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Intellecap – IntelleGrow

Providing Venture Debt to the MSME Sector in India

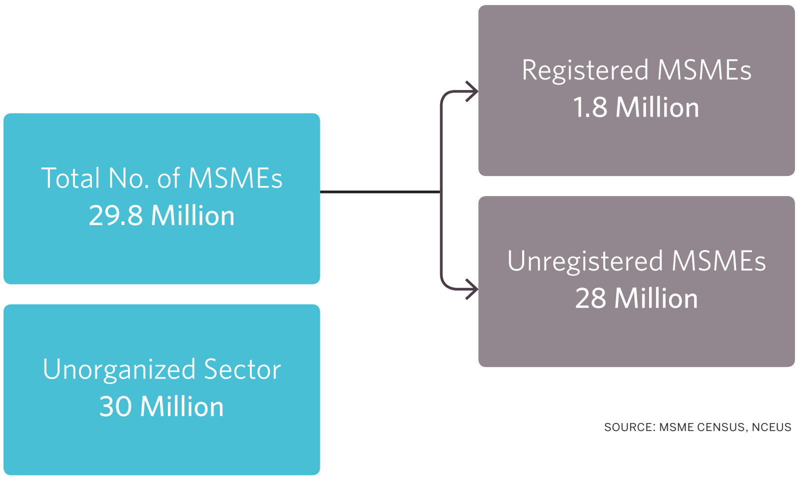
Intellecap
SHAPING OUTCOMES

MSME Sector in India

The Micro, Small and Medium Enterprises (MSME) sector is crucial to India's economy. An enterprise is categorized as Micro, Small and Medium if its initial investment in plant and machinery does not exceed INR 2.5 million (US$ 50,000) for a micro, INR 50 million (US$ 1 million) for a small and INR 100 million (US$ 2 million) for medium enterprise.

There are 29.8 million enterprises in various industries, employing 69 million people. The sector includes 2.2 million women-led enterprises and 15.4 rural enterprises. In all, the MSME sector accounts for 45 percent of the Indian industrial output and 40 percent of exports. Although 94 percent of MSMEs are unregistered, the contribution of the sector to India's GDP has been growing consistently at 11.5 percent a year, which is higher than the overall GDP growth of 8 percent.

BROAD CLASSIFICATION OF THE MSMES IN INDIA



SOURCE: MSME CENSUS, NCEUS

Recently, Intellecap's Consulting Practice Area partnered with IFC (www.ifc.org) to conduct a detailed study to assess the key characteristics of the MSME sector and measure the demand and flow of debt and equity funding to the sector. This study also explored the potential interventions to address the lack of access to formal finance for MSMEs (http://www.intellecap.com/publications/micro-small-and-medium-enterprise-finance-india).

