Micro, Small and Medium Enterprise Finance in India

A Research Study on Needs, Gaps and Way Forward (November, 2012)

International Finance Corporation
World Bank Group

In Partnership with
Government of Japan

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Abbreviations and Glossary

ANBC	Adjusted Net Bank Credit
ARC	Asset Reconstruction Company
B2B	Business to Business
B2C	Business to Consumer
CGS	Credit Guarantee Scheme
CGTMSE	Credit Guarantee Fund Trust for Micro and Small Enterprises
CIBIL	Credit Information Bureau (India) Limited
DSA	Direct-Sales-Agent
GBC	Gross Bank Credit
GDP	Gross Domestic Product
GEMS	Growth capital and Equity assistance for MSMEs
IFC	International Finance Corporation
IIP	Index of Industrial Production
ISARC	India SME Asset Reconstruction Company Limited
Addressable Demand	Demand that can be serviced by formal financial institutions over a institutions in the near term (over a one – two year time frame) without undertaking additional effort for market building
LIS	Low Income States
MFI	Micro-Finance Institution
MLI	Member Lending Institution
MSE	Micro and Small Enterprises
MSME	Micro Small and Medium Enterprises
NABARD	National Bank for Agricultural and Rural Development
NBFC	Non-Banking Financial Company
NCEUS	National Commission for Enterprises in Unorganized Sector
NEDFI	North Eastern Development Finance Corporation Limited
NES	North Eastern States
NFSIT	National Venture Capital Fund for Software and IT Industry
NSIC	National Small Industries Corporation Limited
NTREES	NSE Trade Receivables Engine for E-discounting
OTS	One-Time-Settlement
PSL	Priority Sector Lending
PSB	Public Sector Bank
Rest of India	Rest of India
RBI	Reserve Bank of India
RRB	Regional Rural Bank
SCB	Scheduled Commercial Banks
SFC	State Financial Corporation
SIDBI	State Industrial Development Bank of India
SIDC	State Industrial Development Corporation
SLBC	State Level Banker's Committee
SME	Small and Medium Enterprise
SSI	Small Scale Industries
SVCL	SIDBI Venture Capital Limited
TPA	Third-Party-Agency
UCB	Urban Cooperative Bank

EXECUTIVE SUMMARY

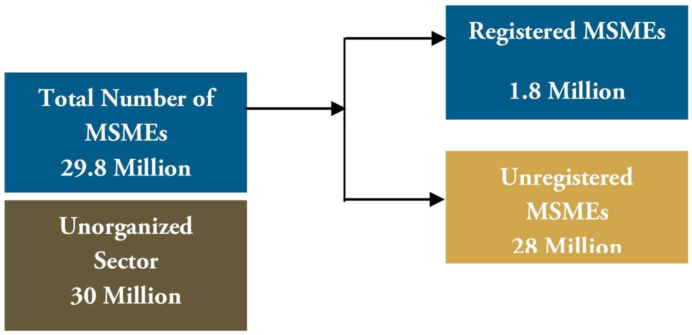
This study aims to provide an assessment of the Micro, Small and Medium Enterprise sector (MSME) finance in India. The chapters in the study highlight the key characteristics of the MSME sector, and assess the demand for, and the flow of finance into the sector. The study also evaluates the consequent gap in the financing needs of MSMEs. Finally, it explores potential interventions to address the lack of access to formal finance for MSMEs.

MSME Overview

The Micro, Small and Medium Enterprise[1] sector is crucial to India's economy. There are 29.8 million[2] enterprises in various industries, employing 69 million people. The sector includes 2.2 million women-led enterprises (~7.4 percent[3]) and ~15.4 million rural enterprises (51.8 percent[4]). In all, the MSME sector accounts for 45 percent of Indian industrial output and 40 percent of exports. Although 94 percent of MSMEs are unregistered[5], 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[6].

Poor infrastructure and inadequate market linkages are key factors that have constrained growth of the sector. The lack of adequate and timely access to finance has been the biggest challenge. The financing needs of the sector depend on the size of operation, industry, customer segment, and stage of development. Financial institutions have limited their exposure to the sector due to a higher risk perception and limited access of MSMEs to immovable collateral.

Figure 1: Broad Classification of the MSMEs in India



Source: MSME Census, NCEUS

[1] Definition of Micro, Small and Medium Enterprise is based on initial investment of the enterprise in plant and machinery per the MSMED Act, 2006

[2] Ministry of Micro, Small and Medium Enterprise, Government of India estimates the population of Micro, Small and Medium Enterprises in India to be 29.8 Million; the sector may also have a larger number of micro livelihood enterprises, estimated to be ~20-25 Million in number

[3] MSME Census, Ministry of MSME, Annual Report, 2009-10

[4] MSME Census, Ministry of MSME, Annual Report, 2009-10

[5] Registered Enterprises: MSMEs that file business information such as investment, nature of operations, manpower with District Industry Centers (DICs) of the State/ Union Territory are considered as registered enterprises;

Unregistered Enterprises: MSMEs that do not file business information with District Industry Centers (DICs) of the State/ Union Territory; The data on enterprise output performance is not adequately tracked by the government agencies

[6] Source: Report of the Working Group on Sick Micro, Small and Medium Enterprises, Reserve Bank of India (RBI), 2009-10

Demand in the MSME Sector

There is a total finance requirement of INR 32.5 trillion ($650 billion) in the MSME sector, which comprises of INR 26 trillion ($ 520 Billion) of debt demand and INR 6.5 trillion ($130 Billion) of equity demand.

To estimate the debt demand that Financial Institutions would consider financing in the near term, the study does not take into account the demand from the enterprises that are either not considered commercially viable by formal financial institutions, or those enterprises that voluntarily exclude themselves from formal financial services.

Thus, after excluding (a) sick enterprises, (b) new enterprises (those with less than a year in operation), (c) enterprises rejected by financial institutions (d) micro enterprises that prefer finance from the informal sector, the viable and addressable debt demand is estimated to be INR 9.9 trillion ($198 billion),which is 38 percent of the total debt demand.

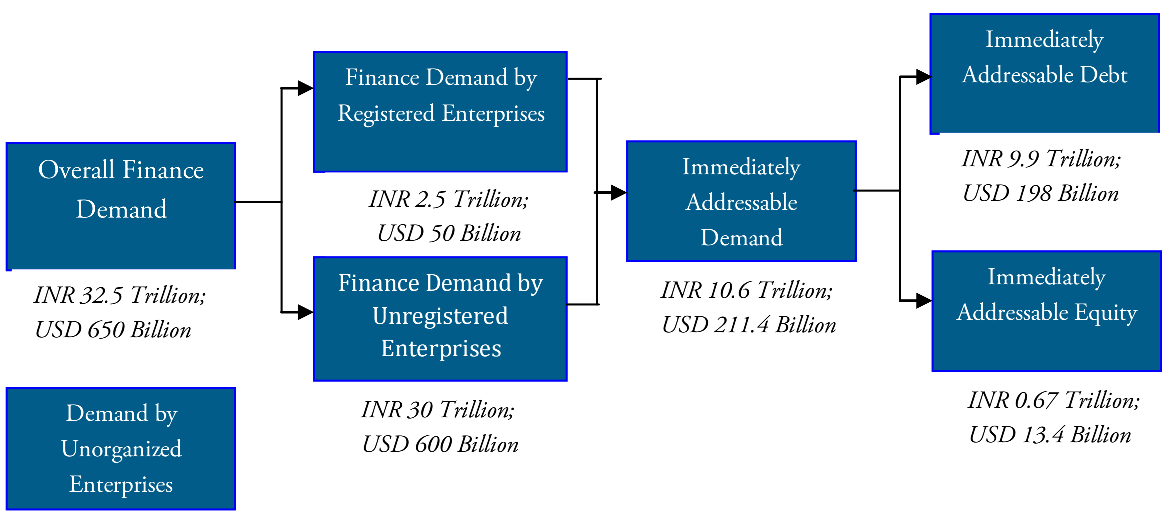
The viable and addressable equity demand is estimated to be INR 0.67 trillion ($13.4 billion), after excluding: (a) entrepreneurs' equity contribution to enterprises estimated at INR 4.6 trillion ($92 billion) and, (b) equity demand from micro and small enterprises that are structured as proprietorship or partnership[7], and are unable to absorb equity from external sources. The second is estimated to be worth INR 1.23 trillion ($24.6 billion),

Flow of Finance to the MSME Sector

This study shows that of the overall finance demand of INR 32.5 trillion[8] ($650 billion), 78 percent, or INR 25.5 trillion ($510 billion) is either self-financed or from informal sources. Formal sources cater to only 22 percent or INR 7 trillion ($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 (USD 118 Billion). Non-Banking Finance Companies 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 rest of the formal MSME debt flow.

Figure 2: MSME Finance Demand Flowchart



Estimated population of unorganized enterprises 30 million

[7] Proprietorship and partnership structures are not amenable to external equity without change in legal structure

[8] RBI, SIDBI, Sa-Dhan, Annual Reports of NBFCs , SME Times-2010, Primary Research, IFC-Intellecap Analysis

Within the informal financial sector non-institutional sources include family, friends, and family business, while institutional sources comprise moneylenders and chit funds.

MSME Finance Gap in the Sector

Despite the increase in financing to MSMEs in recent years, there is still a considerable institutional finance gap of INR 20.9[9] trillion ($418 billion). After exclusions in the debt demand (62 percent of the overall demand) and the equity demand (from MSMEs that are structured as proprietorship or partnership), there is still a demand-supply gap of INR 3.57 trillion ($ 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[10] enterprises. While a large number of these already receive some form of formal finance, they are significantly underserved with only 40-70 percent[11] 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. Of the viable and addressable demand-supply gap, the debt gap is INR 2.93 trillion ($58.6 billion) and the equity gap is INR 0.64 trillion ($12.8 billion).

The micro, small, and medium enterprise segments respectively account for INR 2.25 trillion ($45 billion), INR 0.5 trillion ($10 billion) and INR 0.18 trillion ($3.6 billion), of the debt gap that is viable and can be addressed by financial institutions in the near term. 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 well 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 concentrated in the growth-stage enterprises (~70 percent).

Figure 3: Overall Finance Gap in MSME Sector (in INR Trillion)*

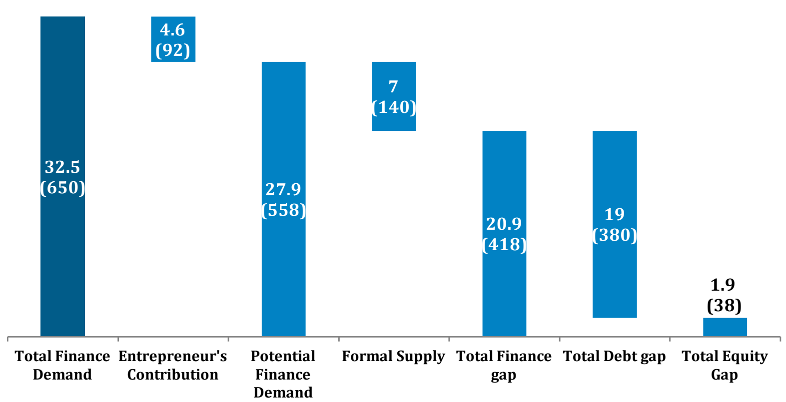


**Figure in brackets is in USD Billion*
Source: MSME Census, RBI, SIDBI, Primary Research, IFC-Intellecap Analysis

[9] Excludes entrepreneur's finance contribution of INR 4.6 Trillion (USD 92 Billion)

[10] Refer Annex A; Table 21

[11] Different across Enterprise Type, Geographies and sectors

Gap by Geography & Type of Enterprise

An overview of the MSMEs spread across the country indicates that although the Low-Income States[12] (LIS) have 32.6 percent of India's total MSMEs, the viable debt gap is disproportionately high at INR 1.93 trillion ($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 ($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 ($18.2 billion) or ~31 percent.

Across India, there are significantly more service sector enterprises than manufacturing units (~ 71 percent versus a 29 percent split 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 the demand for finance arises from the manufacturing sector. The share of the debt gap in the manufacturing sector is also considerably higher at 73 percent of the total gap.

Enabling Environment for Growth of Finance in the MSME Sector

The three main pillars of the enabling environment analyzed in the study are: (a) legal and regulatory framework (b) government support (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.

Figure 4: Schematic of Key Elements of the Enabling Environment

Growth of MSME and MSME Finance

Legal and Regulatory Framework

- Legal and regulatory framework to define the sector - MSMED Act, 2006
- Financial regulations to bolster supply of finance – SARFAESI 2002, Credit Information Companies (Regulation) Act 2005
- Inclusion of Micro, and Small Enterprises (MSE) in purview of Priority Sector Lending (PSL)
- Master Circulars on Lending to MSME

Government Support

- Policies to facilitate multi-pronged support – skill, development market linkage, technology adoption and infrastructure
- Promotion of cluster development
- Financial support through apex sector bodies like SIDBI
- Funding support to credit guarantee schemes to enhance unsecured financing
- Financial support to increase penetration of credit rating

Financial Infrastructure Support

- Credit bureaus to track credit history of enterprises
- Collateral registry for immovable assets
- Credit rating agencies
- Asset reconstruction companies
- Small and Medium (SME) Stock Exchange to facilitate primary and secondary transactions for SME securities

Source: IFC-Intellecap Analysis

[12] IFC considers Bihar, Chattisgarh, Jharkhand, Madhya Pradesh, Odisha, Rajasthan, Uttar Pradesh, West Bengal, and the north-eastern states including Sikkim as low-income states with a high-potential

The study covers, and is not limited to, the following legal and regulatory frameworks – MSMED[13] Act (2006), the SARFAESI[14] Act (2002), the Regulation of Factor Bill (2011); and RBI policies specifically related to MSME finance. Further, this study covers those government activities that are likely to impact increased financial access – skills development, market linkages, technology adoption, cluster development and financial availability.

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. Others are still at a nascent stage and have significant potential to be scaled. Some of the key initiatives include the Credit Bureau, Collateral Registry, the SME stock Exchange, and ISARC[15].

Potential Interventions to Increase Access to MSME Finance

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 conducive 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.

[13] Micro, Small, Medium Enterprise Development Act, 2006 (MSMED Act)

[14] Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

[15] India SME Asset Reconstruction Company Limited

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[16] 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.

Methodology

In the process of completing this study, the research team has referred to several credible sources of data, including existing research literature and industry publications. In addition, a series of primary interviews were carried out to understand and evaluate the size of the MSME finance market, and these results were validated with key stakeholders such as the RBI, SIDBI, public and private sector banks, venture capital firms, and credit rating agencies and incubators.

[16] NSE Trade Receivables Engine for E-discounting

Conclusion

The common theme through this research and the interviews is the commitment to promoting greater finance for MSMEs in India, and looking for innovative ways to overcome the current challenges to the growth of this market, critical for national economic growth. Given the size and scope of this market, the financial sector has a significant role to play in expanding their reach to this underserved segment in an enabling environment, facilitating sustainable growth.

Photo: IFC

1

ASSESSMENT OF MSME LANDSCAPE

MICRO, SMALL AND MEDIUM ENTERPRISES SECTOR IN INDIA

The MSME sector plays a significant role in the Indian economy. A catalyst for socio-economic transformation of the country, the sector is critical in meeting the national objectives of generating employment, reducing poverty, and discouraging rural-urban migration. These enterprises help to build a thriving entrepreneurial eco-system, in addition to promoting the use of indigenous technologies. The sector has exhibited consistent growth over the last few years, but it has done so in a constrained environment often resulting in inefficient resource utilization. Of the many challenges impeding the growth and development of MSMEs, inadequate access to financial resources is one of the key bottlenecks that make these enterprises vulnerable, particularly in periods of economic downturn.

1.1 Defining the Sector

The term 'MSME' is widely used to describe small businesses in the private sector. Regulators and financial institutions across the world use parameters such as employee strength, annual sales, value of fixed assets, and loan size proxies to define the sector in the context of finance. For instance, businesses with employee strength less than 500[17] are considered MSMEs in Mexico. According to the World Bank definition, a business is classified as MSME when it meets two of the three criteria – employee strength, size of assets, or annual sales (Table 1).

[17] Database on SME statistics, OECD

Table 1: World Bank Definition of MSME

Enterprise Size	Employee	Assets	Annual Sales
Medium	<300	≤ USD 15 Million (≤ INR 750 Million)	≤USD 15 Million (≤INR 750 Million)
Small	<50	≤USD 3 Million (≤INR 150 Million)	≤USD 3 Million (≤INR 150 Million)
Micro	<10	≤USD 10,000 (≤INR 500,000)	≤USD 10,000 (≤INR 500,000)

Source: World Bank

The Micro, Small and Medium Enterprise Development Act 2006[18] (MSMED Act) of the Government of India provides the definition of the MSME sector. An extension of the erstwhile definition of Small Scale Industry (SSI), this classification uses the investment metric (Table 2) to define MSMEs because investment in plant and machinery can be measured and verified. The MSMED Act broadly segments the MSME sector in the following manner:

Table 2: MSMED Act Definition of MSME

Initial Investment in Plant and Machinery (in INR Million)*			
Category/ Enterprise Size	**Micro**	**Small**	**Medium**
Manufacturing	<2.5 (<50,000)	2.5 – 50 (50,000 – 1 Million)	50– 100 (1 Million – 2 Million)
Services	<1 (<20,000)	1 – 20 (20,000 – 0.4 Million)	20– 50 (0.4 Million – 1 Million)

**Figures in brackets are in USD; Source: MSMED Act*

[18] MSMED Act was published in gazette of India on June 16, 2006, however came into force from October 2, 2006

1.1.1 Financial Institutions and Definition of MSME

Although investments in plant and machinery are tangible and measurable, the current definition provides limited information on the financial appetite and financial performance of an enterprise. As a result, many financial institutions prefer using annual sales/revenue (turnover) to segment and target MSMEs (Table 3), and as a key parameter for product development and risk management.

