnover is already Rs6m per year (\$60k) and is growing fast. However, he also says that he started the business as he wanted to do something that supported his community.

Plans for future business

Mr Surada already has plans to expand. He has bought land and has approached banks to get a loan to build a larger pharmacy, which will cost Rs1.5m – 2m (\$15k-\$20k). He is confident that he can get a loan, he has collateral and good relationships with the banks. He says that there is a good market and, since Ambalantota is growing, it needs more pharmacies.

He also would like to offer better service, perhaps by buying an x-ray machine. As the local area is agricultural many people come to him with suspected broken bones, but he cannot help them at the moment. Again, this is a longer-term plan and he would like some advice on how to operate these machines, and if it is good business.

Social investing

Lending

The lending needs of the pharmacies appear to mostly be met. They already have good relationships with banks and are able to cover their loans. In any case, the business is not capital intensive and borrowing needs are low.

Funding support

Private pharmacies, in Sri Lanka and many other developing countries, are the primary source of healthcare outside of the major urban centres. Both the rich and the poor depend upon them. This alone is justification for working with the private sector to improve healthcare access and quality. The fact that many of these private enterprises are already providing social services at their own cost gives further justifies external support.

Subsidize business expansion loans on the condition of good quality provision

As seen above, pharmacies want capital to expand and at least some also want to ensure their provision remains high quality. Providing lists of recognized doctors, conducting regular audits of quality and providing guidance on best practice would help maintain quality. Pharmacies would be willing to comply with these tests if they received lower interest rates on loans in return – provided through a local partner bank. Equally, subsidized loans could be provided for a particular purpose, such as to fund outreach to remote villages. This subsidy could make such services economic, so greatly increase provision.

Promote partnerships

Sri Lanka has a long tradition of Ayurvedic (herbal) medicine. Many villages have practitioners, as well as local midwives

and nurses. A program could create a referral system between these informal practitioners and the pharmacies, so more serious cases were referred rapidly to medically trained doctors. This program should increase volumes of business for the pharmacies and, in time, may be self-financing.

Voucher schemes

Where there is a clear target group, for example people impacted by the Tsunami, people over 70 or pregnant women, it may be possible to give them a voucher which could be used in partner pharmacies to obtain free medicine, with the pharmacies then re-claiming the costs from a funder. Similarly, some organizations may want to subsidize certain medicines that 'self-target' to the neediest, for example children's oral re-hydration tablets or inoculation. Further funding may allow pharmacies to do free diagnosis for simple medical conditions, for example simple eye tests or testing for nutritional supplements.

Advice

To help pharmacies enter new markets, a funder could provide business and technical advice. Both enterprises interviewed asked for advice on new medical machinery.

Microfinance organizations

Access to savings and credit allows the poor to bridge the gap between irregular income and expenditure profiles. When no financial instruments are available poor often spend their money when they get it (for fear of losing it) or use inefficient non-monetary forms of savings, such as livestock or gifts. When they want to invest or face an emergency they must turn to private money lenders who charge 200%+ interest

Microfinance institutions (MFIs) are 'social' financial services institutions designed to meet this market need. To be successful, MFIs must have low costs, so they remain profitable even when transactions are small, and good credit discipline, since loans are not easily collateralized. Microfinance institutions usually achieve this by engaging the local community. The community provides low cost (often voluntary) labour, and puts pressure on borrowers who are defaulting. However, maintaining a community based organization is difficult – expertise and support from a national institution is normally needed.

There has been a great growth in microfinance organizations in Sri Lanka – it has one of the highest concentrations of microfinance institutions in the world. Yet access to microfinance is still patchy, especially in rural areas. We visited two microfinance organizations, both SANASA Societies (see [Appendix 3](#) for more details)

SANASA Primary Society at Samanthi Stores

Current business

The Samanthi Stores Primary Society was started in 1990, at the junction of two rural roads where there are a number of shops and workshops. It now has about 570 members, and also provides services to 600 non-members. It has total

assets of Rs1.9m (\$19k) – a 30% increase from the end of 2005.

The society is led by the founder, Hagale Thunkama. As in all SANASA Primary Societies, the members jointly own the institution and all members meet once a month to discuss the development of the society.