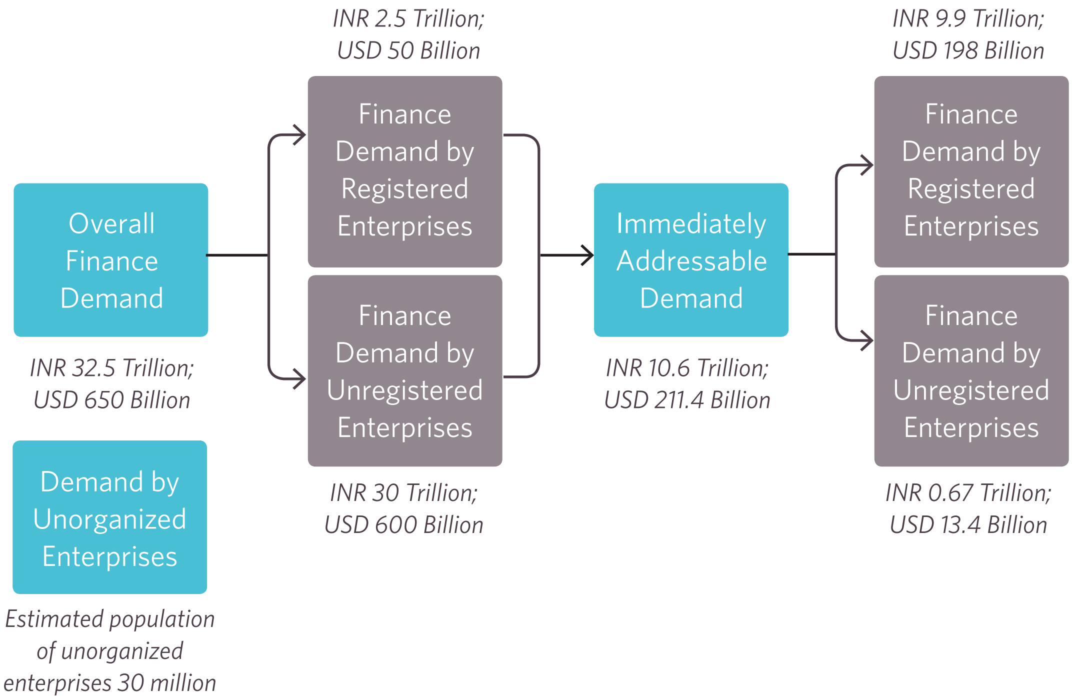
Finance Demand

MSMEs demonstrate high demand for finance, particularly, debt, to finance their growth. There is a total financial requirement of INR 32.5 trillion (US$ 650 billion) in the MSME sector, which comprises INR 26 trillion (US$ 520 billion) of debt demand and INR 6.5 trillion (US$ 130 Billion) of equity demand. However, the viable and addressable debt demand is estimated to be INR 9.9 trillion (US$ 198 billion), which is 38 percent of the total debt demand. This excludes

(a) sick enterprises, (b) new enterprises (those with less than a year in operation), (c) enterprises rejected by financial institutions, and (d) micro enterprises that receive finance from the informal sector.

The viable and addressable equity demand is estimated to be INR 0.67 trillion (US$ 13.4 billion), after excluding (a) entrepreneurs' equity contribution to enterprises estimated at INR 4.6 trillion (US$ 92 billion), and (b) equity demand from micro and small enterprises that are structured as proprietorships or partnerships. Proprietorships and partnership are unable to absorb equity from external sources although equity demand from these firms is estimated to be about INR 1.23 trillion (US$ 24.6 billion).

MSME FINANCE DEMAND FLOWCHART



Flow of Finance/Financial In-flow

Formal sources cater to less than one fourth of total MSME debt financing. Of the overall finance demand of INR 32.5 trillion (US$ 650 billion); 78 percent, or INR 25.5 trillion (US$ 510 billion) is either self-financed or from informal sources. Formal sources cater to only 22 percent or INR 7 trillion (US$ 140 billion) of the total MSME debt financing.

Within the formal financial sector, banks account for nearly 85 percent of debt supply to the MSME sector, with Scheduled Commercial Banks comprising INR 5.9 trillion (US$ 118 billion). Non-Banking Finance Companies (NBFCs) and smaller banks such as Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and government financial institutions (including State Financial Corporation and State Industrial Development Corporations) constitute the balance of the formal MSME debt flow.

Within the informal financial sector non-institutional sources of funding include family, friends, and family businesses while institutional sources consist of moneylenders and chit funds.

Finance Gap

Despite the increase in financing to MSMEs, there is still a considerable institutional finance gap of INR 20.9 trillion (US$ 418 billion). After exclusions in the debt demand (62 percent of the overall demand) and the equity demand (from MSMEs that are structured as proprietorships or partnerships), there is still a demand-supply gap of INR 3.57 trillion (US$ 71.4 billion), which formal financial institutions can viably finance in the near term. This is the demand-supply gap for approximately 11.3 million enterprises. While a large number of these already receive some form of formal finance, they are significantly underserved with only 40-70 percent of their demand currently being met.

With appropriate policy interventions and support to the MSME sector, a considerable part of the currently excluded demand can be made financially viable for the formal financial sector. Micro and small enterprises together account for 97 percent of the viable debt gap and can be addressed by financial institutions in the near term. Available data and primary interviews indicate that medium enterprises in India are relatively self-financed.

The equity gap in the sector is a combined result of demand-side challenges such as the legal structures of enterprises, as well as supply-side gaps, such as a lack of investment funds focused on MSMEs. The equity requirements for the MSME sector are majorly concentrated in the growth-stage enterprises.