1.2 Economic Contribution of MSME

It is important to note that in addition to helping catalyze the growth of the economy, MSMEs feed large local and international value chains as well as local consumer markets as suppliers, manufacturers, contractors, distributors, retailers and service providers. They account for a large share of industrial units, and contribute significantly to employment in the country (Table 4).

Table 3: Internal Definitions used by Private Financial Institutions (Indicative)

Internal Definitions used by Banks for MSME						
Enterprise Size	**Micro**		**Small**		**Medium**	
Institution Type	**Turnover (INR Million)**	**Credit Size (INR Million)**	**Turnover (INR Million)**	**Credit Size (INR Million)**	**Turnover (INR Million)**	**Credit Size (INR Million)**
Private Commercial Banks	1.5 – 50 (30,000 – 1 Million)	0.2 – 1 (4,000 – 20,000)	50 – 200 (1 Million – 4 Million)	5 – 150 (0.1 Million – 3 Million)	200 – 2000 (4 Million – 40 Million)	50 – 200 (1 Million – 4 Million)
Non-Banking Finance Companies	0.05 – 1 (1,000 – 20,000)	1 – 5 (20,000 – 0.1 Million)	5 – 25 (0.1 Million – 0.5 Million)	0.3 – 5 (6,000 – 0.1 Million)	10 – 1000 (0.2 Million – 20 Million)	2.5 – 50 (50,000 – 1 Million)

**Figures in brackets are in USD; Source: Primary Research*

Table 3 outlines some broad parameters used by most of the financial institutions in India to define and segment the MSME sector for internal portfolio management purposes. However, all institutions use the official definition provided by the MSMED Act for reporting purposes to the regulator. This study uses the MSMED Act definition for analysis and assessment of the sector.

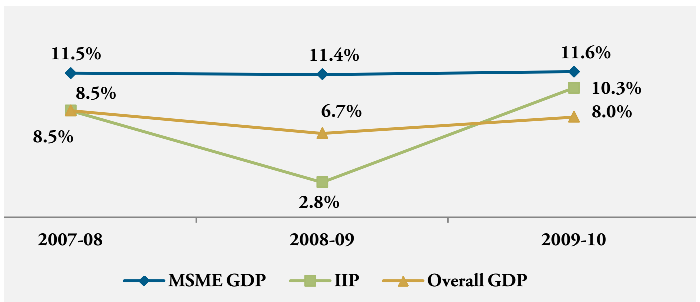
Table 4: Key Statistics on Economic Contribution of MSME

Key Metrics	
Share of	**Value**
Industrial units	95%
Industrial output	45%
Exports (in value)	40%
Gross Domestic Product (GDP)	~8%
Employment (in Millions)	69

Source: Ministry of MSME, Annual Report, 2009-10; RBI

Growing at 11.5 percent a year, the MSME sector has been performing better than the overall GDP (8 percent growth per annum) and overall industrial output (measured by Index of Industrial Production-IIP) (Figure 5). Current estimates of MSME contribution to GDP do not take into consideration the contribution made by unorganized private enterprises[19], for which asset and sales data is not tracked by government agencies.

Figure 5: Growth of MSME Sector vs. Growth in GDP and IIP[20]



Source: Ministry of MSME, Annual Report, 2009-10

MSMEs are also effective vehicles for employment generation. India's cities have been experiencing the burden of a consistently growing population, comprising an ever – increasing proportion of migrants in search of employment and livelihood. City infrastructure is already stretched, and policy makers are seeking solutions to mitigate issues arising from migrant population growth. Rural MSMEs and those based outside of the large cities, offer a viable alternative for employment to local labor, hence presenting an opportunity for people to participate in productive, non-farm activities, without needing to migrate to urban areas.

With adequate financial and non-financial resources, as well as capacity-building, the MSME sector can grow and contribute to economic development considerably higher than it is doing currently.

[19] Unincorporated private enterprises owned by individuals and households, NCEUS, 2007

[20] IIP – Index of Industrial Production, index developed by Office of Economic Advisor, Ministry of Commerce and Industry

1.3 MSME Landscape in India

In 2009-10, the Indian MSME sector was estimated to include 29.8 Million[21] enterprises. In order to encourage these unorganized units to register, the Ministry of MSME has simplified the registration process (replacing the earlier two-stage registration process with a one-step filling of memorandum).

Table 5 The sector has been growing at an effective rate[22] of 4 percent annually[23] over the last three years from 2008-10. The share of registered[24] enterprises in the sector is estimated to be only around 6 percent, which goes to show that the sector is dominated by unregistered[25] enterprises that do not file business information with District Industry Centers (DICs) of the State/ Union Territory. In order to encourage these unorganized units to register, the Ministry of MSME has simplified the registration process (replacing the earlier two-stage registration process with a one-step filling of memorandum).

Table 5: Size of the MSME Sector in India (in Millions)

Year	Registered	Unregistered	Total units
2006-07	1.5 (~6%)	24.6 (~94%)	26.1
2009-10	1.8 (~6%)	28.0 (~94%)	29.8

Source: MSME Census, Ministry of MSME, Annual Report, 2009-10

[21] Ministry of MSME, Government of India, 2009-10: The effective growth of enterprises in the sector is estimated to be 4.5 percent, accounting for permanent closure of enterprises

[22] Accounting for enterprise closures

[23] Fourth All India Census on MSME 2007 (MSME Census), the first survey commissioned by the Government of India to enumerate micro, small and medium enterprise, estimated the size of the MSME sector to be 26.1 million enterprises

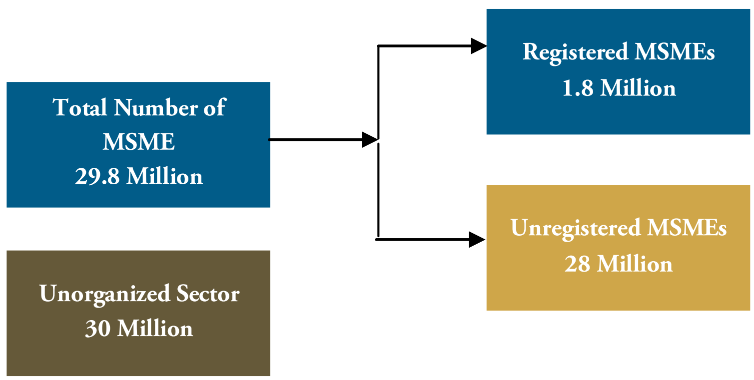
[24] Registered Enterprises: MSMEs that file business information such as investment, nature of operations, manpower with District Industry Centers (DICs) of the State/ Union Territory are considered as registered enterprises; The data on enterprise output and performance is periodically tracked the government agencies

[25] Unregistered Enterprises:; The data on enterprise output performance is not adequately tracked by the government agencies

In addition to the registered and unregistered enterprises covered by the MSME census, the sector has an additional 30 million enterprises[26] (Figure 6).

Activities of these units are not governed by any legal provision, and these typically do not maintain any official financial accounts. Most of these can be defined as the micro enterprises.

Figure 6: Broad Classification of the MSMEs in India



Source: MSME Census, NCEUS

1.4 Heterogeneity in the MSME Sector

The sector is classified into Micro, Small and Medium based on the size of the enterprise, as defined in Table 2. Each of these segments however is extremely heterogeneous, due to differences in ownership structure, area of operation, type of industry, and the stage of development of an enterprise.

1.4.1 Differences in Ownership Structure

The type of ownership structure of enterprises determines the form of capital (equity or debt) these enterprises can access and absorb from external sources. For instance, proprietorship and partnership enterprises cannot accept any form of external equity other than owner contributions. This can significantly impact growth potential both at start-up stage as well as when the enterprise is in need of growth capital.

[26] The National Commission for Enterprises in the Unorganized Sector (NCEUS) pegs the number of enterprises in the unorganized sector at about 58 million, which also includes an estimated 28 million unregistered MSMEs

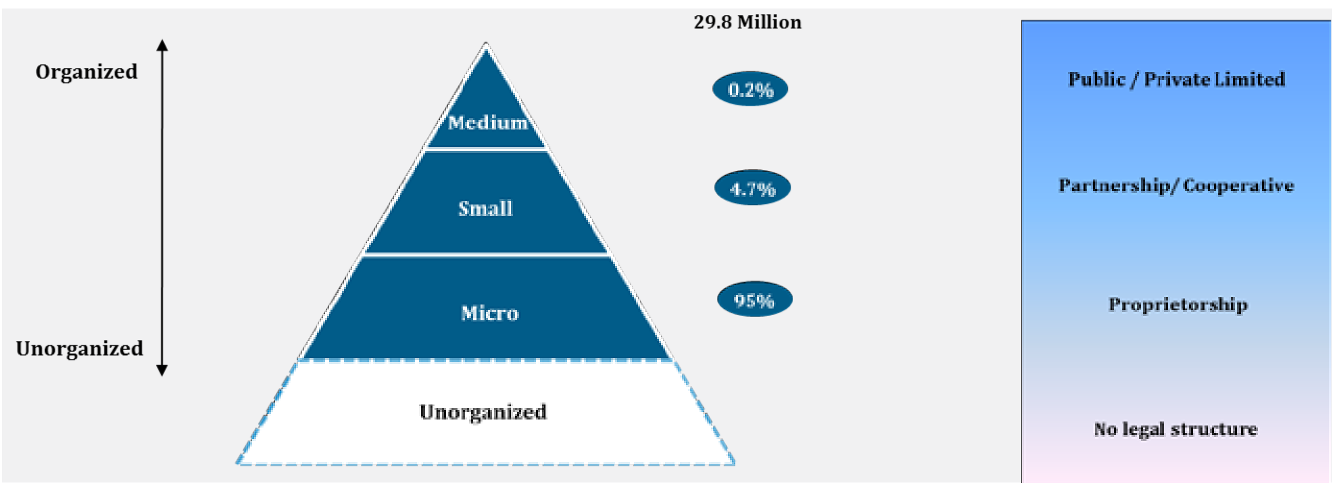
Table 6 indicates at least five different types of ownership structures. Proprietorship is the most commonly adopted ownership structure (94.5 percent of all MSMEs), primarily because this structure requires lower legal overheads. The other ownership structures adopted by enterprises include partnership, cooperative, private limited company and public limited company. Mature small, medium and new knowledge-based enterprises in the sector are mostly structured as private limited or public limited companies (Figure 7).

Table 6: Ownership Structure of Enterprises in the MSME Sector

Ownership Structure in the Sector	
Type of Structure	Share of MSME Enterprises
Proprietorship	94.5%
Partnership, Cooperatives	1.2%
Private Limited, Public Limited	0.8%
Others	3.5%

Source: MSME Census

Figure 7: Distribution of Enterprises in the MSME Sector and Prevalent Ownership Structures



Source: MSME Census, IFC – Intellecap Analysis

The type of ownership structure of enterprises determines the form of capital (equity or debt) these enterprises can access and absorb from external sources. For instance, proprietorship and partnership enterprises cannot accept any form of external equity other than owner contributions. This can significantly impact growth potential both at start-up stage as well as when the enterprise is in need of growth capital.

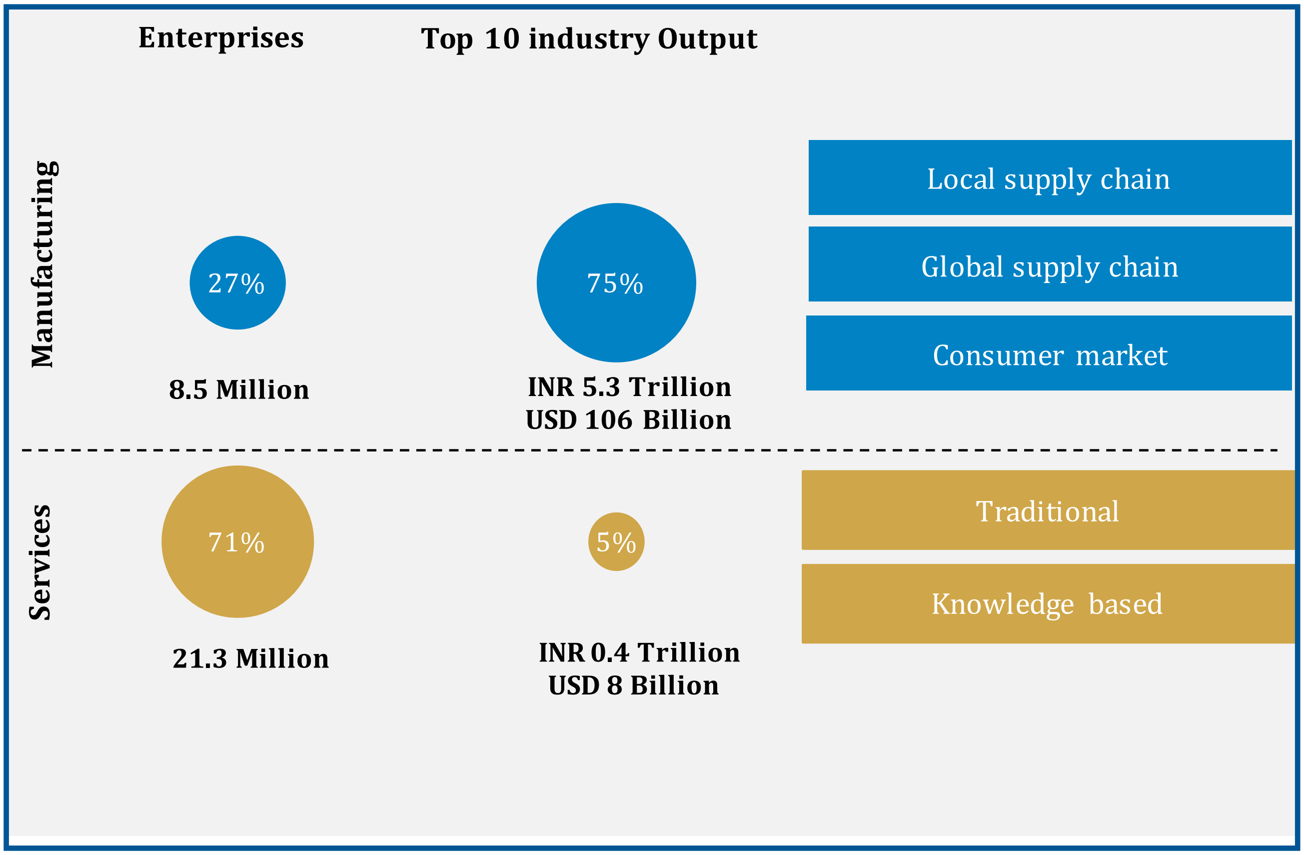
1.4.2 Differences in Industry of Operation

Enterprises in the sector can be further classified into manufacturing and services. With more than 8000 products ranging from hand-made products to high precision machine parts, and numerous services catering to both industrial and consumer markets offered by MSMEs, there is clearly a huge diversity within the two categories.

The manufacturing sector accounts for an estimated 29 percent of total enterprises in the MSME sector, while the services sector accounts for the balance 71 percent (Figure 8).

- Manufacturing MSMEs feed supply chains of local large enterprises, global large enterprises or local consumer markets. Food processing is the key manufacturing industry. Further, a large number of small and medium enterprises in the food and textile industries are export-oriented and serve large global supply chains or global consumer markets.
- Service MSMEs operate in traditional transaction-based industries such as retail trade, small transport operations and knowledge-based industries such as information technology, human resource consulting among others.

Figure 8: Sub-segments of the Manufacturing and Services Sectors



Source: MSME Census

Although the services sector accounts for a larger number of enterprises, it is the top ten industries in manufacturing that account for 75 percent of the sector's total output (Table 7).

Table 7: Share of Top Ten Manufacturing Industries in MSME Sector's Gross Output

Industry	Share of Gross Output of the MSME Sector
Food Products & Beverages	19%
Textiles	10%
Basic Metals	10%
Chemical and Chemical Products	8%
Fabricated Metal Products	7%
Machinery and Equipment	6%
Wearing Apparel	5%
Rubber and Plastic Products	4%
Transport Equipment	3%
Non-metallic Mineral Products	3%
TOTAL	**75%**

Source: IFC – Intellecap Analysis

- The top ten services industries account for a total of 5 percent of the gross output by the MSME sector output (Table 8)
- The services sector is dominated by retail trade, repair and maintenance shops, small transport operators among others, most of which typically contribute far lower compared to manufacturing sector enterprises.
- However, the services sector is witnessing a gradual increase in the number of knowledge-based enterprises, which tend to have a higher output per enterprise as compared to the traditional service enterprises.