The society both takes in deposits from members and gives loans. Most of the loans in the area are for micro-enterprises: working capital for small shops, equipment for mechanics, etc. There is also a large demand for borrowing from paddy farmers. But this is more risky lending since the repayment is in a lump sum and if the rice price is low for one year it is likely that many borrowers will default (i.e. lending to paddy farmers overly concentrates the society's risk). The society would prefer to lend to home gardens (small-scale growers of vegetables, spices and medicinal herbs) since these bring a more regular return.



Plans for future business

The society would like to continue to expand organically, attracting more members and increasing the savings per member. But it realizes that it has some challenges.

Firstly, there are 10 other banks and micro-finance organizations operating locally. Mr Thunkama says the SANASA society has better approaches for poor people – for example it does not require collateral – and is more trusted. But other banks appear more professional – the SANASA society has no IT system and the building does not look so secure, so people with more money go to the larger urban banks nearby.

As a result, the society is not able to grow its deposits per customer – which are currently Rs2,500 per person (or \$25). If the society had more customers it could move to a more secure place or perhaps get an IT system. It is caught in a vicious cycle of low revenue leading to low confidence and hence less business. But the Chairman the society can grow out of this cycle – another nearby society, Bathaata, started in 1986 and now has 1000 members and Rs60m assets (\$600k).

Mr Thunkama thinks he could lend more if he had more liquidity. The society already has a liquidity loan from the SANASA Development Bank for Rs250,000 (\$2,500), which it has on-lent to customers at a 3% margin. It is evaluating if it should get another loan. Mr Thunkama worries that overly rapid growth using external money could damage credit discipline, but thinks the membership can take more loans now. There are still some money lenders operating in nearby areas who charge very high interest rates and he would like to put them out of business.

There is also a clear opportunity to serve people from other areas, especially further from town. The society is close to a housing project – a development of about 70 houses built for Tsunami victims. The society is working with the NGO that built the homes to make 40 of these households members and then give loans for income generation projects.

The opportunity is even greater in rural areas, where there is more demand for financial services, given the uneven income profile of most rural families and lack of institutions. Mr Thunkama would like to work in these areas, but also knows that the model does not allow a single society to cover a large area. “People have to feel a connection to the society, an ownership, or they are not loyal [and credit quality suffers].” The society cannot be too large or they lose the connection.” It would be better to start up new societies in rural areas or develop the societies that already exist.

SANASA Primary Society at Thawaluwila East

Current business

Thawaluwila East is a small village on the coast, just outside Ambalantota. Most of the people in the village are fishermen and paddy cultivators. The Tsunami had a major impact in this community. 27 houses were destroyed (15%) and an additional 60 were damaged (33%).

The society is also small, although most in the village are members. There are 179 households in the village of 1,500. The society has 145 members, plus 50 non-members who leave deposits with the society. The total assets are about Rs1m (\$10k), making the average deposit with the society Rs5,100 per person (\$51)

The society was inactive before the Tsunami. It had a large number of bad debts, most of which were a result paddy

cultivators not repaying loans following a bad harvest. But after the Tsunami the Primary Society revitalised. The community realized it needed to work together and Primary Society meetings re-started. People have started to make deposits and the society has new lending.



Post-Tsunami reconstruction projects, managed by the national Federation of SANASA Societies and the SANASA Development Bank have helped. The first project literally rebuilt the society – the old building was washed away in the Tsunami. Ms M N H Chandra Lalini, the Chairwoman of the society, opens the new office from 9:00 to 3:00 three days per week. She also receives advice on how to build the society from Field Officers. A second program gave grants to recapitalize debts which had become non-performing as a direct result of the Tsunami.

Plans for future business

Ms Lalini wants the society to continue to grow. She has introduced more lending products to raise liquidity for lending. She would also like to raise members' awareness of the benefits of an active cooperative society and to develop new community development programs – which will increase trust in the society and so make people more willing to leave deposits.

Ms Lalini says that they have learnt from their previous lending experience and will not become overly concentrated in one sector. They now lend more to micro-enterprises, like sweet producers, small retail shops and seamstresses. The regular income makes these loans less risky. Paddy farmers still need credit, so they have to turn to local money lenders.

