Sri Lanka: How newfound peace and leadership affects business
For more than three decades, Sri Lanka’s progress had been hampered by the civilian conflict between the Sinhala majority and the Tamil minority. The conflict erupted into full-fledged war when the terrorist group Liberation Tigers of Tamil Eelam (LTTE), claiming to represent the minority population, took up arms against the state. The LTTE was finally defeated in 2009 under then-President Mahinda Rajapaksa’s leadership.

After the civil war’s end, Sri Lanka continued to be somewhat of an international outsider, with Rajapaksa not enjoying the best of relations with the West. However, with the recent election of Maithripala Sirisena as Sri Lanka’s new president, questions arise as to whether political realignments will follow and how they will impact the business environment.

The government is being run by a coalition that includes President Sirisena’s own party, Sri Lanka Freedom Party, along with the All Ceylon Muslim Congress, National Union of Workers, Sri Lanka Muslim Congress, Jathika Hela Urumaya and the United Nations Party (UNP), headed by former President Ranil Wickremasinghe.

President Sirisena appointed Wickremasinghe as the country’s new Prime Minister, as promised before the elections, and the UNP has secured 19 seats out of the 27-member Cabinet of Ministers.

Kroll’s Senior Director Probal Dasgupta shares his insights on what the new government means for Sri Lanka as well as for businesses contemplating new investments in the country.
What is the big picture message from Sri Lanka after the recent presidential elections?

The recent national presidential election demonstrated that Sri Lanka has matured into a robust, functioning and inclusive democracy, notwithstanding the wars of the past. Despite the overwhelming support that former President Rajapaksa enjoyed during a decade in office and especially after the civil war, he and his party lost in the elections. One can attribute this to complex political reasons that included a growing discontent with Rajapaksa’s perceived authoritarian and divisive style and allegations of corruption.

On the other hand, that a long-standing, dominant politician could not take victory for granted and was voted out in a democratic process — and in fact, conceded defeat ahead of a full tally of votes — reflects the country’s political maturity.

Post elections, the smooth transition of power from Rajapaksa to new President Sirisena further demonstrates Sri Lanka’s improving stability. South Asian nations, aside from India, have not been known for their smooth passing of the political baton. The absence of major violent events reported during or after the presidential election is an indication that Sri Lanka’s strong democratic reputation was not damaged.

The new government has signaled that there might be a departure from the earlier policies of Rajapaksa. How does that impact the investment environment?

The new government is unlikely to overturn major policy decisions because it appears to support the direction and momentum of investment and growth. That being said, important legislation must be passed in order to accelerate investment. Parliamentary elections due to be held later this year will determine the strength of the Sirisena government to pass these bills in the Parliament. Given that the investment efforts of Rajapaksa were well received by a people besieged by war for decades, the Sirisena government is likely to continue on the path of aggressive economic development. However, time will tell whether Sirisena abolishes the presidential form of government, which he promised to do after the elections, and retains the parliamentary form instead. The parliamentary elections will also decide whether the current government’s initial few months have struck a positive chord with its citizens. In the ultimate analysis, Sri Lanka will need a majority government to deliver on the expectations that have been raised.

Sri Lanka has recently made certain overtures toward India. The Sri Lankan president visited India, and India and Sri Lanka signed a nuclear deal. What are the repercussions of the government’s foreign policy outlook on investments?

The new government has a different take on foreign policy, which bodes well for the region in terms of fostering egalitarian investment opportunities and lending greater strategic balance. If one examines investments post-civil war, the geopolitical shift in Sri Lanka’s foreign relations toward China occurred after relations soured between Rajapaksa and the West. In 2013, China and Hong Kong SAR led the way by jointly accounting for 36 percent of FDI into Sri Lanka.

However, the sources and amounts of FDI are expected to change in the coming months. For example, the civil nuclear deal with India is a first for Sri Lanka, with the two countries agreeing to exchange knowledge and resources and build capacity to harness nuclear energy efficiency. Additionally, given the growing proximity with India, it is possible that the Sri Lankan government could reach out to consider Indian expertise in developing the Sri Lanka railway network, which will create opportunities for Indian EPC, infrastructure and engineering firms.
How are countries likely to view Sri Lanka as it grapples with its post-conflict peace and a change in leadership?

The Sirisena government’s decision to engage other countries, such as India, early on in its tenure is a good sign that the government has shed the earlier regime’s unilateral preference towards China. Given the presence of Wickremasinghe, this government is likely to be friendlier with European and other Asian countries. Consequently, there is a favorable outlook for broad-based foreign investment, especially from Japan, India, UK and Scandinavian countries that have traditionally expressed regular interest in the political affairs in Sri Lanka. The positive reception to Sirisena’s visit to London in March of this year is another indicator of Sri Lanka’s improving relations with the West. Japan in particular enjoys cultural ties with Sri Lanka at many levels, and the Japanese auto industry which had been reigning supreme in Sri Lanka for many years is likely to get a boost again. It must be mentioned that China already has important infrastructure investments in Sri Lanka which are likely to continue. In fact, Beijing has proposed a triangular partnership with India and Sri Lanka, and the Sri Lankan Foreign Minister Mangala Samaraweera visited China in February. So it appears that there is an increased optimism now in the international arena, and Sri Lanka will progressively become a more exciting investment destination globally.