Table 8: Share of Top Ten Services Industries in MSME Sector's Gross Output

Industry	Share of Gross Output of the MSME Sector
Agriculture-based Activities	1.3%
Repair and Maintenance of Motor Vehicles	1.1%
Retail	0.7%
Professional Business Activities	0.6%
Computers and Information Technology	0.3%
Transport and Travel Agents	0.3%
Forestry and Logging Activities	0.3%
Other Service Activities	0.2%
Utilities Supply	0.2%
Post and Telecommunication	0.1%
TOTAL	**5%**

Source: IFC – Intellecap Analysis

1.4.3 Differences in Geography of Operation

There are significant geographical variations in India that impact the distribution of micro, small and medium enterprises. The availability of natural resources and other regional characteristics (Figure 9) also determine the type of an enterprise and scale of operations. For the purposes of this study, the states in India are split into three broad regions:

- **Low-Income States (LIS[27])–** Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh
- **North-eastern States (NES) –** Assam, Arunachal Pradesh, Nagaland, Manipur, Meghalaya, Mizoram, Tripura
- **Rest of India –** All states other than Low Income States and North-eastern States

[27] Lowest ranking states by GDP per capita at factor cost (at current prices)

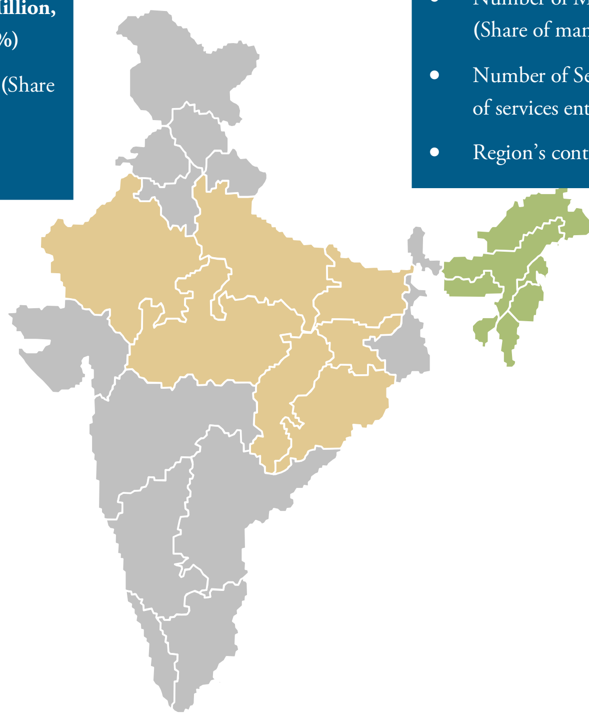
Figure 9: Distribution of MSME Enterprises across India

Low Income States

- Number of Manufacturing Units: **2.7 Million,** (Share of manufacturing enterprises: **31%)**
- Number of Services Units: **7.0 Million,** (Share of services enterprises:**33%)**
- Region's contribution to GDP: **26.5%**

North Eastern States

- Number of Manufacturing Units: **0.2 Million,** (Share of manufacturing enterprises: **2%)**
- Number of Services Units: **0.8 Million,** (Share of services enterprises:**4%)**
- Region's contribution to GDP: **2.6%**



Low Income States
North Eastern States
Rest of India

Rest of India

- Number of Manufacturing Units: **5.7 Million,** (Share of manufacturing enterprises: **67%)**
- Number of Services Units: **13.4 Million,** (Share of services enterprises: **63%)**
- Region's contribution to GDP: **70.9%**

Source: IFC – Intellecap Analysis

While this study is meant to address the challenge of finance to small and medium businesses across India, there is also a more specific focus on MSME activity in the LIS and NES regions. Regional characteristics such as infrastructure availability, investment levels and literacy (Table 9) determine the type and scale of these enterprises in the region. Consequently, the size and nature of finance demand by MSMEs tends to vary with geography.

Table 9: Comparative Characteristics of States in LIS and NES Region

State	Electricity Infrastructure (MW)	Road Infrastructure (KMS) National Highway	No. of Special Economic Zones	State's Share of India's GDP (%)	Literacy (% Population)
Low Income States					
Bihar	1,921	364	-	2.9	64
Chhattisgarh	2,184	4,882	1	1.9	71
Jharkhand	1,984	1,805	-	1.8	68
Madhya Pradesh	8,381	5,027	5	3.7	70
Orissa	5,379	3,704	5	2.8	74
Rajasthan	8,975	5,585	9	4.4	67
Uttar Pradesh	10,458	6,774	21	9	69
Total LIS	**39,282**	**28,141**	**41**	**26.5**	-
North-eastern States					
Assam	979	2,836	22	1.6	73
Arunachal Pradesh	213	1,992	12	0.1	67
Manipur	158	959	6	0.15	80
Meghalaya	290	810	9	0.2	76
Mizoram	139	927	2	0.1	92
Nagaland	103	494	2	0.15	80
Tripura	265	400	4	0.3	88
Total NES	**2,147**	**8,418**	**57**	**2.6**	-
Rest of India (Top three States on the basis on number of MSMEs)					
Tamil Nadu	15,515	4,832	57	7.5	80.3
Maharashtra	22,645	4,191	63	14.9	82.9
West Bengal	8,317	2,578	11	6	77
Total Top Three Rest of India States	**46,477**	**11,601**	**131**	**28.4**	-
All – India	**173,626**	**70,634**	**380**	**100**	**74**

Source: IBEF, 2011

1.4.3.1 Low-Income States (LIS) Region

The LIS region includes some of the largest states by population in India – Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh. However, these states account for only 33 percent of small and medium enterprises in the country. About 28 percent of the units or 2.7 million enterprises in the region belong to the manufacturing category, while the dominant 72 percent of the enterprises or 7 million units) are into services. Some important facts about the MSME sector in this region are:

- While the LIS region comprises seven states, including the most populous state of Uttar Pradesh, the region as a whole, accounts for 26.5 percent of India's total GDP. It should be noted that the GDP contribution of the LIS region is comparable to the GDP contribution of top three states in rest of India.
- MSMEs in the region are most active in industries like trade, hotels, transport, agro-processing and communications[28] (Table 10).
- The LIS region connects northern, western and eastern India through trade corridors (40 percent of the National Highways are in LIS); hence a large number of these businesses in this region are in the transport industry.
- LIS states have a considerable area (~25-30 percent) under agriculture; hence MSMEs are active in the food processing industry too. In Orissa, a large number of micro-enterprises are involved in businesses related to forest produce, such as trading and processing of tendu and kendu leaves and timber trade for paper industry. Similarly in Madhya Pradesh too, there are a significant number of small and medium enterprises in the bio-pharmaceutical space because of the forest produce.
- MSMEs are also active in trade and metal processing industries in Orissa, Jharkhand and Chhattisgarh, which have a large concentration of mineral deposits.
- Tourism, handicrafts and construction are the other major area of operation of the small and medium enterprises in the region.
- The region has been historically characterized by low access to infrastructure such as electricity and roads. With recent political stability, however, there is a focus on development of infrastructure sectors. Recent investments in electricity alone account for 30-50 percent of total government spending. Development of infrastructure in the region could potentially increase the industrial base in the region.

Table 10: Primary Economy and Key Industries in LIS

States	Key MSME Industries
Bihar	Food Processing Rubber and Plastics Transport Equipment
Chhattisgarh	Food Processing Gems and Jewelry Iron and Steel
Jharkhand	Mining/Iron and Steel Rubber and Plastic Handloom
Madhya Pradesh	Auto Components Textile Pharmaceuticals
Orissa	Iron and Steel Aluminum Handloom
Rajasthan	Food Processing Tourism Information Technology
Uttar Pradesh	Food Processing Leather/Sports Goods Tourism

Source: IBEF, IFC – Intellecap Analysis

[28] Source: IBEF Reports on states in India, 2011

1.4.3.2 North-eastern States (NES) Region

The NES region includes seven states in India – Arunachal Pradesh, Assam, Nagaland, Manipur, Meghalaya, Mizoram and Tripura – which account for 3.4 percent of MSMEs in the country. Cluster activity in NES region is mostly comprised of micro and small units in the handloom and crafts industry. 20 percent of the enterprises in the region belong to the manufacturing category, while the dominant 80 percent of the enterprises are into services. Some important facts on the MSME sector in this region are:

- Seven states in NES account for 2.6 percent of India's total GDP, suggesting that the level of industrialization in the region is considerably lower compared to the Low-Income States and Rest of India. The state and central governments are taking steps to provide basic infrastructure such as electricity and roads, and provide fiscal incentives for more industries to step-up operations in the region.
- Due to abundant natural resources such as forest produce, fruits and vegetables, MSMEs in the region are mostly involved in handloom, handicrafts, food processing, tourism and sericulture (silk production) (Table 11)
- As the businesses use local natural resources as inputs, working capital demand tends to be lower on an average.
- Assam, the largest state in the region and regarded as the "gateway" to the north-east, has the largest network of national highway network in the region. As a result, a large number of MSMEs in the north-eastern states are involved in transport services.

Table 11: Primary Economy and Key Industries in NES

States	Key MSME Industries
Arunachal Pradesh	Arts and Craft Weaving Cane and Bamboo
Assam	Tea Tourism Traditional Cottage Industry
Manipur	Handlooms Handicrafts Sericulture Food Processing
Meghalaya	Food Processing Horticulture Mining
Nagaland	Bamboo Food processing Horticulture
Mizoram	Bamboo Energy Sericulture
Tripura	Food Processing Bamboo Handloom Handicrafts

Source: IBEF, IFC – Intellecap Analysis

1.4.3.3 Rest of India

The 'Rest-of-India' region includes 15 states – Delhi, Uttarakhand, Andhra Pradesh, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu & Kashmir, Punjab, Karnataka, Kerala, Maharashtra, Sikkim, Tamil Nadu and West Bengal – which together account for 64 percent of MSMEs in the country. Only 30 percent of the enterprises in the region are involved in manufacturing, while the dominant 70 percent operate in the services category. Among some of the important facts about the MSME sector in this region are:

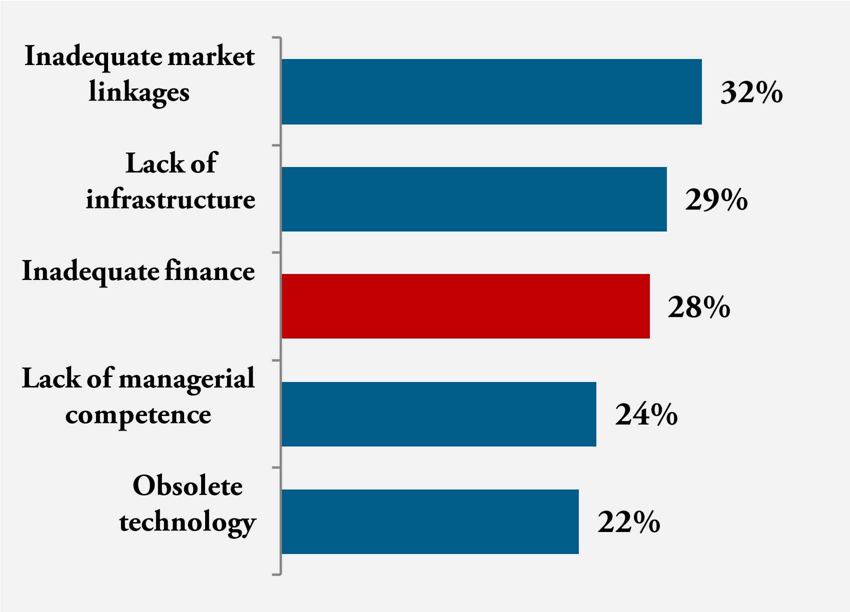
- The Rest–of-India region accounts for 70.9 percent of the national GDP. Large-scale industrialization in the region is one of the key reasons for the high GDP contribution from these states. As a result of a more developed industrial environment, many MSMEs opt for manufacturing. Tamil Nadu and Andhra Pradesh, for example, have emerged as large textile processing centers, building an eco-system supporting micro and small enterprises.

- The states in the region also have significant natural resources, and investment in infrastructure has made it possible for them to exploit these natural resources. Many of the MSMEs therefore operate in industries such as drugs and pharmaceuticals, biotechnology, mines and minerals, textiles, leather, and tourism.
- States such as Maharashtra, Karnataka, Kerala, Andhra Pradesh, Tamil Nadu and New Delhi – the National Capital Region as a whole – have a large pool of skilled workforce, encouraging many of these units to operate in the knowledge-based industries such as IT and ITeS. In fact, unlike the low-income states and north-eastern states, the services sector in Rest-of-India is largely comprised of knowledge-based services industries.
- States such as Gujarat, Maharashtra, Kerala and Tamil Nadu are also major hubs of sea trade, which spurs the growth of small and medium transport services in the region.

1.5 MSME Growth impacted by Multiple Constraints

Although the MSME sector has been growing at a faster rate than the overall industrial sector, MSMEs experience multiple constraints that threaten to derail the sector's growth trajectory. Some of key hindrances that MSMEs face are highlighted in Figure 10.

Figure 10: Key Growth Constraints for MSMEs



(N=76 Percentage of respondents; Respondents include commercial banks, regional rural banks, MSME Associations)

Source: Report of Working Group on Rehabilitation of Sick MSMEs, Reserve Bank of India

- **Inadequate market linkages:** Except in the case of cluster-linked and ancillary MSMEs that have natural linkages with large enterprises, MSMEs tend to have poor market access. The non-cluster MSMEs are fragmented, and as a result, are unable to organize themselves in order to reduce procurement cost from large enterprises or streamline the output supply chain. What is worse, in the absence of adequate market linkages, any demand disruption in the supply chain can severely impact operations because the enterprise capital of these businesses tends to be locked in illiquid inventory and receivables.

- **Lack of infrastructure:** Limited access to infrastructure such as power, water and roads increases operational costs for MSMEs and makes their businesses uncompetitive. Inadequate access to support infrastructure discourages these units from adopting newer technologies, where available. In addition, poor infrastructure forces small and medium businesses to operate in select geographies, increasing the demand for natural resources in that region.

- **Inadequate finance:** MSMEs consider challenges in access to finance as one of the biggest constraints in growth. A study[29] on the MSME sector also suggests that the multiple growth constraints (like those mentioned above) can be largely linked to inadequate access to finance. The Report of Working Group on Rehabilitation of Sick MSMEs by RBI also finds lack of adequate and timely access to working capital finance is one of the key reasons for sickness in the sector.

- **Lack of managerial competence:** Micro and small enterprises in particular largely comprise first-generation entrepreneurs, who have had a limited structured training on resource planning, capital management and labor management. As a result, lack of managerial competence often shows in poor book-keeping and a limited knowledge of formal financial institutions, which further inhibits the growth of these enterprises.

- **Obsolete technology:** While industries such as automotive, forging, software development sector require advanced technologies in operations, the majority of the small and medium enterprises do not have that kind of technological edge. A low technology base results in low productivity, which makes these enterprises uncompetitive. Financial institutions associate lack of technology with uncompetitive businesses and therefore are wary of financing enterprises which are not technologically up-to-date in operations. These enterprises too have limited awareness about new technologies, or the technology financing schemes.

The 2007 MSME Census indicated that only 5 percent of enterprises in the sector had access to some form of formal finance, while over 92 percent of the units lacked access to any form of institutional finance (Table 12). Studies on financing pattern[30] in the sector and the MSME census suggest that MSMEs prefer self-financing, which not just includes the savings of the entrepreneurs, but also the finance availed from friends, family and relatives. (Refer Section 3.1).

[29] How Important are Financing Constraints, Ayyagari, Kunt, Maksimovic, 2005

[30] Hundred Small Steps, Rajan R, 2009

Table 12: Percentage Split of MSMEs by Sources of Finance

Percentage of enterprises by sources of finance			
	No finance/ Self-finance	Through Institutional Sources	Through Non-Institutional Sources
Percentage of enterprises	92.8%	5.2%	2.1%

Source: MSME Census, 2007

However, the situation has been changing in recent years. As a result of greater focus on the MSME segment by the government and the regulator as well as by the financial sector, institutional finance to MSMEs has increased considerably. Building on the 2010 data[31] from the Reserve Bank of India (RBI), the study estimates that financial institutions[32] serve, to some extent or the other, nearly (33 percent)[32] of the enterprises. However, despite the improved access, many micro and small enterprises remain unserved and underserved.

Policymakers in India have always retained a focus on MSME finance, as indicated by the Priority Sector Lending (PSL) norms for commercial banks that were established, and have been in place, for several decades now. Establishing programs such as the Credit Guarantee Trust in recent times has given a renewed thrust to that objective. However, despite the policy efforts and a clearly more responsive formal financial sector, the MSME sector continues to face a financing gap due to inherent demand and supply-side constraints. This study focuses on some of these key challenges.