Ultimately, however, the society is likely to face difficulties as it is too small. Even if the society is able to capture all of the financial services needs of the village, with only 179 households it will always struggle to be financially viable or to invest in new systems. Thawaluwila East is quite close to Ambalantota and the society already loses customers to the more modern and better equipped urban banks located there. There are other SANASA societies near-by that the Thawaluwila East society could cooperate with, perhaps sharing infrastructure or facilities. Ultimately, it may be possible to merge and then provide the same level of service as a commercial bank, while retaining the advantages of local cooperative ownership.

Social investing

Liquidity lending

Most successful Microfinance institutions collect a majority of their funds from deposits, since this increases customer's commitment to repay loans. However, in some cases an MFI may need additional funding, for example if borrowing needs grow fast (and the institution is confident it can maintain credit quality), or if the MFI wishes to provide longer-term loans. In Sri Lanka, the SANASA movement has set up a bank to provide these needs – the SANASA Development Bank, which specializes in lending to SANASA Primary Societies. In other countries these types of banks may not be set up. Alternatively, in some cases the 'Apex bank' itself needs funds for on-lending: many of the funds that SDBL on-lends are from international partners and are earmarked for particular sectors.

Risk reduction products

Small MFIs realize the risk of overly concentrating in one sector, since if there are problems in that sector it will put too many loans at risk, and could bring down the whole institution. However, this precludes them from lending to sectors where they could create major benefit – for example in Ambalantota where many of the local population are paddy farmers, few MFIs are willing to lend to this sector.



If the MFI could 'sell this risk', it would open up a large potential market. In theory there is no reason why this cannot be done. The challenge is pricing – both how to determine the cost of this risk and how to be able to minimize transaction costs. If all the SANASA societies worked together, through the SANASA Development Bank, there should be sufficient volume to allow the risk to be sold.

Funding support

Funding support to MFIs carries a risk. If customers perceive that the MFI is receiving significant sufficient external they may believe that they do not need to repay loans. Equally, if the MFI receives subsidies for loans it may start to lend with less attention to repayment. Ultimately this will undermine the MFI's most valuable asset – the credit discipline of its members.

Funders should restrict their involvement with MFIs to supporting the development of the institution. This will allow the institution to grow, to bring in more deposits and then lend more. It should make the institution more financially sound, by reducing unit costs and increasing profitability.

There are still a number of ways that external funders can support MFIs. They can become engaged in any part of the institution, through training, promoting best management practice, or motivating members. Two example projects are described below, which the SANASA movement is already implementing and which could be replicated in other MFIs.

Organizing new societies and disseminating best practice

The SANASA movement has 8000 societies across Sri Lanka. Yet the movement could grow more. Many societies created during rapid growth in the 1980s are now less active. In some areas there are few SANASA societies, despite the

demand for credit. There are particularly few societies in the East and North of the country where travel is difficult. And a large number of the 8000 societies are now inactive.

The SANASA movement has developed an approach to initiate and support these societies. It defined a standard set of 'Best practices' at its education campus and field officers travel the country, working with the existing SANASA societies to help the societies implement these practices. Support includes leadership development, accounting, product development, building and security, etc. The field officers also work with communities who want to start a new SANASA Society to describe how a society works and to help in the initial meetings. These field officers are partially paid by the SANASA Development Bank, which is interested in developing Primary Societies as future customers, and partially by external funding.

Implementing IT into Primary Societies

Larger SANASA Societies resemble small banks. They can have several thousand members and process up to 1000 transactions per day. Already, more than 200 societies have purchased computers and use simple IT systems to manage their accounts.

The National SANASA Federation is developing standard software for roll-out to SANASA Societies. This system should use PCs for larger societies and simpler hardware, such as a hand-held credit-card reader, for smaller societies. Implementing IT allows fewer processing and accounting staff. It reduces operational risk from errors and incorrect auditing practices. It also increases customer confidence, reducing the number of customers who move their accounts to urban banks. The SANASA movement estimates that the project has an internal rate of return of approx 140%. It is currently implementing a pilot in two primary societies.

Water supply systems

Begagamana Water Supply System

Current business

Begagamana, a village of 365 houses and about 1200 people is about 60 km inland from Ambalantota. This is a poor region, the countryside is dry and sparsely populated. The farmers of Begagamana practice shifting cultivation, cutting a new field every few years out of the local scrub, planting it and cultivating it until the soil is depleted and then moving on to allow the soil to recover.