Will Sirisena’s background as a left-of-center politician hurt Sri Lanka’s investments and business-friendly image that Rajapaksa had built up?

In this case, it is important to view the issue from the overall context of global perceptions. Though Rajapaksa aggressively courted foreign investments, his proclivity toward China and his hostility toward the West and India negatively impacted Sri Lanka’s image as a long-term business destination for global firms. The current government may have a former left-centered minister, but it also brings in the hugely experienced Wickremasinghe, who as a third-time prime minister brings positive elements to the table such as influence, good will and sound relations with India and the West. The Sirisena government appointed a Tamil as the chief justice of the Supreme Court when it chose Judge Kanagasabapathy Sripavan, who is an ethnic Tamil. This shows that the government is more inclusive in its approach, given the ethnic tensions of the past in the island.

What is the extent of opportunity available for investors in Sri Lanka; which sectors do you think are likely to witness large-scale investment and growth?

Despite its complexities, Sri Lanka presents a great opportunity for investors with its stable democracy, improving infrastructure and a peaceful environment, which are all standout features. One of the best indicators of Sri Lanka’s potential is the rapid growth achieved after the end of the civil war.

Key Sectors

Infrastructure

Post war, the infrastructure sector has attracted the most investment, with large investments spurting consistent growth in the last three to four years. Engineering and infrastructure firms can expect to get more work given the ambitious construction plans for the countrywide railway and road network. Until now, Chinese companies have been at the forefront, investing in large port projects such as Hambantota Port and road projects such as the Colombo–Katunayake Expressway. The Northern Province offers several investment opportunities as well as it rebuilds following the war’s destruction. The post war investment drive is likely to continue as it was largely welcomed across the provinces; however, the approach may take a different turn as the government’s client base could shift from China to include countries such as Japan and India. Chinese investments in infrastructure are likely to continue but
European investors, especially Scandinavian countries who had been kept away earlier by the previous administration because of persistent enquiries on human rights violations during the war, could possibly make a comeback under Sirisena.

Manufacturing
Japanese companies, which have been dominating the automobile industry in Sri Lanka, could make fresh headway again. Investments from India to Sri Lanka also began in the 1980s with manufacturing of heavy vehicles and buses, and over the 1990s and 2000s saw investment in sectors such as steel, telecom, banking and tourism.

Textiles
The textile and apparel industry is the highest industrial employment generator and the highest foreign exchange earner for the Sri Lankan government. The Sri Lankan textile industry currently produces apparel for global brands such as Victoria’s Secret, Nike, Gap and Pierre Cardin, and most of the industrial units are located in the Western Province. The other areas of the country, such as Northern and Eastern provinces, are relatively untapped and offer potential investment opportunities.

Tourism
A key sector in Sri Lanka, tourism remains underdeveloped due to the limited tourist arrivals during the war period. The Northern Province, especially so, was not accessible to tourists and only recently did the government provide tourists with permission to visit the area. As of 2012, the country had only 15,000 registered rooms, and the government had planned to triple the supply of rooms by 2016. The country also offers opportunities in traditional sectors which got a boost after the war, such as tea export and rice production. Education and health care have a good deal of potential for investment as well. Mining, especially graphite mining, is another promising area for Sri Lanka, though political issues make it somewhat problematic. Defense imports are

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<th>FOREIGN INVESTMENTS IN SRI LANKA</th>
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<td><strong>Tata Housing</strong></td>
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<td>Tata Housing, a real estate development company promoted by the Tata Group of India, entered Sri Lanka in 2014 with an investment of USD 400 million to jointly develop a township project in Colombo with Urban Development Authority of Sri Lanka.</td>
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| **Lanka IOC**                    |
| Lanka IOC, a subsidiary of Indian Oil Corporation, has been operating more than 150 fuel stations in Sri Lanka and has a market share of approximately 43 percent in the country. In 2012, the company had planned to invest over USD 3 billion to establish a refinery in Sri Lanka. |

| **Shangri-La**                   |
| Shangri-La, Hong Kong based hospitality group, is developing a seven-star luxury hotel with an investment of USD 500 million in Colombo, which is expected to be operational in 2017. The group is also developing a resort in Hambantota, in the south of Sri Lanka, and the property is expected to be operational in 2016. |

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<th>BUSINESS FRIENDLY REGULATIONS</th>
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<td><strong>Free Trade Agreement</strong></td>
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<td>Sri Lanka has signed a free trade agreement with India, which gives Sri Lankan companies access to the Indian market. Sri Lanka has also been discussing a free trade regime with China, and the same is expected to be signed during 2015.</td>
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| **Tax Concessions**              |
| Sri Lanka offers income tax exemptions to foreign companies which are engaged in various activities, including agriculture, manufacturing, information technology, health care and tourism. |
an area where Chinese firms dominate of late, but it remains to be seen what kind of policy the current government adopts in this sector.