[31] Empowering MSMEs for Financial Inclusion and Growth – Role of Banks and Industry Associations, K C Chakrabarty, Reserve Bank of India, 2012

[32] Refer to Annex A for methodology. Also note that, the base here is taken as 29.8 million enterprises; not counting the approximate 30 million in the unorganized sector (on including the same, this would be around 16 percent)

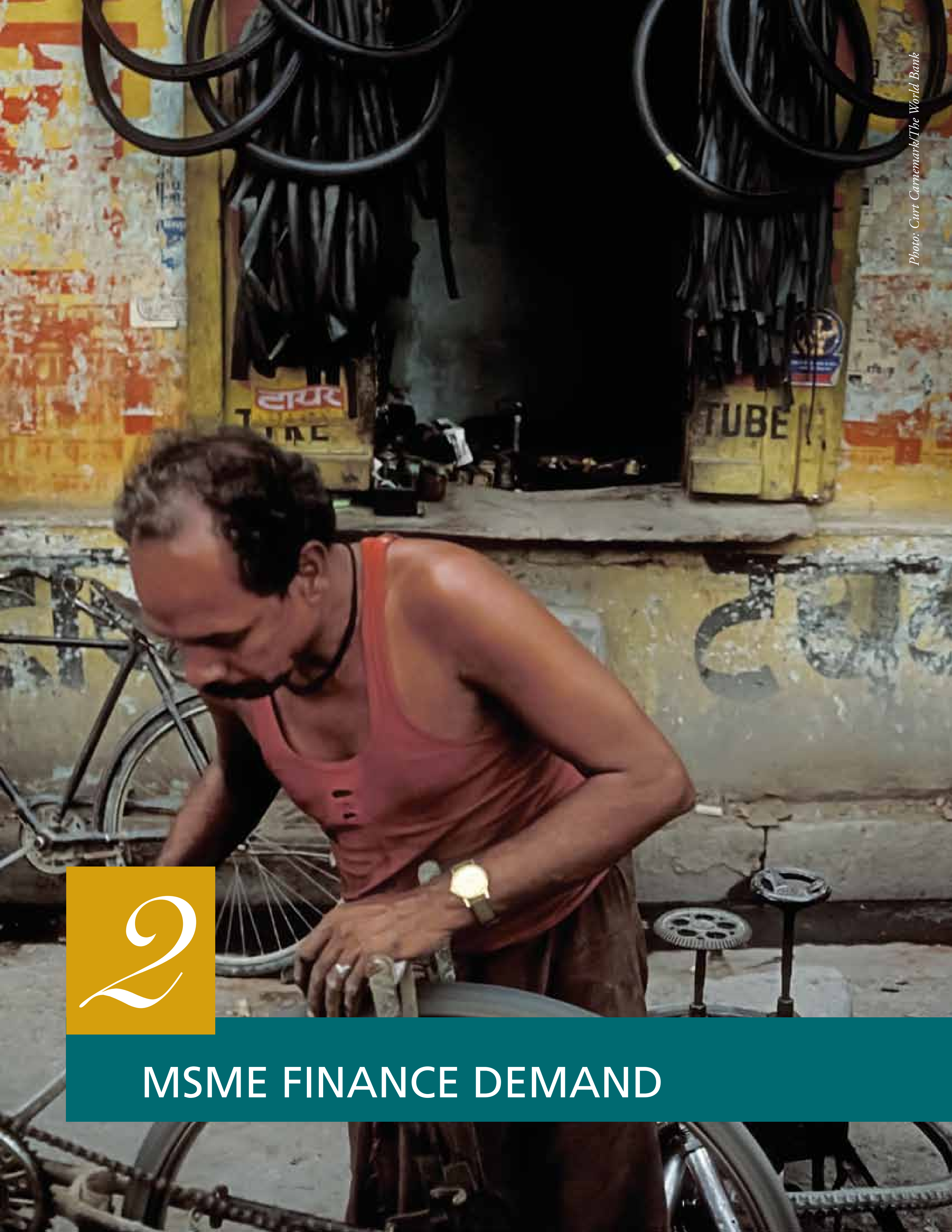


Photo: Curt Carnemark/The World Bank

2

MSME FINANCE DEMAND

OVERALL DEMAND FOR FINANCE IN MSME SECTOR

The overall demand for finance in the MSME sector is estimated to be INR 32.5 trillion[33] ($650 billion) (Figure 11). The majority of finance demand from these enterprises is in the form of debt, estimated at approximately INR 26 trillion ($520 billion). Total demand for equity in the MSME sector is INR 6.5 trillion ($130 billion), which makes up 20 percent of the overall demand. The sector has high leverage ratios with average debt-equity ratio of ~4:1. But these leverage ratios are not even across the sector and variations exist based on the size of the enterprise. For instance medium-scale enterprises exhibit a more balanced debt-equity ratio of ~2:1.

The unregistered[34] enterprises, which comprise ~94 percent of the MSMEs, account for INR 30 trillion ($600 billion) of the finance demand. This demand estimate does not take into account the demand for finance by unorganized enterprises[35] (there are an additional 30 million such enterprises) (Figure 12).

Figure 11: Overall Finance Demand in MSME Sector (in INR Trillion)*

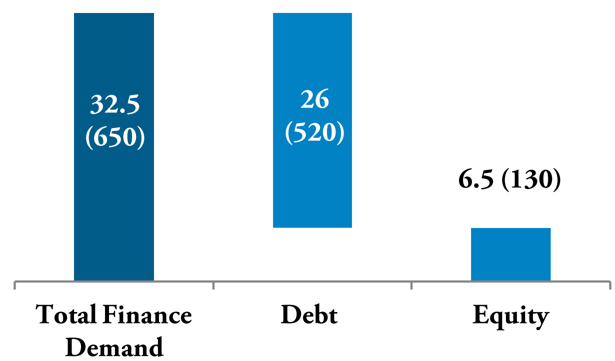
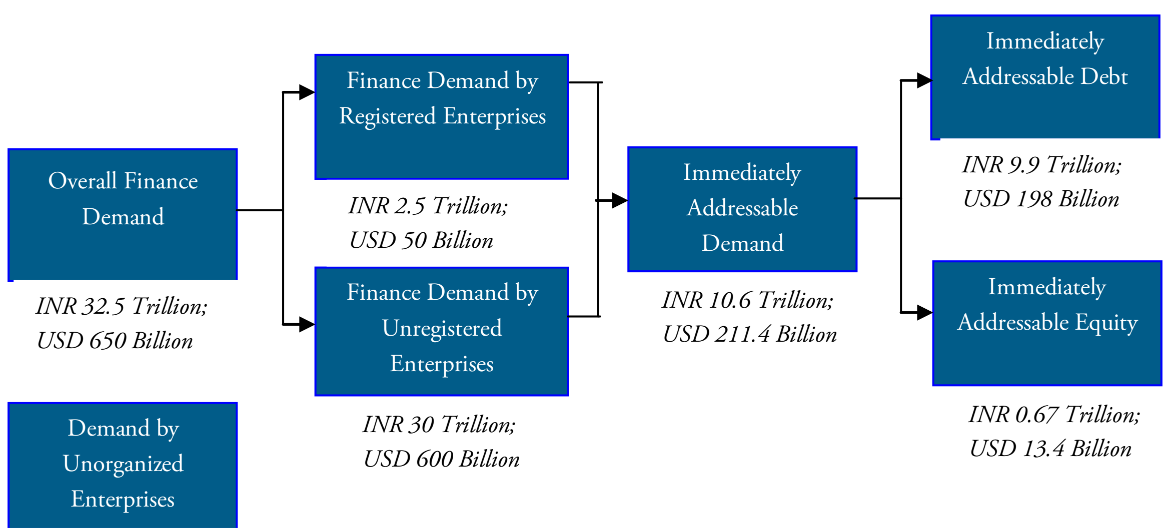


**Figure in brackets is in USD Billion*

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

Figure 12: MSME Finance Demand Flowchart



Estimated population of unorganized enterprises 30 million

[33] Details provided in Annex A

[34] Unregistered Enterprises: MSMEs that do not file business information with District Industry Centers (DICs) of the State/ Union Territory; The data on enterprise output performance is not adequately tracked by the government agencies

[35] Unincorporated private enterprises owned by individuals and households, NCEUS, 2007

2.1 Debt Demand

Financial institutions have traditionally limited their exposure to the sector due to the perception that these businesses carry high risk and high cost of delivery, and have limited access to immovable collateral. Although the overall debt demand in the sector is estimated to be INR 26 trillion ($520 billion), not all of it can be met immediately by the formal financial sector due to several reasons (Table 13). To estimate the viable debt demand that can be addressed by financial institutions, the study does not take into account the demand from the enterprises that are either considered unviable in the near term, or those that voluntarily exclude themselves from formal financial services. Table 13 provides these exclusions and their share of the total debt demand.

Table 13: Exclusions from Overall Debt Demand

Type of enterprises	Share of debt demand (in percentage)
Sick enterprises in default	13%
New enterprises with less than one year of operations	23%
Portion of enterprises rejected by formal financial institutions	1%
Voluntary exclusions of micro services sector enterprise segment	25%
Total	**62%**

Source: IFC-Intellecap Analysis

- It is clear from the above that almost 38 percent of the overall debt demand is not viable and addressable as it comprises enterprises that are sick, or with limited operational history, or suffer from poor financial health (Table 13)
- A large number of micro services enterprises such as small retail trade and repair shops account for 25 percent[36] of the debt demand. These enterprises prefer informal sources to the formal financial institutions due to the ease of access, speed of disbursal and need for negligible documentation. Additionally, the urgency of demand for finance often outscores the cost differential between the two sources.
- Based on the above exclusions, it is estimated that of the total debt demand of INR 26 trillion ($520 billion), at least 38 percent[37] or INR 9.9 trillion ($198 billion) is the size of the viable demand that can be addressed by the formal financial sector in the near term[38] (Figure 13).

Figure 13: Viable and Addressable[39] Debt Demand in MSME Sector (in INR Trillion)*

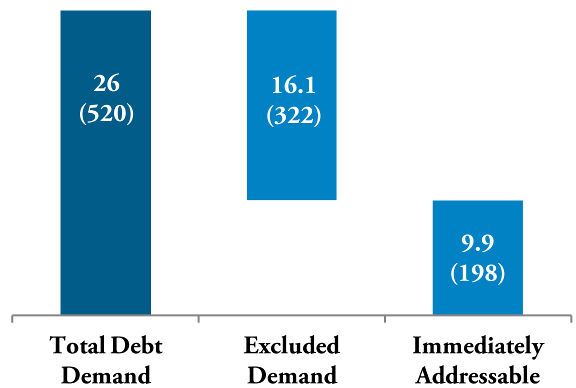


**Figure in brackets is in USD Billion*

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

Nearly 90 percent of the total viable and addressable debt demand (approximately INR 8.9 trillion or $178 billion) is from unregistered enterprises, and the balance demand of INR 1 trillion ($20 billion) is from registered MSMEs. What is interesting though is that registration of enterprises in no way impacts the access to finance from formal financial institutions.

[36] Primary Research

[37] Refer Annex A

[38] One –two years' time frame

[39] Demand that can be serviced by formal financial institutions over a one – two year time frame without undertaking additional effort of market building

Of the total viable and addressable debt demand(Figure 14) of the MSMEs, the working capital requirement is the biggest, estimated to account for approximately 61 percent of the total need. Analysis of a typical MSME's balance sheet and available financial data corroborates the fact. Current assets account for 74 percent balance sheet growth year-on-year[40], while capital expenditure accounts for only 26 percent of the growth, clearly indicating the critical role of working capital finance in the functioning and growth of MSMEs.

Figure 14: Viable and Addressable Working Capital and Capital Expenditure Demand (In INR Trillion)*

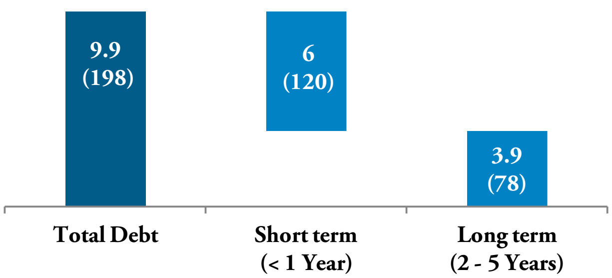


**Figure in brackets is in USD Billion*

Source: Reserve Bank of India, SIDBI, MSME Census, IFC-Intellecap Analysis, Primary Research

2.1.1 Breakdown of Debt Demand by Size of Enterprise

Of the total INR 9.9 trillion ($198 billion) of viable debt demand that can be addressed by financial institutions in the near term, the micro, small, and medium enterprise segments respectively account for INR 4.4 trillion ($88 Billion), INR 2.9 trillion ($58 billion) and INR 2.6 trillion ($52 billion). The micro and small enterprises sub-segments together account for 74 percent of this debt demand (Figure 15), and hence form the focus of the priority sector lending norms.

[40] SME Insights, Volume 1, CRISIL 2011; Sample size: 5,000 SMEs

Figure 15: Viable and Addressable Debt Demand in Micro, Small and Medium Enterprise Segments (in INR trillion)*

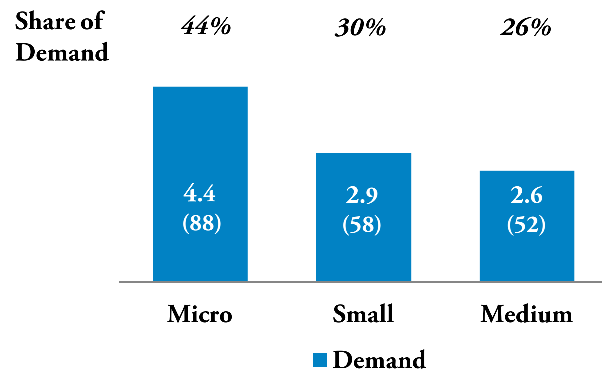


**Figure in brackets is in USD Billion*

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

2.1.1.1 Micro Enterprise Segment

Micro enterprises mostly operate in order-driven industries such as retail trade, repair and maintenance, restaurants and textiles among others, and have a significant working capital demand. Following characteristics are noteworthy:

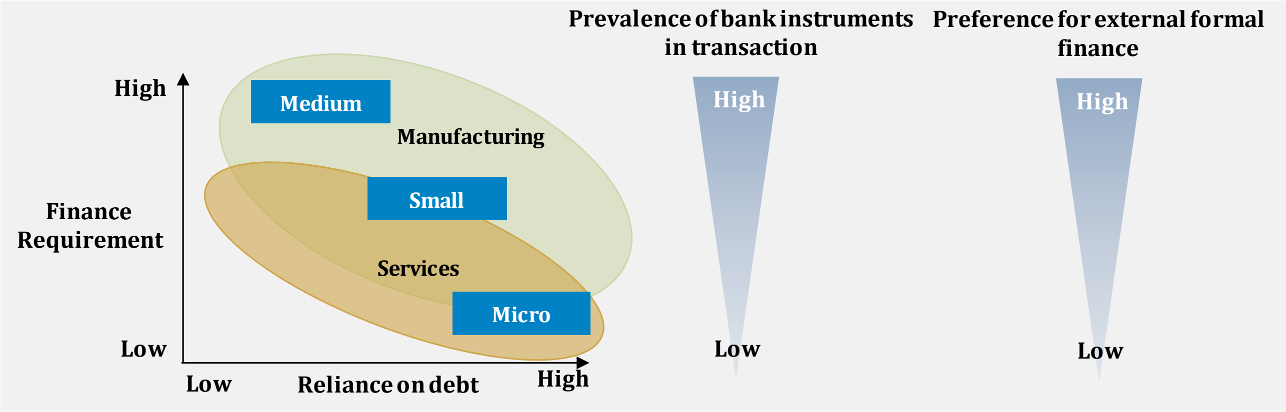
- Analysis of the viable and addressable debt demand indicates that at least 10.6 million micro enterprises constitute a viable financing segment for formal financial institutions[41] in the near term[42].
- Primary research shows that the average credit requirement of a micro enterprises across manufacturing and services is estimated to be INR 0.3 million – INR 0.4 million[43] ($6,000 – $8,000).
- Most of these enterprises largely transact in cash, and hence do not have accurately recorded financials, making it difficult for financial institutions to assess their credit worthiness (Figure 16)

[41] IFC-Intellecap Analysis, estimation methodology provided in Annex A

[42] Near Term: Time frame of 1-2 years

[43] Primary Research

Figure 16: Nature of Finance Demand in the MSME Sector



Source: IFC-Intellecap Analysis

- Micro enterprises are also characterized with limited access to both immovable and movable collateral, while the majority of financial institutions prefer collateral-based financing as a risk mitigant. These enterprises are mostly centered around entrepreneurs alone, which makes them vulnerable because micro-entrepreneurs have often had limited training in resource planning and are not always aware of all the potential financing avenues available.

2.1.1.2 Small Enterprise Segment

Small enterprises require higher capital investments and tend to operate in value-add manufacturing and knowledge-based service industries. Entrepreneurs who run small enterprises have a relatively better knowledge of external sources of finance. Some key facts about this segment are:

- Estimates indicate that 0.7 million small enterprises are viable for financing and addressable by formal financial institutions[44] in the near term.
- The average credit requirement of a small enterprise across manufacturing and services industries is estimated to be INR 4 million – INR 4.5 Million[45] ($80,000 – 90,000). With limited access to immovable collateral or assets, small enterprises especially in knowledge-based industries, are handicapped in their ability to access adequate debt from formal financial institutions.
- Although mature small enterprises (particularly knowledge-based enterprises) tend to use bank instruments for most of their business transactions, cash continues to be preferred across the overall small segment as entrepreneurs have limited incentive to maintain financial records. Lack of financial documentation further increases the challenge of accessing finance from formal financial institutions.
- Small enterprises access finance from both formal and informal sources, but in case of formal sources, these units tend to have relationships with 1-2 financial institutions.

[44] IFC-Intellecap Analysis; Estimation methodology provided in Annex A

[45] Primary Research – enterprises and financial institutions

2.1.1.3 Medium Enterprise Segment

Unlike micro and small enterprises, medium enterprises exhibit a more predictable demand for debt, and these units are able to access multiple sources of capital. Businesses in the segment are typically structured as limited companies that allow for infusion of alternative forms of capital such as equity. In addition, predictable cash flows and a formal structure, allows medium enterprises to choose formal financial institutions as their preferred financiers. The study estimates that 0.05 million medium enterprises can be served by the formal financial institutions[46]. Some of the characteristic aspects about the segment are:

- The average credit requirement of a medium enterprise across manufacturing and services industries is in the range of INR 40 million – INR 55 million[47] ($0.8 – 1.1 million).
- Medium-sized enterprises are professionally managed and hence depend a lot less on the entrepreneur for management of day-to-day operations, allowing him to explore broader aspects like financing from multiple sources.
- The financial history of these enterprises tends to be traceable. Coupled with high average value of financial transactions, these enterprises are able to access financial services more easily, forming financial relationships with multiple financial institutions.

2.1.2 Breakdown of debt demand by Type of Enterprise

The manufacturing sector accounts for 61 percent of the viable debt demand that can be addressed by formal financial institutions in the near term, whereas the services sector accounts for the balance 39 percent (Figure 17). Accordingly, the share of manufacturing and services in the viable debt demand that can be addressed by financial institutions in the near term is INR 6 trillion ($120 billion) and INR 3.9 trillion ($78 billion) respectively.