Until a few years ago, drinking water was supplied by weekly deliveries from a government tanker – 3 gallons per house per week. The only other source of water was a reservoir 5 km away, which people would walk to so they could wash and collect water for domestic needs.

The village leaders decided that this was not acceptable. They wrote to a minister in the national government, asking him to help. As a result, and with the assistance of an Asian Development Bank (ADB) project, the government built a pipe from the reservoir to an overhead tank in the village, with taps going to each household, so long as the village contributed 20% of the cost – Rs3,500 per household (\$35) plus 25 man-



days of work. The local contributions and the management of the water supply system was the responsibility of Mr Mohinda, who now leads the community organization that oversees the project. Although he would not consider himself as an entrepreneur, Mr Mohinda is in effect running a community owned water supply company.

Most of the households were able to raise the money. The remainder took out loans from local money-lenders at high interest rates or got grants from a local charity. The money was put into a fund, which is now kept in a bank, and used to pay the electricity bill, maintain the line and buy chemicals for purification of the water. The village organization also collects charges for the water supply, based on meters that have been placed at each tap.

Work started in December 2005. By May 2006 the main pipeline and pumps were installed and the overhead tank completed. So far 150 households have been given taps, leaving 206 households without.

But the project has hit problems. The pumps installed at the lake are not pumping enough water to fill the tank, so the village has stopped connecting more families to the water supply. People who paid Rs3,500 in 2005 are still not connected. The community organization has arranged for the pipe to be cleaned – perhaps it has become full of mud. Or perhaps the pumps are simply not big enough.

Once the pipe is cleared, the community organization hopes that it can quickly connect up the remaining 206 houses, but some in the village are losing confidence.

Future business

Now that the community has become organized, Mr Mohinda wants to develop. He says that there is a great need for agricultural credit in the village - at the moment farmers who need credit have to go to private money lenders who charge 20% per month. He says that this is more important than developing the water supply or starting sanitation projects. Mr Mohinda wants to lend the water fund to people in the village.

This scheme could work, but it carries risks. The community organization does not have experience in lending and is not following some of the normal rules of MFIs, such as regular group meetings and external audits. The risk is that the lending does not go well, the fund being depleted and there being no money when the pumps need replacing

Kurawella water supply system

Current business

The village of Kurawella is running a similar project, also partially funded by the ADB. In this village a tube-well was sunk, connected by a 250m pipe to an overhead tank which was used to supply water to 200 families – the other 50 families in the village have their own wells. The project cost Rs4.8m (\$48k). The village contributed 30% of the total cost, paid through labour and Rs4000 (\$40) per person in the village.

The project was technically simpler to implement – the community leaders say there have been no problems.

Future business

Now that the village has created a community organization and has put Rs700k (\$7,000) in the bank, it wants to start



providing credit. The leader of the water organization says there is a major need for credit in the village, especially for agriculture (seed and fertilizer) and machinery.

The village plans to convert the water supply company into a SANASA society. The initial plan (created during the visit) is for the organization to register as a cooperative (allowing it to lend) and the SANASA Development Bank to grant a credit line to cover the cost of a new pump should the old one fail. Once the society is well established, it can start to lend its

savings to farmers, who will have their water supply cut off if they default. Development officers from the SANASA Development Bank will help the society make this transition.

Social investing

Set up a technical advisory company

There is a need for more technical advice on how to maintain the water supply system, working across all the water supply projects in the ADB project. This company could be subsidised by the Government and, in time, could advise on sanitation (there are very few toilets in the villages) or contracting for repairs. A company that works across all villages would have the scale to employ specialists and buy machinery, as well as learn from different projects. This company should not replace the community organization, would provide the community organisations technical inputs. Social investment could provide the seed capital for this type of company.

Once this company is well established, it could start to market projects to more villages, working in collaboration with social investors or local banks to provide credit.

Funding support

Expand an established microfinance organization to the village

The water supply organizations are right to aim to start a microfinance institution, since there is demand for credit. It is best to join an established network, which will have procedures to ensure good credit discipline and which can bring other valuable services, such as interlending, access to larger credits, training etc. External support could help the organisations make the transformation.