OVERALL FINANCE GAP IN MSME SECTOR (IN INR TRILLION)*

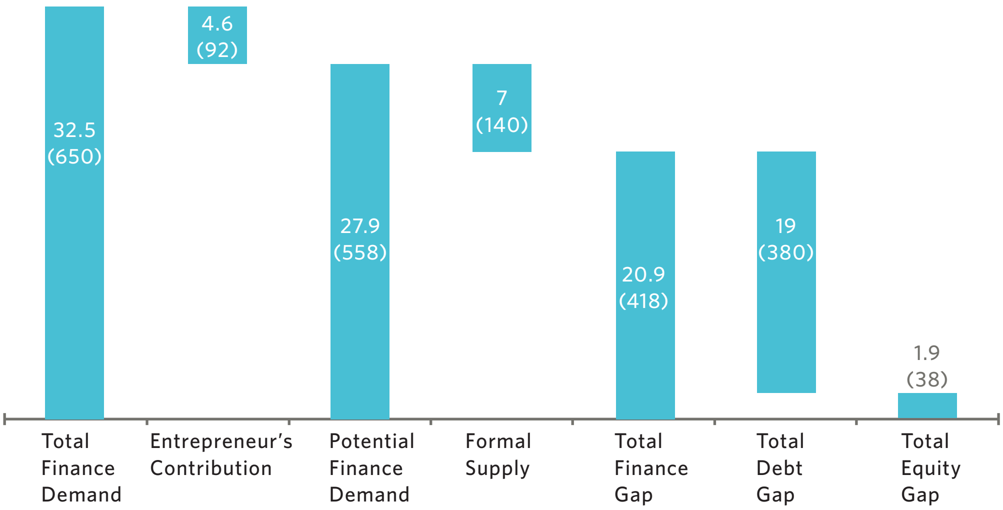


*Figure in brackets is in USD Billion

Source: MSME Census, RBI, SIDBI, Primary Research, IFC-Intellecap Analysis

MSME Sector – Gap by Geography and Type of Enterprise

An overview of MSMEs spread across India indicates that although the Low-Income States (LIS) have 32.6 percent of India's total MSMEs, the viable debt gap is disproportionately high at INR 1.93 trillion (US$ 38.6 billion) or 66 percent of the country's total. On the other hand, only 3 percent MSMEs are based in the North-Eastern States, accounting for a viable debt gap of INR 0.09 trillion (US$ 1.8 billion). The rest of India accounts for the remaining 65 percent of MSMEs, with a viable and addressable debt-supply gap of INR 0.9 trillion (US$ 18 billion) or 31 percent.

Across India, there are significantly more service sector enterprises than manufacturing units (71 percent versus 29 percent, respectively). However, manufacturing enterprises are more capital-intensive with longer working capital cycles and consequently have higher working capital requirements. Therefore, nearly 60 percent of MSME demand for finance arises from the manufacturing sector.

Enabling Environment for Growth of Finance in the MSME Sector

The three main pillars of the enabling environment analyzed in the Intellecap-IFC MSME study are: (a) legal and regulatory framework, (b) government support, and (c) financial infrastructure support. MSMEs function in a highly competitive environment and require an enabling environment to sustain growth. Well-rounded fiscal support, a strong policy framework, and incentives promoting innovation by financial institutions can significantly increase the penetration of formal financial services to the MSME sector.

While there have been commendable efforts by the government and the financial sector to develop and implement multiple support mechanisms for the MSME sector, many of the current interventions have not been completely successful in meeting their original objectives.

Potential Intervention to Increase Financial Access to MSME

Building on the efforts already underway, there are several potential interventions that can be undertaken to expand the access to MSME finance in India through enabling infrastructure, liquidity management, and risk management. Some of these potential interventions include:

ENABLING INFRASTRUCTURE

- Encourage securitization of trade-receivables in the sector through approriate legal infrastructure.
- Promote institutions to syndicate finance and provide advisory support to MSMEs in rural and semi-urban areas.
- Incentivize formation of new MSME-specific venture funds by allowing existing government equity funds to make anchor investment in venture funds.

LIQUIDITY MANAGEMENT

- Improve debt access to non-banking finance companies focused on these enterprises and provide regulatory incentives for participation in the sector.
- Develop an IT-enabled platform to track MSME receivables to facilitate securitization of these trade receivables, or alternatively expand the scope of SIDBI and NSE's IT-platform NTREES to facilitate securitization.
- Provide credit guarantee support for MSME finance to non-banking finance companies.

RISK MANAGEMENT

- Develop a better understanding of financing patterns of service enterprises in the sector.
- Expand the scope of the sector's credit information bureau to collate and process important transaction data, including utility bill payment.
- Strengthen the recently established collateral registry and create stronger linkages with other financial infrastructure.
- Facilitate greater debt access to non-banking finance companies.

Key Challenges

Poor infrastructure and inadequate market linkages are key factors that have constrained growth of the MSME sector. The lack of adequate and timely access to finance has been the biggest challenge which MSMEs have faced and this has impacted their growth. One of the key reasons for poor access to finance appears to be availability of information on MSME's financing requirements.

The financing needs of companies in the MSME sector depend on the size of operation, industry, customer segment, and stage of development of each enterprise. Financial institutions have limited their exposure to the sector due to a higher risk perception and limited access of MSMEs to immovable collateral. In addition, many MSMEs do not have audited financial statements, written business plans, or well documented and consistent cash flows. The largely informal and unorganized nature of the sector means no concerted effort was made by various stakeholders to gather data on demand for debt and equity finance among MSME.