Figure 17: Viable and Addressable Debt Demand in Manufacturing and Services Sectors (In INR Trillion)*

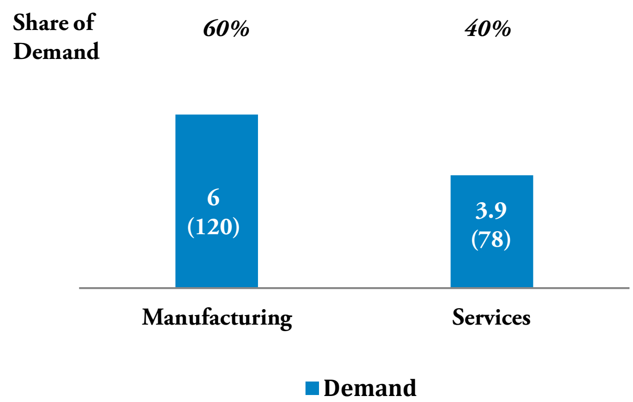


**Figure in brackets is in USD Billion*

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

2.1.2.1 Manufacturing Sector

Although the manufacturing sector accounts for a smaller share of enterprises, operations are more capital-intensive, as a result of which working capital requirement tends to be higher in the manufacturing sector than that in the services sector. Some of the features of finance needs of manufacturing MSMEs are:

- The average requirement for capital expenditure in manufacturing enterprises is estimated to be INR 0.5 million[48] ($10,000) per year.
- The demand for working capital in the manufacturing sector is driven primarily by enterprises that tend to operate with significant amount of trade finance. Additionally, lower operating margins, coupled with inefficient utilization of capital in this sector, increase the average demand for finance.

[46] IFC-Intellecap Analysis; Estimation methodology provided in Annex A

[47] Primary research with enterprises and financial institutions

[48] IFC-Intellecap Analysis; estimation methodology provided in Annex A

- At over 100 days, working capital cycles in the manufacturing sector are typically quite long because of which average working capital requirements also tend to be higher (estimated to be INR 1.2 million; $24,000). As a result, working capital accounts for an estimated 70 percent of the total debt demand from the manufacturing sector.
- Enterprises that feed large supply chains are known to experience longer working capital cycles as payment cycles are unpredictable and depend on many players within the supply chain, resulting in higher working capital demand.
- Export-oriented enterprises are particularly vulnerable to currency exchange rate fluctuation. In case of adverse currency movement, the working capital needs of the enterprises increase.
- MSMEs that feed local consumer markets usually transact with other MSMEs in retail trade. Typically, retailers provide goods on consignment basis, which carries the uncertainty with regard to the timing of sales and subsequent payments. All this increases the need for working capital finance to continue production.

2.1.2.2 Services Sector

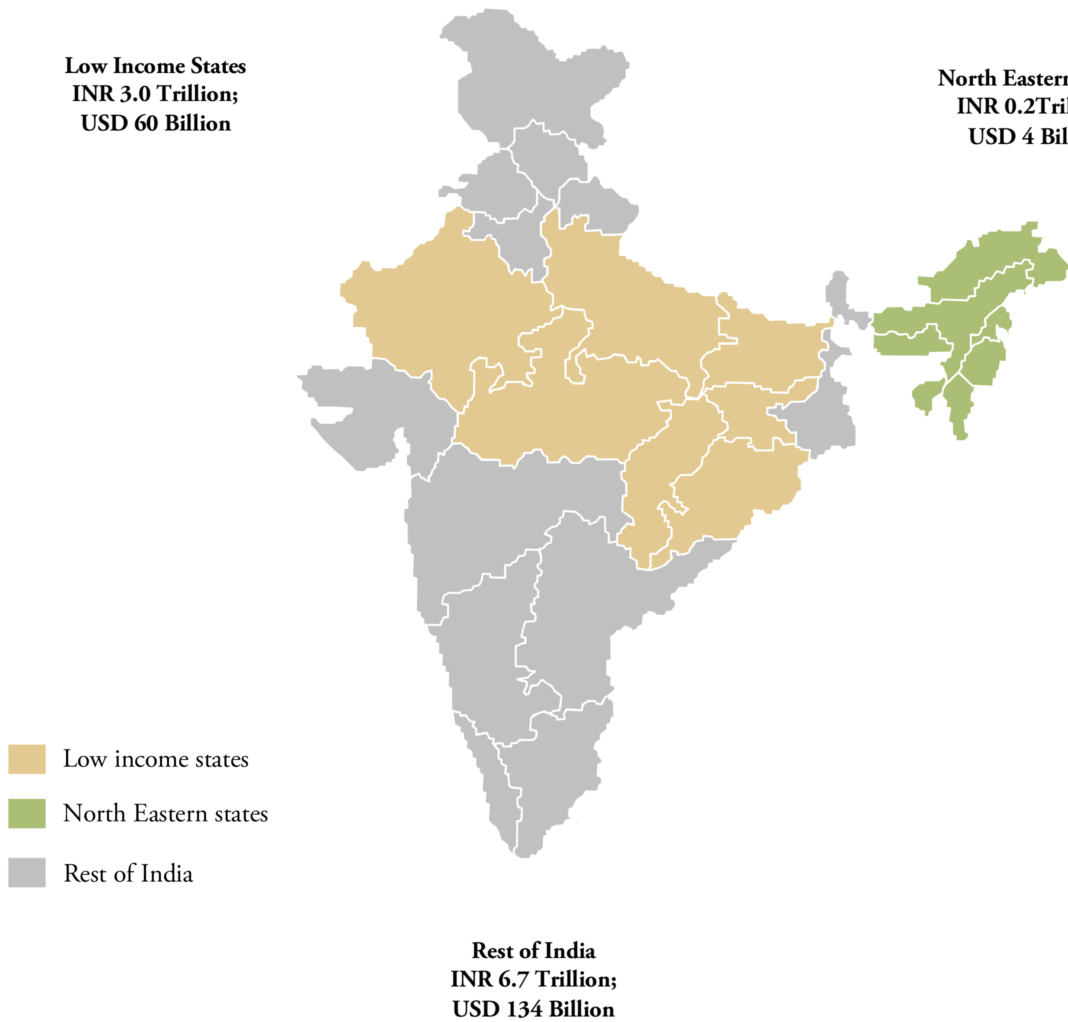
Service industries such as retail trade, repair and maintenance, and restaurants are typically cash businesses with shorter turnaround, because of which their overall external capital requirements tend to be low on an average. On the other hand, there are knowledge-based services industries such as software development and management consulting within the services sector, the finance requirements of which are similar to that of manufacturing industries i.e. higher working capital and capital expenditure requirements. Some characteristic traits of the demand of services enterprises are:

- The share of working capital as a portion of the average debt demand for services enterprises is estimated to be ~41 percent.
- Services enterprises require less external capital on an on-going basis, except for such things as work premises renovation, purchase and refurbishment of equipment. They do, however, need significant capital support during the start-up stage.
- Given the nature of most of these enterprises, they have limited access to immovable collateral which makes access to formal finance challenging.
- Knowledge-based enterprises require working capital for primarily investing in people. For this, businesses either depend on internal accruals or internal equity investments, as debt from formal financial institutions for financing of man power costs remains a challenge.

2.1.3 Breakdown of debt demand by Geography

The Low-Income States[49] (LIS) and North-eastern States (NES) respectively account for INR 3 trillion[50] ($60 billion) and INR 0.2 trillion ($4 billion) of the viable and addressable debt demand (Figure 18), which is a total of 32.3 percent of the overall viable debt demand that can be addressed by financial institutions in the near term.

Figure 18: Viable and Addressable Debt Demand in LIS, NES and Rest of India States in India (In INR Trillion/ USD Billion)



Source: MSME Census; SIDBI; Primary Research; IFC – Intellecap Analysis

[49] India Country Overview, World Bank, September 2011

[50] The immediately addressable debt demand in LIS, NES and Rest of India regions is split in the same ratio as the overall debt demand is regions i.e. 30.3%, 2.0%, and 67.7% for LIS, NES and Rest of India respectively

2.1.3.1 Low-Income States

Factors such as the level of industrialization, access to infrastructure, and the availability of natural resources determine the type of industries that thrive in a region. With limited access to infrastructure support, the LIS region is largely dominated by services industries that account for 72 percent of the MSMEs in the region.

- The overall debt demand in the region is lower as a large number of micro and small enterprises in the region are services industries with lower debt demand.
- Uttar Pradesh is the largest state accounting for 34 percent of the demand that can be addressed by financial institutions in the near term. The other leading states in the region are Madhya Pradesh comprising 17 percent of the demand and Rajasthan making up 16 percent of the demand.
- Knowledge-based enterprises in the region are confined to a few pockets such as Jaipur in Rajasthan and Noida in Uttar Pradesh. Therefore the demand for finance tends to be higher only in these select pockets.
- Jharkhand and Chhattisgarh account for only 7 percent of the addressable debt demand in the region as most of the MSMEs in these states focus on low-scale activities such as retail, handloom and the processing of forest produce processing that need lower capital on an ongoing basis.

2.1.3.2 North-Eastern States

The North-Eastern States have had relatively limited industrialization; hence MSMEs in the region have been mostly focused on handlooms, crafts, trade and transport. Only 19 percent of the small and medium enterprises in the region operate in manufacturing industries. Because service enterprises are dominant, the average finance demand in the region is lower. The size of viable and addressable debt demand[51] in the region is estimated to be INR 0.2 trillion ($4 billion).

- Assam has the largest number of MSMEs in the region, and accounts for an estimated 64 percent of the viable and addressable debt demand. Assam is the gateway to North-eastern states, because of which a significant number of small businesses are in the trade and transport industry, and account for the largest share of the debt demand in the region.
- Tripura and Manipur account for another 14 percent and 9 percent of the demand respectively that can be addressed by the financial institutions in the near term in the region. Tripura accounts for 12 percent and Manipur for 7 percent of the MSMEs in the region, although the two together, account for only 0.6 percent of MSMEs in the country.
- The average debt demand from MSMEs in the region other than Assam tends to be lower as most units operate in the handloom and handicraft industry, which require less capital compared to the manufacturing units.

2.1.3.3 Rest of India

High industrialization in the states constituting the Rest-of-India makes it conducive for both manufacturing and services enterprises to operate effectively. A large manufacturing base provides the right eco-system for small and medium enterprises to operate as ancillary units. High population level in the industrialized states provide a surging demand for consumer services, leading to the growth of many services micro and small enterprises in the region. As the number of MSMEs is the largest in the Rest-of-India, so is the viable and addressable debt demand, estimated at INR 6.7 trillion ($134 billion). Some of the prominent features of finance demand of the MSMEs here are:

- The top five states in the region – Tamil Nadu, West Bengal, Maharashtra, Andhra Pradesh and Karnataka – account for 48 percent of the viable debt demand that can be addressed by the financial institutions in the near term across the country.

[51] The immediately addressable debt demand in LIS, NES and Rest of India regions is split in the same ratio as the overall debt demand is regions i.e. 30.3%, 2.0%, and 67.7% for LIS, NES and Rest of India respectively

- Other states such as Kerala, Gujarat, Punjab, Haryana, Delhi, Jammu and Kashmir, Uttarakhand and Himachal Pradesh also contribute significantly to the rest of the viable and addressable demand.

- Tamil Nadu accounts for the highest share of debt demand as the state has the highest number of MSMEs in capital-intensive industries such as textile, auto components and pharmaceutical. The state also has a large number of export-oriented enterprises in areas such as Tirupur and Erode that account for a higher up-take of export credit.

- High industrialization in other leading states too has helped to promote the formation and growth of a large number of manufacturing MSMEs that are ancillaries to large enterprises – higher share of manufacturing MSMEs increases the share of the debt demand for the region.

- The top five states mentioned above are also well-connected through seaports, accounting for a higher share of export credit.

2.2 Equity Demand

The overall equity demand in the sector is estimated to be INR 6.5 trillion ($130 billion), with short-term equity requirement accounting for INR 4 trillion ($80 billion), and long-term equity making up a demand of INR 2.5 trillion ($50 billion).

Analysis of financing patterns in the MSME sector suggests that enterprises use internal accruals and informal sources to finance the short-term equity demand (INR 4 trillion; $80 billion) and 25 percent of the long-term equity demand (INR 0.6 trillion or $12 billion)[52].

Excluding entrepreneurs' equity contribution (internal accruals and informal sources), the equity demand from external sources is estimated to be INR 1.9 trillion ($38 billion). However, all the equity demand may not be viable and addressable[53] as 95.7 percent of enterprises are structured as either proprietorships or partnerships that are not amenable to external equity infusion. In the estimation, all the micro enterprises[54] and a section of small enterprises are assumed to be structured as either proprietorships or partnerships.

Excluding the equity demand totaling INR 1.23 trillion ($24.6 billion) from proprietorship and partnership enterprises , the viable and addressable equity demand is estimated to be INR 0.67 trillion ($13.4 billion) (Refer Figure 19).

Figure 19: Viable and Addressable[55] Equity Demand in MSME Sector (in INR trillion)*

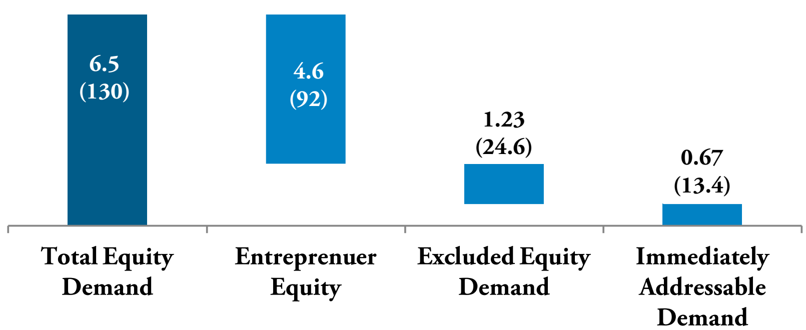


**Figure in brackets is in USD Billion*

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

[52] IFC-Intellecap Analysis; Estimation methodology provided in Annex A

[53] Market can be immediately addressed through innovative structures such as convertible debt or change of legal structure

[54] All the micro enterprises are considered to be proprietorship/ partnership enterprises

[55] Demand that can be serviced by formal financial institutions over a one – two year time frame without undertaking additional effort of market building

2.2.1 Small Size of Equity Investments in the Sector

Based on the analysis of the typical capital structure of enterprises, the overall equity demand in the sector ranges from INR 0.1 million ($2,000) for micro enterprises to INR 24 million ($0.48 million) for medium enterprises. Excluding the entrepreneur's contribution towards short-term and long-term financing, the average investment sizes tend to be much lower (Table 14).

- Micro and small enterprises have limited access to external equity primarily because only a handful of players provide early-stage equity capital. Even if the equity were made available, the uptake would remain low due to: (a) legal structure of enterprises that prevent infusion of external equity; (b) low level of willingness and ability of entrepreneurs to manage formal sources of equity capital; and (c) entrepreneur's concern regarding control and management. However, the equity demand from small enterprises that have legal structures other than proprietorship and partnership is considered as viable and addressable in the near term. Such demand is estimated to be of the order of INR 0.26 million ($5.2 billion).
- Medium-scale enterprises demonstrate a more balanced debt-equity ratio with estimates of around ~2:1 leverage. This is due to the increased ability of the entrepreneur to contribute capital, a more amenable legal structure and the presence of business models that are scalable. The viable and addressable equity demand for medium enterprises is estimated to be INR 0.41 trillion ($8.2 billion).

Table 14: Range of Equity Investment Size*

Enterprise	Average Investment Size (in INR Million)
Micro	0.04-0.05 (800 – 1000)
Small	0.3 – 0.5 (6000 – 10,000)
Medium	7 – 10 (0.14 – 0.2 Million)

** Figures in bracket in USD; Source: IFC – Intellecap Analysis*

Smaller investment sizes per enterprise tend to increase the transaction cost and management cost for equity investors, making this segment relatively less attractive.

2.2.2 Equity Demand in Early-Stage and Growth-Stage Enterprises

Early-stage enterprises are defined as those that have an operational history of one-year or less. Analysis suggests that these enterprises account for 23 percent of the overall long-term equity demand. As can be seen in Figure 20 below, that demand is estimated at INR 0.58 trillion ($11.6 billion). The balance equity demand, after excluding early-stage equity, comprises an estimated INR 1.32 trillion ($26.4 billion) as growth-stage equity.

Figure 20: Equity Demand[56]Early and Growth Stages in MSME Sector (in INR Trillion)*

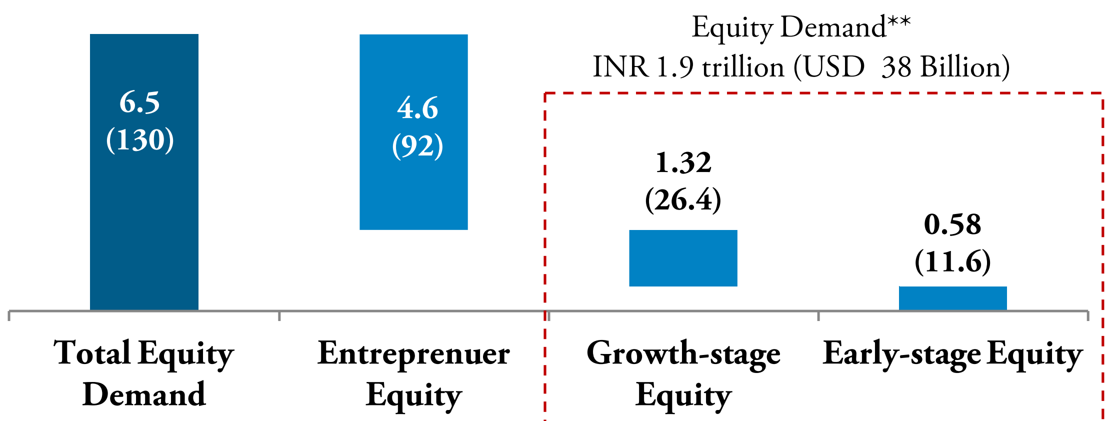


**Figure in brackets is in USD Billion*

***Includes equity demand by micro enterprises*

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

[56] Equity demand which can be addressed by financial institutions in near term

2.2.3 Challenges for Enterprises in Equity Infusion

The ability of an enterprise to accept external equity depends on its legal structure. Limited companies[57] and limited liability partnerships[58] allow investors to infuse external equity into the enterprise to the extent their liability is limited to their respective shareholding. Other legal forms such as proprietorship[59] and partnership[60] transfer unlimited liability to the equity investor, hence discouraging equity infusion in such enterprises.