Fund sanitary works in the villages

Although the villages now have access to water, few toilets have been installed, which will have a detrimental impact upon health, especially of children. The water supply company could help select locations and families which should have toilets installed, conduct a public awareness campaign on the importance of good sanitation and arrange partial recovery of the investment costs.

Small retailers

Retail is not normally seen as a 'social sector', but for people living in rural areas it is vital. Communications shops can provide farmers information on market prices or sales opportunities, as well as allowing children living in cities to stay in touch with their parents. Clothes shops and general stores allow farmers to get provisions locally without having to leave their crops and pay for transport.

In many rural areas the challenge for a retailer is scale – there are not enough people to justify a shop and a shopkeeper. However, new ways to reduce unit costs are appearing, such as cheaper credit or lower cost equipment.

Nihal's communication centre

Nihal is a young man who has just started a new enterprise. There are 10 villages in his local area, but no phones or communications, so he has opened a shop that gives access to a phone, a fax, e-mail and the internet.

The shop has been open for 3 months and so far most of his customers use the phone lines for calling relatives. But Mr Nihal wants to introduce farmers to more services, like giving people weather reports (so they know when to harvest crops)

and information on market prices, or doing typesetting and letter writing.



The shop was simple to set up. It cost Rs150,000 (\$1,500) for all the equipment, which he got as an informal loan. The telephone line only took 2 days – it is a wireless connection. His revenues are already Rs55,000 per month (\$550).

Communications centres are good business. New technology has reduced

costs, as well as barriers to entry. SANASA Development Bank often provides loans for new communications centres.

Sumandha Limarachi's groceries and shirt shop

Mr Limarachi opened his shop in 1988. He now sells groceries in half the shop – run by his daughter. In the other half of the shop his wife sells and repairs shirts and lungis.

When he started his shop the only source of credit was a money-lender. He took a Rs 20,000 loan (\$200) and paid back Rs250 every day for 100 days – an interest rate of 180%.

Now, to expand his shop he can go to a commercial bank. He has a good relationship with the bank and can offer land as collateral. His situation has changed – as he is now a successful shop owner, but Mr Limarachi says that more importantly the banks have changed. Before bank officers

stayed in the branch and were not interested in people like him. Now people from the bank come to visit him and offer him loans. There are some money-lenders still working in nearby areas, but generally only lending to paddy farmers.



Social investing

In Sri Lanka, there is little need for external funding for retail operations. Shops can be started up relatively cheaply – premises costs are low and stocks are generally small. Returns are regular and many banks and microfinance organizations are willing to fund start-up costs. Where SME funding is less available, retail would be a good sector for a specialized fund or financial institution.

Funding support

Information sharing through communications centres

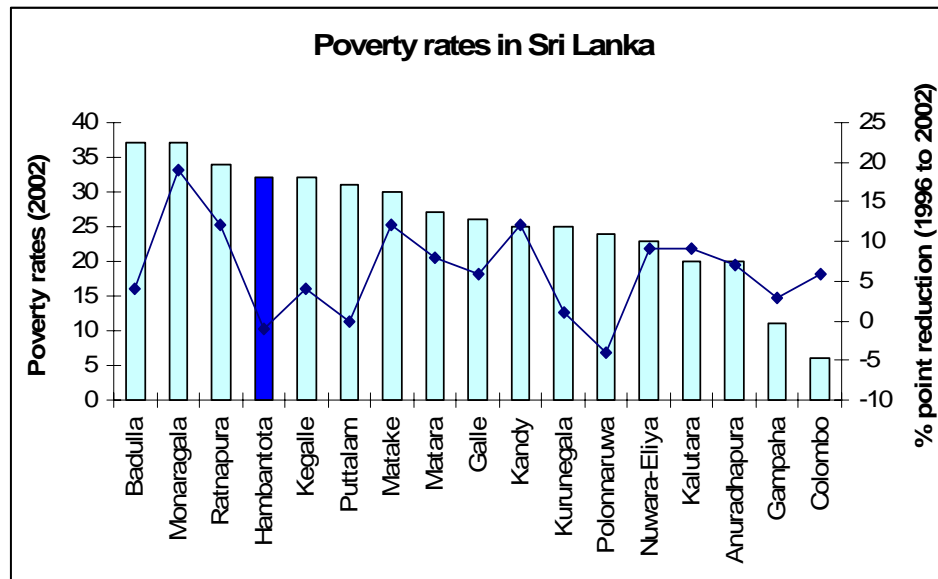
Communications centres are becoming ubiquitous. They could be a simple way to educate large numbers of people cheaply, either by fax or through the internet. Agencies could, for example, fax public health messages to villages, or training guides. Or they could provide web-sites with agricultural information and training. In time, a networked model might develop, whereby franchised communications centres become known for providing accurate and relevant information. This would meet the objectives of a funding agency and bring value to the franchisee.