Structural Market Gap – The "Missing Middle"

MSME's in India today face a severe shortage of options to access appropriate debt finance. Indian banks overwhelmingly engage in traditional collateral-based lending to enterprises operating in established industries and with at least three years of track record. Other financial institutions capable of lending to small businesses tend to be highly bureaucratic or will only lend to a certain sector.

Despite their importance to India's social and economic development, early stage enterprises operating, for example, in the energy, infrastructure or the affordable healthcare sector often face constraints in accessing debt finance, as their technologies and business models are not yet widely adopted and understood by local financial institutions.

MSMEs with limited operating histories, collateral, and financial skills generally constitute the "missing middle" of the financial sector. This "missing middle" should in the future constitute an important new asset class for lenders dedicated to serving the demand for unsecured debt finance and skills support above the funding levels offered by Microfinance Institutions and below the funding levels offered by traditional Bank lending and Private Equity.

Intellecap's Role in MSME Sector

Intellecap is a pioneer in providing innovative business solutions that help build and scale profitable and sustainable enterprises dedicated to social and environmental change. Intellecap, through its Consulting and Investment Banking Practice Areas, has long recognized the importance of the MSME segment in India and has worked with and raised funding for many MSME's. The study that Intellecap conducted with IFC represents the first comprehensive analysis of the funding gap in the MSME sector and also the first careful look at many characteristics of the sector.

In addition, Intellecap founded and incubated IntelleGrow as a specialized company, formed to address the financing challenges of the "missing middle" by providing loans to young and emerging MSME. IntelleGrow was also formed to pioneer and particularly focus on venture debt financing in India, a form of financing that provides tailored debt funding to companies which are already backed by angel, venture capital, or other equity investors.

IntelleGrow, a venture debt financing company for small and growing social enterprises in India, was founded by Intellecap with support from the Shell Foundation in 2011. To date, IntelleGrowhas disbursed 25 loans totaling US$ 4.6 million to Small and Medium Enterprises (SMEs) across India – from sectors such as waste water recycling, clean energy solutions, low cost irrigation, rural healthcare, rural electrification and non-credit financial inclusion among others. In early 2013, IntelleGrow received a capital commitment from the Michael and Susan Dell Foundation amounting to approximately US$ 2 million.

IntelleGrow's Unique Lending Model

IIntelleGrow's mission is to provide debt financing to small and growing enterprises during startup or early stage. This segment of the financial services market is largely overlooked by banks and other formal sector lenders. IntelleGrow particularly seeks out companies that have already received equity investments from venture investors and who expect to receive further equity investments. In these cases, IntelleGrow is often the earliest debt investor for these young and growing enterprises.

STAGE	AVAILABILITY OF DEBT FINANCE	SERVICE PROVIDERS (DEBT)
Start-up (<1 year)	Very Low	IntelleGrow's target
Early growth (1-3 years)	Low	
Growth & Expansion (4-6 years+)	High	NBFCs, private banks
Late Stage Expansion (7 years+)	Very High	All Banks

IntelleGrow follows a unique model for risk assessment, which differentiates it from other players in the market. Risk management is done through an emphasis on the quality of the promoter and offering loan products that are tied to specific anticipated cash inflows. Also customized debt is provided via a viability-based approach to lending. Unlike traditional collateral-based lenders, IntelleGrow lends primarily on the basis of business viability and cash flow and offers loans customized to the particular needs of each business. In addition, IntelleGrow provides fast processing times for loans and takes a 'more-than-money' approach that involves extension of skills support to borrowers.

Conclusion

There is a INR 3.57 trillion (US$ 71.4 billion) institutional demand-supply gap in the MSME sector in India, which formal financial institutions can viably finance. Of this, the debt gap is INR 2.93 trillion (US$ 58.6 billion) and the equity gap is INR 0.64 trillion (US$ 12.8 billion). Micro and small enterprises together account for 97 percent of the viable debt gap. Working capital demand accounts for an estimated 61% of this debt demand. This represents a significant opportunity for Indian financial institutions that seek to address the "missing middle" by providing debt products and services specially designed to meet the needs of this large market. IntelleGrow, a company that Intellecap has sponsored and grown with funding and investment from the Shell Foundation and the Michael and Susan Dell Foundation, currently provides specialized debt financing to this market, along with skills support to small and growing businesses. In doing so, IntelleGrow is set to become a pioneer in developing the "missing middle" and "venture debt" as new and important asset classes in India.

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