An overwhelming 95.7 percent of MSMEs in India are proprietorships or partnerships and as a result, are unable to attract external equity. While change in the legal form of an enterprise to limited company or limited liability partnership is an option, it entails taxation and compliance overheads for the enterprises, often rendering the business model financially unviable. In addition, many entrepreneurs have limited awareness of alternative sources of finance; hence the benefits of changing their legal structures are not always obvious. In the absence of external equity, entrepreneurs use informal sources (usually debt) to meet the needs of their enterprise.

Equity investors require transparency in both financial record-keeping and governance. As a result, it is mostly the medium enterprises and mature small enterprises which are able to keep their financials transparent, and tend to attract more equity investors. Also, the legal structure of medium and mature small enterprises allows for infusion of external equity.

2.3 Non-addressable Finance Demand in the MSME Sector

While the viable and addressable debt and equity demand presents a significant opportunity for formal financial institutions, the potential size of the MSME finance market can be further increased by gradually transforming some components of the currently non-addressable demand into demand that financial institutions would consider viable.

The current non-addressable demand comprises (a) in the debt market – new enterprises, sick enterprises, voluntary exclusions and enterprises with poor financial records, and (b) in the equity market – micro and small enterprises that have legal structures such as proprietorship and partnership. Considerable efforts by way of policy and building market and business models are required to gradually transform the above demand and make it financially viable.

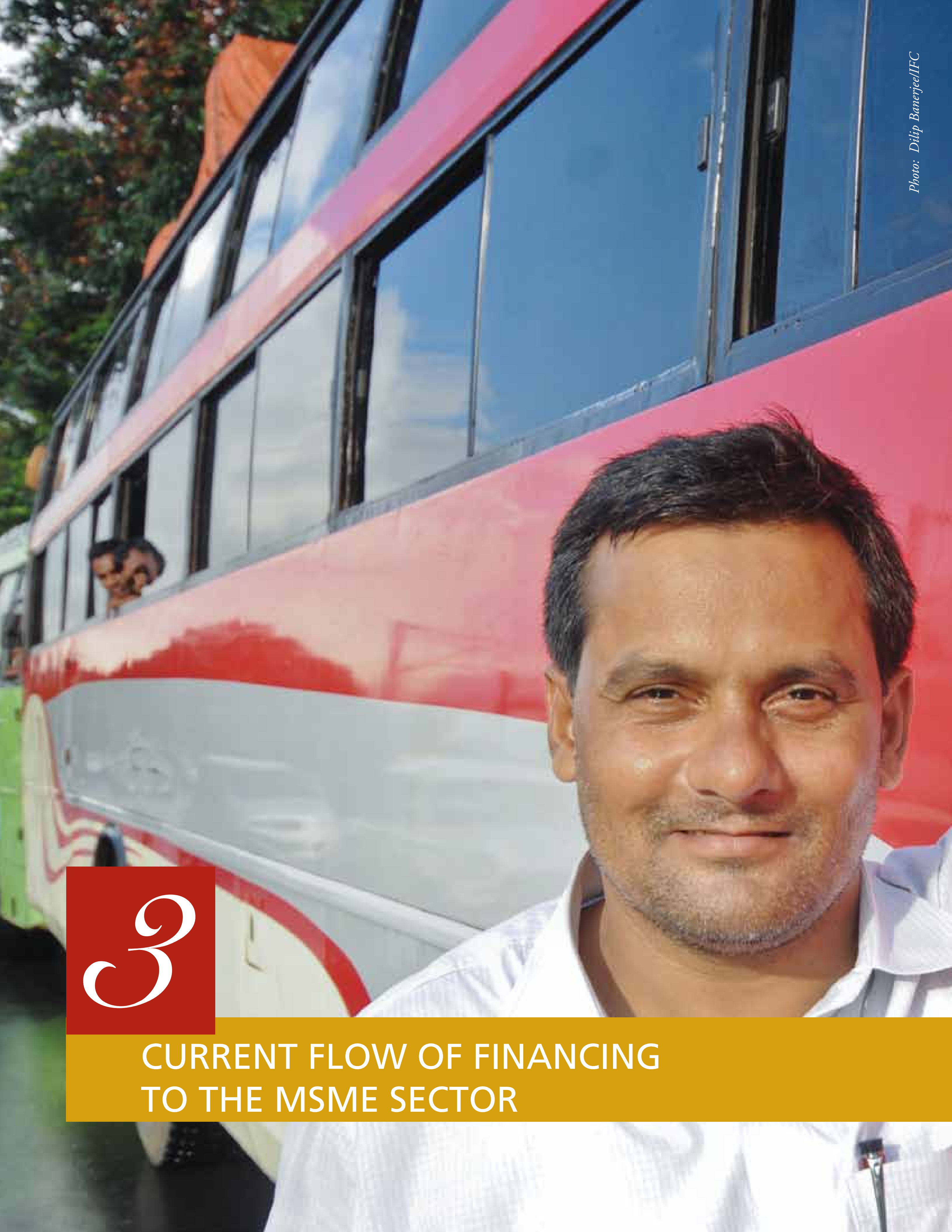
Some of the interventions that can help transition the MSMEs into lucrative financing opportunities for the financial sector include: (a) increasing awareness among entrepreneurs about how access to formal sources of finance can benefit the growth of their business, (b) incentivizing entrepreneurs to increase financial transparency and plan their financial requirements better, (c) creating an effective policy environment to revive sick enterprises and make them financially viable, (d) providing incubation support to early-stage enterprises and, (e) increasing the enterprise knowledge on various low-overhead legal structures available to them. Expansion in the level of formal finance to the MSME sector could unlock enormous potential for the sector's growth and corresponding contribution to GDP.

[57] Companies Act 1956, Government of India

[58] Limited Liability Partnership Act 2008, Government of India

[59] Indian Proprietorship Act 1908, Government of India

[60] The Partnership Act 1932, Government of India



3 CURRENT FLOW OF FINANCING TO THE MSME SECTOR

OVERALL FLOW OF FINANCE TO THE MSME SECTOR

Working with the assumption that all finance demand by the MSME sector is met by either formal or informal sources, the estimate for overall supply of finance to the MSME sector is also INR 32.5 trillion[61] ($650 billion). This comprises informal finance, self-finance and finance from the formal financial sector. However, what is characteristic of the finance flow is that informal sources and self-finance together make up most of the finance channeled into the sector. An estimated INR 25.5 trillion ($510 billion), or nearly 78 percent of the sector's debt demand, is fed by these two sources, while formal sources cater to just over 22 percent of the demand at INR 7 trillion ($140 billion) (Figure 21).

- Formal sources of finance, i.e. banks and non-banking institutions, account for INR 6.97 trillion ($139.4 billion) of the overall formal finance supply, and commercial banks are the largest formal sources of finance, primarily providing debt capital to the MSMEs
- The study estimates that the supply of formal equity to the sector is INR 0.03 trillion ($0.6 billion)
- The study estimates that informal sources account for an estimated INR 24.4 trillion ($488 billion) in finance to the sector. Informal sources include both institutional sources such as moneylenders and chit funds, and non-institutional sources such as family, friends, and family business
- In addition, entrepreneurs also leverage personal resources and contribute equity to the enterprise. Self-equity contributions are estimated to account for INR 1.1 trillion[62] ($22 billion) of finance flow into the sector.

Figure 21: Supply of Finance to the MSME Sector (in INR Trillion)*

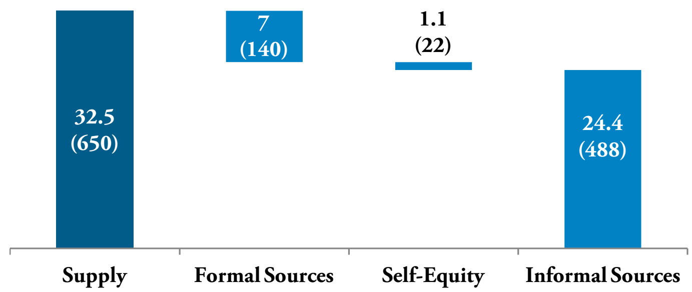


**Figure in brackets is in USD Billion*

Source: RBI, SIDBI,SME Times – 2010, Primary Research, IFC-Intellecap Analysis

3.1 Flow of MSME Debt Finance from the Informal Sector

Informal finance dominates the sector and 95 percent of it comes from non-institutional sources. The study estimates that these sources such as family, friends, and family business (Figure 22) together account for INR 23.2 trillion[63] ($464 billion) of the informal finance to the MSME sector.

- Financial transactions with non-institutional informal sources are typically in the form of debt; these transactions are not bound by any contractual agreement, and the repayment terms are mutually agreed. Typical repayment terms include bullet payment of principal and regular interest payments. Due to the non-contractual nature of transactions, many micro enterprises prefer informal sources over formal sources despite the relative higher rates of interest.
- Non-institutional lenders typically do not insist on any immovable collateral. Instead such sources tend rely on personal reputation or social collateral[64] to hedge repayment risk, making it easier for enterprises to access informal finance.
- Costs of funds from such sources tend to vary from 1 percent per month to 5 percent per month[65].

[61] RBI, SIDBI, Sa-Dhan, Annual Reports of NBFCs , SME Times-2010, Primary Research, IFC-Intellecap Analysis

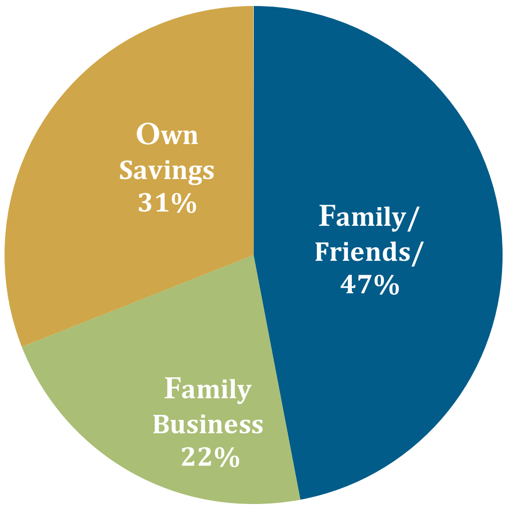
[62] Fourth All India MSME Census, 2007; SIDBI MSME Database, 2010, IFC-Intellecap Analysis

[63] Fourth All India MSME Census, 2007; SIDBI MSME Database, 2010, IFC – Intellecap Analysis

[64] By enforcing social pressure, each borrower is forced to keep on his/her repayment of the loan

[65] Primary Research – Interviews with Financial Institutions

Figure 22: Share of Non-institutional Informal Sources of Finance



Source: Report on Entrepreneurship in India, National Knowledge Commission

Institutional informal sources such as registered trade credit, chit funds and moneylenders channel an estimated INR 1.2 trillion ($24 billion) of finance into the MSME sector. Unlike in the case of non-institutional informal sources, transactions with institutional informal sources are bound by legal contracts.

- Institutional informal sources also provide financing in the form of debt on the basis of mutually agreed terms of repayment or transactions that are documented in the contract. Repayment cycles are typically in the form of bullet payments as well as daily, weekly or monthly installments of interest. Studies[66] suggest that trade-credit accounts for 30-40 percent of the working capital finance in the MSME sector. While trade credit plays an important role in working capital finance, longer debt cycles often offset any advantage that such financing has to offer.

- As with other informal sources of finance, institutional informal sources typically do not insist on any immovable collateral. Inclusion of individuals in such community-based finance institutions[67] is based on referrals, and personal reputation is used in lieu of collateral.

- Enterprises also avail finance from community institutions such as chit funds[68]. The size of the organized chit funds market in India is estimated to be INR 0.3 trillion[69] (USD 6 billion). Chit funds offer flexible repayment options and on-demand finance with limited or no collateral.

- Although the cost of funds (Table 15) from informal sources tends to be high, timely disbursal and shorter turnaround times make them more attractive sources of finance, particularly for micro and small enterprises.

Table 15: Cost of Funds in Select Institutional Informal Sources

Source	Cost of Funds (per month)
Registered Chit Funds	0.5% – 3.5%
Unregistered Chits Funds	1% – 2%
Registered Moneylenders	1% – 10%

Source: IFMR[70], All India Association of Chit Funds, IFC – Intellecap Analysis

Note: *It is challenging to accurately quantify finance from informal sources due to inconsistent definitions of informal sources, unavailability of documented data on institutional informal sources and limited mapping of trade credit in the sector.*

[66] Financing Firms in India, Allen, Chakrabarti, De, Qain, 2007

[67] Such as Chit funds, Trade creditors etc.

[68] Rotating Savings and Credit Associations

[69] Business Logistics of Informal Lending, Schoar A, Mukkawar R, 2008

[70] Business Logistics of Informal Lending, Schoar A, Mukkawar R, 2008

3.2 Flow of MSME Debt Finance from the Formal Financial Sector

The MSME sector receives INR 6.97 trillion ($139.4 billion) debt from banking and non-banking institutions. Banks and government financing agencies constitute the largest share of formal debt to the MSME sector, and are estimated to provide INR 6.4 trillion ($128 billion) to these enterprises. The balance INR 0.57 trillion ($11.4 billion) of formal debt is supplied by non-banking finance companies (NBFCs). Unlike in many developing countries in Latin America where large banks are down-scaling to serve the Small and Medium Enterprise (SME) market, in India large banks have been the largest formal source of finance to MSMEs for decades. Figure 23 exhibits the structure of formal debt supply to the sector.

Figure 23: Structure of Formal Debt Supply to the MSME Sector (in INR trillion)*

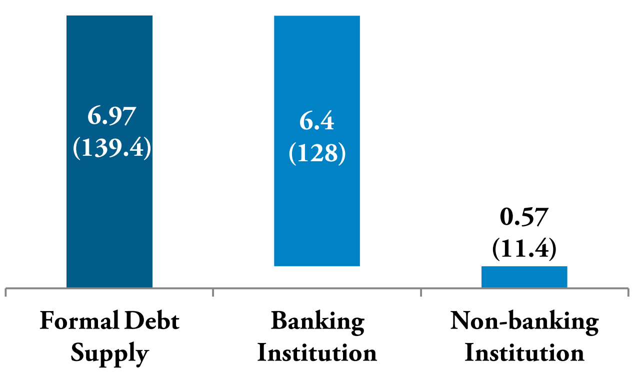


**Figure in brackets is in USD Billion*

Source: RBI, SIDBI, Sa-Dhan, Annual Reports of NBFCs, Primary Research; IFC-Intellecap Analysis

Although banks have a higher risk perception of the MSME sector, they continue to be the key players in formal financing. The higher share of bank supply can be attributed primarily to Priority Sector Lending[71] (PSL) guidelines set by the Reserve Bank of India (RBI) that require banks to supply debt to priority sectors such as agriculture, micro and small enterprises. Some key focus areas of PSL, with regard to the MSME sector are:

- PSL guidelines require banks to allocate sizeable share of their credit portfolio to micro and small enterprises. The existing PSL guidelines have set targets (i.e. share of credit portfolio) for micro and small enterprises financing. The Nair Committee Report (February 2012) on Priority Sector Lending (February 2012 has recommended that all domestic and foreign banks allocate 7 percent of their credit portfolio solely for financing micro enterprises.
- The Nair Committee has also recommended that foreign banks should have priority sector commitment of 40 percent of Annual Net Bank Credit (ANBC), with a sub-target for the micro and small enterprise sector at 15 percent of ANBC. If implemented, this policy is expected to have a significantly positive impact on the participation of foreign banks in the MSME finance over the medium term.

With continuous policy focus on financing to micro and small enterprises, the share of large banks in the MSME finance landscape is also expected to grow in the future.

NBFCs, unlike banks, are not required to comply with the PSL guidelines. However their participation in the MSME sector is driven to a large extent by unmet finance demand of these enterprises, and the ability of NBFCs to develop innovative financial products and deliver finance in a cost – effective manner, with greater flexibility and quicker turnaround times.

In order to encourage banks to increase their direct lending to the MSME sector, an RBI regulation in April 2011 excluded loans sanctioned by banks to NBFCs for on-lending to micro and small enterprises from priority sector targets. However, the Nair Committee Report has recommended that commercial bank loans to NBFCs for on-lending to specified segments may be considered for classification under priority sector, up to a maximum of 5 percent of ANBC, subject to certain due diligence and documentation standards. Although the new recommendations allow a small window for indirect lending, there are other attractive priority sector segments (such as microfinance) that are also vying for the same pool of funds. Hence, it is not clear if these recommendations will specifically increase indirect financing for the MSMEs via NBFCs.