Appendix 2: Description of Ambalantota, Sri Lanka

The examples in this paper come from structured interviews with social entrepreneurs based in and around Ambalantota.

Ambalantota is a small town, close to the sea, in the South East of Sri Lanka. It is in the district of Hambantota, an area which is towards the bottom of most measures of welfare in Sri Lanka. It is also one of the few areas in Sri Lanka where poverty increased from 1996 to 2002 (see chart). Hambantota also falls lowest on other measures of poverty. For example, while the national average for underweight children (under 5 year old) is 29% in Sri Lanka, in Hambantota it is around 40%.

The situation became considerably worse following the Tsunami of December 2004, which killed 30,000 people and destroyed houses, infrastructure and markets along the south and eastern coast of Sri Lanka. Ambalantota was in one of the most directly impacted areas of the country, facing directly the direction of the water. For example, 92% of the fishing fleet was destroyed, in some villages 40% of the houses were destroyed or damaged. Houses have now been re-built in



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most of the town. There is still, however, considerable disruption to the market. Relationships need to be re-established, businesses that were destroyed need to be re-built, etc



Appendix 3: Details of the SANASA Movement and the SANASA Development Bank

The SANASA movement has a long history. The Thrift and Credit Cooperatives of Sri Lanka were founded in 1906. For many years they provided basic savings and lending services to its members in rural areas. However, by the 1960s the movement had stagnated, and remained scattered and hidden until they were revitalized in 1978.

In 1978 a National Federation and regional 'District Unions' were formed to support the Primary Societies. This was the start of the development of the national support structures that now include a training centre – the SANASA Campus, a bank - SANASA Development Bank (SDB) that specializes in inter-lending between different primary societies and funding other community development projects, an insurance company that sells insurance through the SANASA Primary Society network and a construction company (SEDCO).

There are now 8400 SANASA Primary Societies in Sri Lanka, already providing basic savings and loans services to 800,000 households, and hence serving approx 2,000,000 people or 10% of the population of Sri Lanka. The majority of these households are in rural areas and surveys have confirmed that they are predominantly from poorer sectors of society. The Primary Societies are cooperatives – they are owned and controlled by the members, not by a central organization. Many have full-time managers.

The national support structure facilitates projects that are implemented in the Primary Societies. These projects include training, society development, community mobilization, support to set up new societies and support in exceptional circumstances, such as the Tsunami.

SANASA Structure



The SANASA Development Bank now has 14 branches, across the country. Its main customers are community based organizations, such as SANASA societies. It offers traditional financial services, such as deposits and loans, but also helps the community development organizations develop, for example by advising on accounts, possible future directions for the organization and channeling government and international assistance. In addition, the bank offers retail financial services to the general public. Most customers are from less well off sections of the population who already have a loyalty to SANASA. The SANASA Development Bank is owned by the SANASA Primary Societies.

The SANASA Development Bank has been growing steadily since being founded in 1997. From 2005 to 2006 its revenues increased by 39% to Rs362m (\$3.6m). Its profits increased by 113% to Rs124m (\$1.2m).

Appendix 4 Importance of the Private Sector in Health and Education in India

Health Sector in India – Long history of private provision, still expanding

Only 12% of health expenditure in India is public, 78% goes to private enterprises.⁵ India has an estimated 450,000 private doctors, 1.25m rural clinics and 12 million chemists.

Traditional healers assist for minor complaints: 70% of anti-diarrhoea medicine is sold by them⁶. In a poor area of 2,000 families visited by the author there were 5 'clinics' + 3 dai (traditional mid-wives) - 1 practitioner per 250 families.