Do you see issues of corruption being addressed under the new administration and how will that impact companies?

Sirisena’s political history seems largely free of allegations of corruption, which undoubtedly lent credibility to his campaign. It was recently reported in the media that Sirisena would review the USD 1.5 billion Colombo Port project by China Communications Construction Company and has blocked the USD 400 million casino project of Australia’s Crown Resorts Limited, both projects which were signed during Rajapaksa’s administration. According to local sources, corruption in Sri Lanka may be less rampant in the lower levels of government compared to the higher levels; this view seems to be supported by the 2010 and 2013 Corruption Perception Index (CPI) reports of Transparency International, which noted that public sector corruption in Sri Lanka is somewhat less compared to other South Asian countries in the region. This being said, companies would do well to understand all patterns of corruption. To avoid being inadvertently linked with corrupt officials, when choosing a partner or investing in a local entity, companies should identify the stakeholders involved, their direct and indirect roles and the source of project funding. Companies will also need to delve into the backgrounds and the market relationships of their local partners to understand their ethical standards and the integrity of their business practices.

What are the big challenges of doing business in Sri Lanka?

Conducting business in Sri Lanka can be as complex as running businesses in other parts of South Asia, with similar overlapping issues such as lack of transparency, opaque disclosure norms, corruption, unstable government regulations and a strong nexus between politicians and businesses that impacts business dynamics at each stage. There have been several instances of beneficial relationships between Sri Lankan politicians and business people in recent years. For example, Basil Rajapaksa, the former president’s brother, allegedly tried to sell off a premier seafront property owned by the government to a Chinese defense company. The opposition came to know about it, and the deal was stalled after protests grew louder. Companies should look at doing business in Sri Lanka as an opportunity to take advantage of an emerging economy that has virtues of stable democracy, low cost of operations, growing market demand and a huge pool of employable local population.

Will the proposed changes in policies by the new government help companies conduct business more easily?

Policy changes certainly help encourage companies to invest, but the local environment will continue to influence the way companies conduct business. For example, access to credit has improved over the years, but to manage businesses smoothly, investors still need to protect themselves against the opaque nature of corporate disclosures and evolving standards of corporate governance. Businesses need to be careful about whom they are partnering with and must understand the various consequences of their relationships, especially with respect to any potential political witch hunt, which is a peculiar feature in Sri Lanka.

Former President Rajapaksa had incarcerated individuals, such as the former chief of army staff, who had fallen out of favor. As mentioned earlier, the new President has ordered an investigation into several business transactions signed by the previous government. Additionally, given that the country has only recently emerged from a three-decade civil war,
there are people who are likely to be linked with a controversial, or perhaps even a bloody past which an investor would do well to be aware of.

There is additional concern that the country will adopt regulations unfriendly to business. For example in 2011, the Sri Lankan government passed the Underperforming Enterprises and Underutilized Assets Act (UEUAA), which gives complete powers to the government to take over any business which is deemed to be underperforming.25

Other realities of doing business in Sri Lanka include the fact that with no digitized land registry available in the country, it takes eight different steps and more than 60 days to register a property in the country.26

In view of the changing environment in Sri Lanka, how should foreign investors conduct due diligence before investing?

Apart from conducting conventional due diligence to ascertain the financial risks and the strategic business environment, the investor will have to focus on other dynamics, such as the following:

- Given Sri Lanka’s recent political and conflict history, it would be good to determine the background, reputation and track record of a promoter to understand how your future business partner is connected to politicians, bureaucrats and other business people.

- Governments have changed in the island nation during and after the war. Anti-incumbency is a common phenomenon. The political climate is also one where vindictiveness isn’t uncommon in political and business circles. Therefore, it is important to understand what kind of past deals and relationships possible partners would have had and extrapolate what kind of issues they might face in the near future. That would help an investor in staying ahead of likely political and business risks in the country.

- Because of the lack of digitized information and absence of transparency, the actual business practices and true health of a business may not be reflected in the financial statements of the investment partner. It is important to understand the local environment in terms of its actual practices, integrity and reputation.

- Integrating cultural and local issues with the financial and business challenges while approaching business operations always helps foreign firms optimize their capacity to deal with changes and avoid surprises.

- Understand the quality of senior management at the company, focusing on the human resources, finance and key operations functions.

About Kroll

Kroll is the leading global provider of risk solutions. For more than 40 years, Kroll has helped clients make confident risk management decisions about people, assets, operations and security through a wide range of investigations, due diligence and compliance, cyber security, physical and operational security, and data and information management services. Headquartered in New York with more than 53 offices across 28 countries, Kroll has a multidisciplinary team of over 2,000 employees and serves a global clientele of law firms, financial institutions, corporations, non-profit institutions, government agencies and individuals.

The latest World Bank study ranks Sri Lanka 99th out of the total 189 economies which were part of the study on ease of doing business.21 According to a study conducted by Transparency International, Sri Lanka is ranked at 79th place in the global CPI.22

However, it is encouraging to note that Sri Lanka has improved its ranking from 71st place in 2013 to 33rd place in 2014 when it comes to starting a business.
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