[71] Priority Sectors Lending (PSL) includes the following sectors – agriculture, micro and small enterprises, weaker sections, export credit and lending at differential rate of interest. PSL target is 40 percent of Adjusted Net Bank Credit (ANBC) for nationalized banks and private banks, while the PSL target for foreign banks currently is 32 percent of ANBC (Note: Nair Committee, in its Feb 2012 report recommends this to be 40 percent). Advances to micro and small enterprises sector is reckoned in computing performance under the overall priority sector target. However within advances to micro and small enterprises, RBI has put the following mandates – i)There must be 20 percent y-o-y growth in MSE lending, ii) 60 percent of the total advances to MSE must go to micro enterprises segment, and iii) there must be 10 percent y-o-y growth in the number of accounts of micro enterprises

3.2.1 Breakdown of Debt Flow by Type of Financial Institutes

As already highlighted, scheduled commercial banks account for 92 percent of formal debt flow to the MSME sector. Scheduled commercial banks comprising public banks[72], private banks and foreign banks[73] supply INR 5.9 trillion ($118 billion) debt, while smaller banks such as Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and government financial institutions such as State Financial Corporation (SFCs) and State Industrial Development Corporations provide INR 0.5 trillion ($10 billion) as debt finance (Figure 24)

Figure 24: Structure of Banking Institution[74] Supply to the MSME Sector (in INR Trillion)*

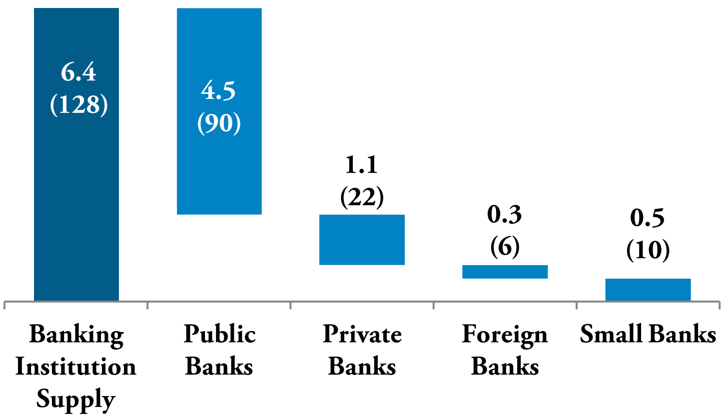


**Figure in brackets is in USD Billion*

Source: RBI; SIDBI; Sa-Dhan, Annual Reports of NBFCs; SME Times, 2010; Primary Research; IFC-Intellecap Analysis

Analysis of the MSME credit portfolios of banks suggests that all bank groups do not contribute equally to the overall MSME sector.

- Data from RBI suggests that public banks account for 70 percent (INR 4.5 trillion; $90 billion) of the banking debt to the MSME sector, while the private and foreign banks account for 22 percent (INR 1.4 trillion; $28 billion), and small banks such as regional rural banks, urban co-operative banks account for 8 percent (INR 0.5 trillion; $10 billion) of banking finance.
- The study estimates that commercial banks serve an estimated 8.4 million – 8.5 million MSMEs[75]; financial institutions such as small banks, NBFCs, MFIs and others, serve the balance MSMEs receiving formal finance. The above estimates take into account the fact that medium and small enterprises may have multiple banking relationships. This estimate is considerably higher than that of the MSME Census 2007 on the number of enterprises served, however it builds on the RBI data available on the total number of micro and small enterprise accounts currently served, and the average credit disbursed per enterprise (Refer Appendix A). Public banks serve the largest section, an estimated 6.9 million MSMEs, while other banking institutions serve an estimated 1.5 – 1.6 million units.

The reason for the variance in the banks' share in MSME debt finance is because of the inherent differences in: (a) knowledge of the MSME sector (b) size of the branch network (c) internal risk management policies and (d) operational efficiencies. These characteristics also determine the type of enterprise banks prefer to finance, the risk segment or pricing range for financial products, targeting mechanism and outreach strategy.

[72] Banks in which Government of India has majority shareholding

[73] Foreign Banks in India operate as branches of parent bank

[74] Public Sector banks are the ones which have a greater share of government(more than 50 percent) where as Private Sector Banks are those Banks where the management is controlled by Private Individuals and government does not have any say in the management of these banks. Foreign Banks in India operate as branches of parent bank. There are currently 27 Public sector banks, 23 Private sector banks and 36 foreign banks. Small banks include Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and government financial institutions such as State Financial Corporations (SFCs), State Industrial Development Corporation (SIDCs). Currently there are 83 RRBs, 1,721 UCBs, 18 SFCs and 28 SIDCs

[75] RBI, Primary Research, IFC-Intellecap Analysis

3.2.1.1 Scheduled Commercial Banks

Public Banks have a better access to MSMEs, and take the lead in lending to the sector, as compared to private and foreign Banks.

- Public banks have considerable empirical knowledge of the MSME sector, and with the increased use of core banking technology, they are able to analyze historical data on MSMEs to develop targeted products and better risk management techniques.
- The extensive branch network of public banks provides unparalleled outreach across the country – public banks account for 64.1 percent of the total bank branches in the country, providing them with a distinct advantage in terms of reach to the MSME segment (Table 16). Private and foreign banks on the other hand have a limited branch network, and tend to target MSMEs in the vicinity of existing branches, or deploy third-party agencies to increase outreach[76].
- In order to manage cost of transactions, banks prefer to finance mature small enterprises that have larger credit requirement as compared to micro enterprises.

Table 16: Statistics on Branch Network

Type of Bank	Number of Branches	Share (%)
Public Banks	55,438	64.1%
Regional Rural Banks	15,127	17.5%
Private Banks	8,877	10.0%
Urban Cooperative Banks	6,773	8.0%
Foreign Banks	293	0.3%
Total	**86,508**	**100%**

Source: Statistical tables relating to banks of India, Reserve Bank of India (2009-10)

  - Financial institutions continue to consider the branch banking model to be the best approach to relationship banking, hence, the high emphasis on an extensive branch network.
  - Although RBI has relaxed the branch licensing requirement for Tier II and below cities, not many banks are aggressively planning on branch expansion due to concerns of feasibility regarding newer branches[77] and high costs involved in setting up of these branches.
  - Traditionally, many private and foreign banks overcame the challenge of limited outreach by indirect participation through NBFCs. Banks either lent capital to NBFCs or purchased securitized assets from NBFCs that meet priority sector lending guidelines. However, under the current guidelines, indirect lending to the MSME sector through intermediaries such as NBFCs is excluded from the priority sector.

- All public sector banks, private banks and foreign banks have an internal framework to manage risk. Primary research suggests that while loan policies, prudential limits and pricing limits of all banks tend to be similar, processes such as sourcing and underwriting are varied.
  - Public sector banks adopt a branch-based multi-tiered[78] approach to source, service and monitor credit proposals. In such a system, the branch personnel are responsible for both sourcing and underwriting and the risk is managed by setting limits on the amounts approved.
  - On the other hand, most private and foreign banks typically segregate their sales and underwriting teams to manage the risk. Underwriting in such banks tends to be centralized.

[76] In terms of the BCSBI's Code of Bank's Commitment to Customers, banks which have subscribed to the Code are required to prescribe a Code of Conduct for their Direct Sales Agents (DSAs) whose services are engaged by banks for marketing their products/services.

[77] Primary Research – Interviews with Financial Institutions, Refer Annex G

[78] Elaborated in following sections

- While the comprehensive processes enable effective risk management, these processes also tend to increase the turnaround time of proposals, which is a key constraint for MSMEs that require timely access to credit.

- The focus of the private and public sector banks on efficiencies and higher profitability limits the expansion of their branch network, hindering them from reaching out to newer customer segments such as the MSMEs. Because of the limited branch network these banks have to rely on third-party agents to source customers.

3.2.1.2 Small Banks

Small banks such as RRBs, UCBs and government financial institutions such as SFCs, SIDCs have extensive potential for outreach.

- Analysis of the data on RRBs and UCBs suggests that these have a combined network of approximately 21,900[79] branches across India. RRBs cover around 525 districts across the country – their branch outreach is second only to the infrastructure of public, private and foreign banks.

- Smaller banking institutions have better knowledge of the local context and have first-hand access to information on enterprises and entrepreneurs. This means that these banks have the potential to serve a much larger MSME customer base than they are currently serving.

Despite the potential for reach, these institutions account for only 8 percent of the formal debt supply to the MSME sector. Assessments of reports [80]by the RBI suggest that these banks have certain strategic and operational challenges. These are:

- RRBs operate in smaller, resource-poor markets but tend to have organization structures and operating costs similar to that of full-service bank branches.

- RRBs face the perception of being a poor man's bank, resulting in lower deposit mobilization and increased dependence on sponsor banks.

- With borrowers wielding considerable influence over the management, resulting in a conflict of interest and weaker decision making, UCBs suffer from challenges of poor governance.

- High non-performing assets, poor credit appraisal and inadequate under-writing policies have stifled the growth of State Finance Corporations. In fact, very few of these corporations are active.

3.2.1.3 Non Banking Finance Companies

NBFCs provide an estimated INR 0.57 trillion ($11.4 billion) of debt finance to the MSME sector. The size of credit disbursed ranges from INR 0.3 million ($6000) for micro enterprises to INR 50-100 million ($1 million – $2 million) for medium enterprises[81]. A large share of the finance is used for asset purchase. Analysis of the NBFCs' MSME portfolio and primary research suggests that enterprises in transport business dominate the portfolio. Engineering, vendor supply chains and retail trade are among the other key industries served by NBFCs.

NBFCs are companies registered under the Companies Act 1956 and engaged in business of loans, leasing and hire-purchase. NBFCs function akin to a bank, with few key differences such as: (a) NBFCs are not part of the payment and settlement mechanism, i.e., NBFCs cannot issue transaction instruments such as cheques (b) NBFCs don't have the facility of deposit insurance and credit guarantee.

[79] RBI; RRB branches:15,127, UCB branches: 6773

[80] Report of the Expert Committee on Licensing of New Urban Cooperative Banks, Reserve Bank of India, 2011; Task Force on Empowering RRB Boards for Operational Efficiency 2007, NABARD

[81] Primary Research – Interviews with Non-Banking Financial Companies

NBFCs are governed by a separate set of regulations[82] with lower compliance overheads, affording them several operational advantages and the flexibility to adopt innovative business models. Key traits are:

- The operational structure of NBFCs tends to be more flexible, nimble, and cost-effective (operational costs) compared to a bank.
- The branch outreach of NBFCs is comparable to that of the combined network of RRBs and UCBs. Due to their reach, NBFCs have a better knowledge of the local context and non-financial information on entrepreneurs and enterprises.
- Armed with greater knowledge on enterprises, NBFCs are better placed to finance assets that are considered risky by conventional banks.

Although NBFCs enjoy considerably lower regulatory overheads, they experience challenges in raising debt, as all NBFCs cannot accept public deposits[83]. Hence:

- NBFCs rely heavily on commercial banks and promoter's equity for growth.
- Due to high reliance on bank financing, the cost of funds for NBFCs tends to be higher. As a result, NBFCs loans carry higher interest than those offered by banks.

NBFCs leverage their operational strengths to differentiate products and offer personalized service. Also, these require relatively less documentation, process loan applications faster and allow flexible collateral options. Primary research suggests that niche NBFCs tend to use immovable property and hypothecated assets as collaterals, while some larger NBFCs also offer collateral-free finance, based on the cash flows and financial performance of the beneficiary enterprises.

[82] Section 45-IA/B/C of the RBI Act, 1934

[83] Only those NBFCs holding a valid Certificate of Registration with authorization to accept Public Deposits can accept/hold public deposits. The NBFCs accepting public deposits must have minimum stipulated Net Owned Fund/Promoter Equity and comply with the Directions issued by the Reserve Bank of India

3.2.1.4 Micro Finance Institutions (MFIs)

Microfinance institutions are often incorporated as NBFC-MFIs, and are mostly active in the unregistered and unorganized microenterprise segment. MFIs are gradually scaling up from providing individual loans to providing business loans for micro enterprises. The average size of credit disbursed by MFIs ranges from INR 0.015 million ($300) to INR 1 million ($20,000) per enterprise[84]. Primary research suggest that MFIs accept immovable property such as land, building and/or hypothecated assets as collateral.

- MFIs have extensive fleet-on-street structures for ground operations that enable them to reach unserved regions.
- With extensive outreach and experience in joint-liability operations[85], MFIs often have a better understanding of the enterprise potential and financial performance, helping them in their customer acquisition strategies.

The study estimates that MFIs supply INR 0.02 trillion ($0.4 billion) of debt to the micro enterprise segment. In line with broad sector financing trends, short-term working capital accounts for a larger share of the portfolio. Despite the huge market potential, the current activity of MFIs is limited due to constraints in accessing capital and other stringent regulatory requirements.

MFI activity in micro enterprise financing is limited to loan sizes of INR 0.05 million ($1,000), or less, due to recent changes in the regulation. The new regulations for MFIs require them to be structured as MFI-NBFCs, which will not have more than 15 percent of the loan portfolio in loan assets of INR 0.05 million ($1,000) and above. In other words, 85 percent of the loan portfolio of MFIs must comprise loan assets, specifically for income generating activities and not exceeding the INR 0.05 million ($1,000) limit.

[84] Report on financial performance of Indian MFIs, Sa-Dhan, 2010; Primary Research – Interviews with Non-Banking Financial Companies

[85] A Joint Liability Group (JLG) is an informal group comprising preferably of 4 to10 individuals but can be up to 20 members, coming together for the purposes of availing loan either individually or through the group mechanism against mutual guarantee. The JLG members would offer a joint undertaking to the bank/MFI that enables them to avail loans.

3.2.2 Breakdown of Debt Flow by Enterprise Size

The current flow of debt finance is uniformly distributed across micro, small and medium enterprises. Based on the analysis of the data from RBI and other financial institutions, debt channeled to micro, small, and medium enterprise segments respectively is estimated to be INR 2.15 trillion ($43 billion), INR 2.4 trillion ($48 billion) and INR 2.42 trillion ($48.4 billion) (Figure 25).

Figure 25: Debt Supply in Micro, Small and Medium Enterprise Segments (in INR trillion)*

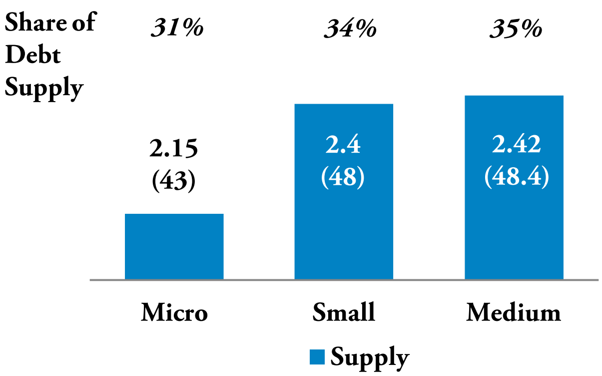


**Figure in brackets is in USD Billion*

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

The above data suggests that although micro enterprises have the largest demand, financial institutions prefer serving the small and medium enterprise segment. Higher average debt demand and lower cost of transactions makes small and medium enterprises more attractive to formal financial institutions.

- Analysis of debt finance flow suggests that a micro enterprises on an average gets disbursed a debt of INR 0.15 – 0.3 million[86] ($3,000 – $6,000), while average credit disbursement for small enterprises is INR 1.5 – 3.5 million[87] ($30,000 – $70,000).
- Limited data is available to estimate average credit provided to medium enterprises. However, primary research suggests that average disbursement is approximately INR 40 million – 50 million[88] ($0.8 – 1 million).
- A comparison of the average finance demand of a micro or small enterprise, and the average disbursement shows that the formal financial sources meet only 40 to 60 percent of the actual requirement of these enterprises. The shortfall exists in both short-term and long-term financing. However, unlike micro and small enterprises, most medium enterprises are adequately financed by formal financial institutions.
- One of the reasons why formal finance is limited is because enterprises are not able to provide adequate collateral to secure the loan. Financial institutions typically calculate the value of loan sanctioned as a ratio to the value of the collateral available. Data from banks suggests that 98 percent of the MSME portfolio of banking institutions is secured by tangible assets[89].

[86] RBI, Statistical Tables Relating to Banks of India, IFC-Intellecap Analysis, Primary Research

[87] RBI, Statistical Tables Relating to Banks of India, IFC-Intellecap Analysis, Primary Research

[88] Primary Research – Interviews with Financial Institutions

[89] RBI, CGTMSE, Primary Research

3.2.3 Breakdown of Debt Flow by Type of Enterprise

The flow of debt finance provided to the manufacturing and services sectors respectively is estimated to be INR 3.85 trillion ($77 billion) and INR 3.12 trillion ($62.4 billion). Although one would expect that debt offered to the services sector is lower as financial institutions do not have access to any financing benchmarks similar to those in manufacturing sector, Nayak Committee Recommendation[90] data suggests that the services sector in fact accounts for 45 percent of the total debt (Figure 26).