Public provision is focused on the rich. The richest 20% receive 32% of public health expenditure, the poorest 20% receive 12%. In poorer states such as UP the bias is more extreme; 41% compared to 10%. 30% of women in the richest 20% deliver in public hospitals, while only 7% of the poorest 20% do so⁷.

As a result, the poor do not have access to public healthcare. They say *"it takes too long to go to the govt. hospitals – they are too far away and there are too many forms to fill in. We do not have money to travel, we cannot take time off work. The private clinic is close."* The average distance to a medical facility for the poorest fifth in India is 2.5km, 3.5 times further than for the richest fifth⁸. And where there is provision in poor areas, service is bad. In spot checks in rural areas the medic was absent 43% of the time⁹.

The major gaps in healthcare in India are in sectors where the private sector is not active. For example, there is little private vaccination. As a result, the level of immunisation is falling and infant mortality rates are not falling¹⁰. 74% of antenatal

care is provided by the public sector¹¹, but 3/4 of births take place at home and maternal mortality rates are very high.¹²

In future, it is likely that private provision will increase. The private sector is increasing its share of pharmaceutical procurement. Traditional healers are becoming more professional and offering more health services. The government increasingly supports private sector provision¹³.

A major challenge will be the private sector's ability to treat HIV/AIDS, the likely next health crises in India. It is estimated that there will be 110m HIV/AIDS cases in India by 2025¹⁴ (from the current 5.2m) and HIV/AIDS is likely to be the leading cause of death.

Education Sector in India – Communal and private provision taking up the slack

Private education in India is significant. Official statistics say 10% of rural and 26% of urban primary education is private. Yet expenditure surveys indicate official figures underestimate; 30% of rural households with children and 50% of urban households use private education¹⁵. One third of education spending goes to private institutions. In a peripheral area of Delhi visited by the author, 60% sent their children to private schools. There were 5 private schools and only 1 state school in the area.

Public provision is directed to the wealthy. More state money goes into secondary and tertiary education, which caters to the rich. Private schooling is most common in primary and junior education, where poor children are more represented.

The poor are forced into private schools as the public sector is failing. Parents regularly complain that “Teachers do not care at the government school, class sizes are too big. Private schools are more modern. Government school is too far”¹⁶. Government surveys show major problems in public schools. 50% have no drinking water available. There is frequently no sanitation, especially for girls. Few have additional teaching facilities or books – all money is spent on teacher salaries. Yet many teachers do not turn up, absence rates vary from 15% in Gujarat to 39% in Bihar¹⁷. Where public schools are worst (Bihar, Uttar Pradesh), the private sector is strongest, even though these states are also the poorest¹⁸.

State schools are failing due to a lack of funds and misallocation. The proportion of GDP spent on public education in India has fallen over the past 15 years, and an increasing proportion of funds have gone on teacher salaries, rather than equipment or infrastructure. State governments are unwilling to confront strong teachers unions and salaries in public schools are now up to ten times higher than in private schools.

As a result, the poor pay for private education. It is common for very poor people in shanties in Delhi to pay Rs100/mo for private schools (\$2, or approx 15% of household income for a family of 4). Education is seen as the best way to lift the whole family out of poverty.

1 PriceWaterhouseCoopers (PwC) on ‘Working towards Wellness: An Indian Perspective’. April 2007

2 OECD Statistics database – 2003 data

3 Indian Public Finance Statistics, GoI, - 2001 data

4 Filmer, Deon. 2003 “Determinants of Health and Education Outcomes. ”Background note for the WDR 2004. Quoted in World Development Report 2004, World Bank - 1996 data

5 WHO World Health Organization, 1999

6 Janani web-site

7 WHO World Health Organization, 1999

8 Filmer 2003b, quoted in World Development report 2004

9 World Development report, 2005

10 21st Century India – Dyson, Cassen and Visara, 2004

11 World Development report, 2004

12 21st Century India – Dyson, Cassen and Visara, 2004

13 Conversation with PSP-One

14 Human development report 2003

15 21st Century India – Dyson, Cassen and Visara, 2004

16 PROBE Team in association with Centre for Development Economics, confirmed in interviews conducted by the Author

17 World Development report, 2005, World Bank

18 Human development report 2003, UNDP