Figure 26: Debt Supply in Manufacturing and Services Sectors (in INR trillion)*

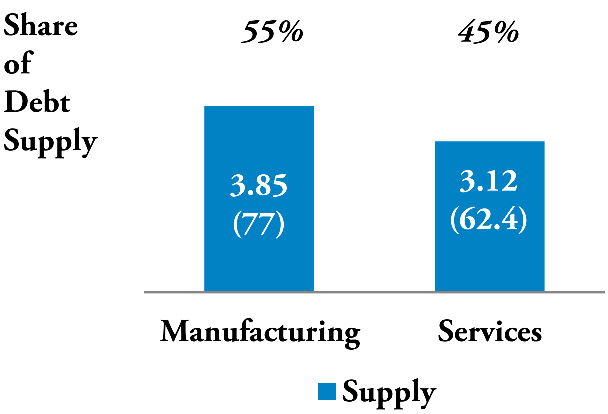


**Figure in brackets is in USD Billion*

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

- RBI data and primary research suggests that a manufacturing enterprise on an average gets debt of INR 0.85 million ($20,000). Food processing, basic metal and metal products, textile and chemicals products receive the majority of debt that gets channeled to the manufacturing sector.
- Only 50 percent of the average demand of a manufacturing enterprise is met, suggesting that many manufacturing enterprises remain underserved.
- Although the manufacturing sector still accounts for a large share of debt by volume, growing at a compounded annual growth rate of 20 percent a year, it is still lower than the overall sector average of 30 percent. This suggests that financial institutions are slowly shifting to financing the service sector.
- Manufacturing enterprises that operate in clusters are relatively better informed on formal sources of finance than the services enterprises, which are generally dispersed.
- Estimates indicate that a services enterprise on an average gets around INR 0.55 million ($11,000). Traditional services business such as restaurants, small transport operators, and small water transport operators are the main beneficiaries of formal credit uptake because financial institutions have developed a good understanding of these industries over the years.
- Traditional services businesses tend to have significant primary security/asset or collateral to secure financing. Transport operators for example have trucks that can be pledged as primary security.
- The study estimates that formal financial institutions meet approximately 40 to 70 percent of the debt demand of an enterprise, forcing enterprises to resort to informal sources to finance the gap.
- Currently, the volume of formal debt in the services sector is lower compared to the manufacturing sector. Including retail trade in priority sector lending is one reason why the services sector is seeing increasing credit inflows (an estimated INR 0.5 – 0.6 trillion or $10 – 12 billion).
- Knowledge-based enterprises such as software companies, management consultants and human resource consultants get far lower debt finance than traditional services businesses. That is because financial institutions have yet to develop appropriate risk assessment frameworks to assess such enterprises and most such units require finance primarily to cover manpower costs. Moreover, knowledge-based enterprises tend to have limited collateral to secure financing.

[90] The committee constituted in 1991 by the RBI recommended that working capital requirement of an small scale enterprise can be estimated to be 25 percent of the annual turnover of the enterprise

3.2.4 Breakdown of Debt Flow by Region

Low--Income States (LIS)93 and North-eastern States (NES) jointly receive only 17 percent of the debt finance, respectively getting INR 1.08 trillion ($21.6 billion) and INR 0.1 trillion ($2 billion) (Figure 27).

Figure 27: Debt channeled in LIS, NES and RoI (in INR trillion)*

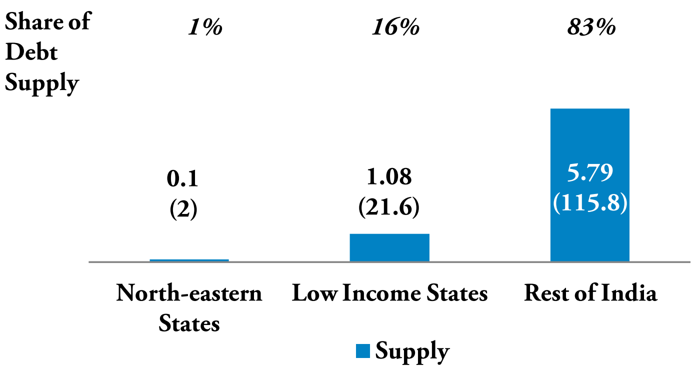


**Figure in brackets is in $billion*

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

The current distribution of debt across LIS, NES and Rest-of-India, can be explained by the differences in banking infrastructure, level of industrialization and the nature of MSMEs in each of the regions. A few noteworthy characteristics are:

- An analysis of the banking infrastructure in LIS, NES and Rest–of-India (Figure 28) shows that banking outreach is significantly lower in the LIS and NES regions, primarily due to operational challenges such as security, political environment, and less developed physical infrastructure.
- Primary research suggests that like commercial banks, the footprint of non-banking institutions and MFIs is also lower.
- With 9,658[91] branches (12 percent share of branches), Uttar Pradesh has the largest network across the country. However, the credit-to-deposit ratio in the state remains low at 41 percent[92], indicating either a lower preference for formal financing, or limited financial awareness among the enterprises and entrepreneurs about financial products to meet enterprise needs (Uttar Pradesh ranks in the bottom quartile of states with lower overall literacy[93]).
- Penetration of banking in NES has been constrained by operational challenges such as sparse population, infrastructural bottlenecks, particularly transport, and poor law and order conditions. In addition, the region has low commercial activity and lower demand for finance.
- The literacy levels in NES and LIS are low[94], and so is the awareness about banking and payments services.
- As pointed out in earlier sections, both the LIS and NES regions have low industrialization, and hence service-oriented enterprises focusing on retail trade, hospitality and transport are dominant in the region. This results in low average demand, because of which financial institutions find it difficult to serve such enterprises profitably.
- The Four top states –Maharashtra, Tamil Nadu, Delhi and Karnataka – account for 28 percent of all MSMEs in India, claiming 58 percent[95] of the overall debt, and 70 percent[96] of the debt channeled in the Rest-of-India region.

[91] RBI

[92] RBI

[93] Census, 2011

[94] Census, 2011

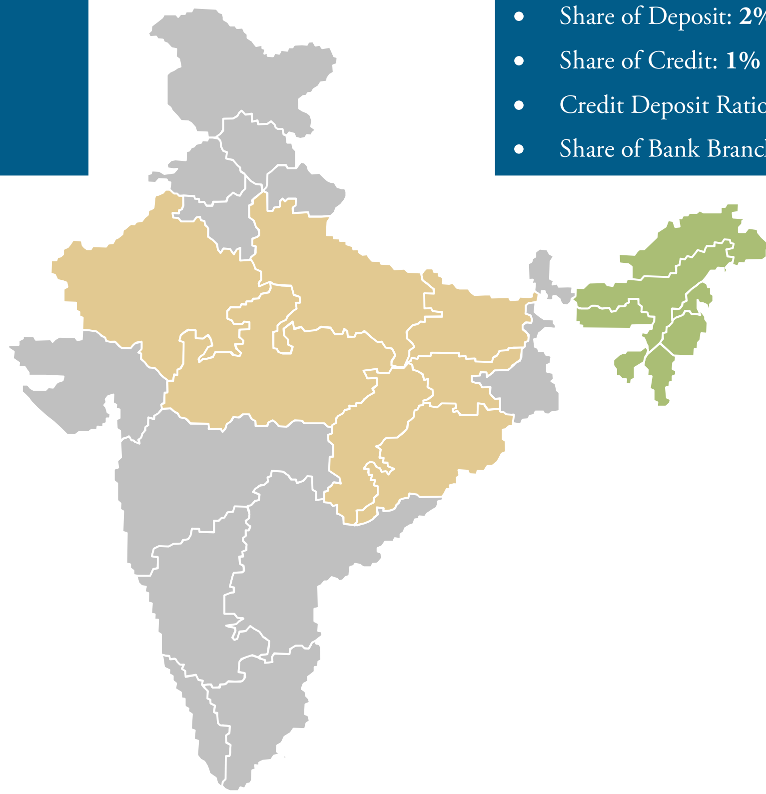
[95] Statistical Tables relating to Banks of India, RBI, IFC – Intellecap Analysis

[96] Statistical Tables relating to Banks of India, RBI, IFC – Intellecap Analysis

Figure 28: Banking Infrastructure in LIS, NES and RoI

- Share of Deposit: **18%**
- Share of Credit: **14%**
- Credit Deposit Ratio: **51%**
- Share of Bank Branches: **29%**

- Share of Deposit: **2%**
- Share of Credit: **1%**
- Credit Deposit Ratio: **33%**
- Share of Bank Branches: **2%**



Low income states

North Eastern states

Rest of India

Rest of India

- Share of Deposit: **80%**
- Share of Credit: **85%**
- Credit Deposit Ratio: **64%**
- Share of Bank Branches: **69%**

Source: MSME Census; SIDBI; Primary Research; IFC – Intellecap Analysis

3.3 Equity Finance Flows to the MSME Sector

It is estimated that a total of INR 0.03 trillion[97] ($0.6 billion) is directed to the MSME sector by way of equity financing. Most of the enterprises in the sector are proprietorships and partnerships that do not allow for infusion of equity. In addition, equity investors require a high level of operational and financial transparency, which is lacking in a significant number of MSMEs. In sum, there are several legal challenges that constrain the small and micro enterprises from getting equity capital. Consequently, it is primarily the mature small and medium enterprises that are the beneficiaries of equity capital financing.

[97] SME Times, SIDBI, IFC-Intellecap Analysis, Primary Research

SIDBI Venture Capital Limited, along with a few private equity firms, is currently leading the supply of equity capital to the sector. In the General Budget of 2012-13, the Government of India announced the intention to set up an INR 50 billion ($1 billion) India Opportunities Fund through the Small Industries Development Bank of India (SIDBI). The proposed fund is expected to enhance the availability of equity for MSMEs. The fund could also potentially encourage private sector funds to participate and innovate in setting up equity/debt funds specifically targeting the MSME sector.

3.3.1 Challenges in Equity Financing

Equity investment in MSMEs is difficult not only because of legal constraints already highlighted, but also because of significant operational challenges involved in managing MSME-focused funds, which include:

- Size of investment deals is typically quite small, and there is a lack of adequate information on the market segment as well as on individual enterprises. Hence a high level of due diligence is required, which increases the transaction cost and is not always commensurate with potential returns.
- In the absence of credible data and information, accurate valuation of enterprises becomes difficult.
- The failure rate of enterprises in this segment tends to be high, significantly increasing risk for investors.
- Options for exit from the MSME segment are limited, and there have been few actual exits[98] in this sector in the past.

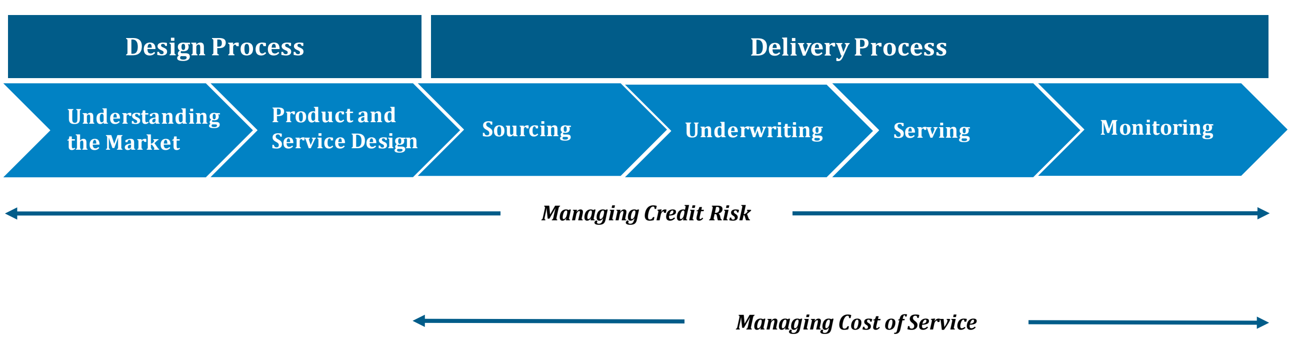
3.4 MSME Finance Process Flow and Challenges

Although the process of providing debt and equity capital for financing the MSME segment is not a lot different from that followed for other segments, yet investors need to have differentiated product and marketing strategies for the sector. This is to factor in the heterogeneity and risk inherent in the MSME sector.

3.5 Typical Debt Finance Process and Challenges

The process for debt finance to the MSME segment comprises the following: (a) understanding the market (b) product and service design (c) sourcing (d) underwriting (e) serving and (f) monitoring (Figure 29).

Figure29: MSME Debt Finance Process Flow



Source: IFC-Intellecap Analysis

[98] Primary research – Interviews with Venture Capitalists and Private Equity Firms

3.5.1.1 Understanding the Market

The MSME sector is extremely heterogeneous and the market needs to be segmented beyond the size criterion of micro, small and medium enterprises.

- Financial institutions can use several parameters such as area of operation, industry segment, vintage, legal structure, cluster operations to identify sub-segments that can be effectively served by leveraging institutional strengths.
- Most of the MSME data is centered around the MSMED Act definition of the sector that sheds little light on the financial appetite of an enterprise. Financial institutions need to go beyond aggregate data to obtain granular information on the target market and identify segments that can be effectively served given the strengths and weaknesses of the respective financial institution.

Figure30: Current Practices and Challenges in the Design Process

Design Process	Understanding the Market	Product and Service Design
Current Practices	• Conventional strategies adopted to segment the market • Local branches responsible for market assessment • Limited sub-segmentation of the market • Smaller institutions have better understanding of niche markets	• Design process tends to be centralized in large institutions • Institutions operate in specific risk segments – avoid high risk assets • Product portfolio more inclined towards fund-based products • Smaller institutions design innovative collateral and customized products
Challenges	• Significant upfront investment required for market assessment vis-à-vis portfolio size • Difficulty in obtaining information on enterprises	• Regulatory emphasis on volume growth • Higher historic non-performing assets • Limited information infrastructure – credit bureau, collateral registry • Limited financial strength of small institutions and absence of credit guarantee support

Source: IFC-Intellecap Analysis

Current Practices

- Public sector banks continue to use the conventional MSMED Act definition of the sector and target the enterprises based on the investment in assets. Private financial institutions on the other hand tend to use internal definitions based on revenues, loan size, and employee strength, among others to target customer segments[99].
- Not many financial institutions have specific MSME strategies in place that are based on strategic data analysis and sub-segmentation of customers (Figure 30). Most institutions use a branch-based approach to identify and target the MSME market, with local branches taking on the responsibility of assessing the MSME potential within their geographical vicinity.
- NBFCs typically develop an understanding of niche MSME segments and develop financial products tailored for those segments, for example, small transport operator asset loans, and machine tool finance loans. NBFCs tend to use the fleet-on-street model to develop both market intelligence, and as a means of sourcing.

Challenges

- Inconsistent definitions and limited documented data on the MSME sector make segmentation and analysis extremely difficult, making it challenging to target the specific needs of the sector.

3.5.1.2 Product and Service Design

The process of product and service design is closely linked with understanding the market. Most financial institutions identify enterprises in the vicinity of branches and use rule-of-thumb to address the financial needs of micro and small enterprises. Instead, information about key business drivers and cash flow cycle could better help financial institutions develop targeted products and services. In the absence of quality data on enterprises, financial institutions tend to offer standardized products and services to select sub-sectors within the MSME sector.

The current product and service portfolio of financial institutions includes both fund-based and non-fund based products. Parameters such as interest rate, collateral requirements and repayment cycle are all evaluated while designing products. Demand from the MSME segment is sensitive to each of these parameters. For instance, a frequently quoted constraint, of a 1 percent fee on a bank guarantee that is charged by banks can often be difficult for a small enterprise to service.

[99] Private banks use internal definition to source MSME assets, later the MSMES assets that comply with the MSMED Act definition are reported to the RBI as PSL compliant assets

Fund-based products account for an estimated 80 percent[100] (Table 17) of the current flow of formal finance to the sector.

Table 17: List of Key Fund-Based Products Offered to the MSME Sector

Products	Financial Institution	Tenure	Collateral	Credit Size Limit[101]
Overdraft*	Commercial Banks	1 year; revolving credit, renewed annually	Primary Security – Hypothecation of stocks in trade and receivables Collateral Security – A minimum value of the loan amount in the form of mortgage of immovable property and/ or other liquid security	50% – 60% of the amount of receivables
Cash Credit*	Commercial Banks	3 months – 1 year; revolving credit, renewed annually	Primary Security – Hypothecation of stocks in trade and receivables Collateral Security – A minimum value of the loan amount in the form of mortgage of immovable property and/ or other liquid security	50% – 60% of the amount of receivables
Short-Term Loan	Commercial Banks NBFCs	3 months – 1year; revolving credit, renewed annually	Mortgage of fixed assets such as land, building, factory	-
Long-Term Loan	Commercial Banks NBFCs	1-5 years	Mortgage of fixed assets such as land, building, factory	60-80% of the cost of the collateral
Asset-Based Financing	Commercial Banks NBFCs	3-7 years	Secured by an asset (e.g., a purchase order, contract, accounts receivable, invoice, letter of credit, inventory, machinery, equipment	80-90% of the cost of asset
Credit Cards*	Commercial Banks	1-3 years	No collateral required, only a third-party guarantee for a lower limit on the card, and hypothecation of stock in trade, receivables, machinery, office equipment etc. for an upper limit (beyond INR 0.5 million)	Maximum limit of INR 1 million

Source: Primary Research, IFC – Intellecap Analysis

**These financial products are provided only by scheduled commercial banks*

[100] Primary research – Interviews with Scheduled Commercial Banks

[101] Credit size limit varies with the bank type, product type, tenures and the credit history of the enterprises– the figures given are the average approximated figures

The list of non-fund based products offered by financial institutions is provided in Table 18.

Table 18: List of Key Non-Fund Based Products Offered to MSME Sector

Product	Financial Institution	Description
Letter of Credit	Commercial Banks NBFCs	Letter of Credit is extended to MSMEs and is mostly used by export-oriented MSME units; however importers too are increasingly making use of products like 'Buyer's Credit'. Credit is available for procuring raw material, manufacturing the goods, processing and packaging and shipping the goods. Letters of credit are available against 25%-35% cash margin and mostly on a 100% collateral security in the form of residential property, corporate guarantees or liquid securities
Bank Guarantee	Commercial Banks NBFCs	Bank Guarantees are extended for advance payment, tender money security deposit, for getting orders, for procurement of raw materials among others.
Current Account	Commercial Banks	Commercial banks provide the facility of the current account transaction to their MSME customers. The MSME units have to maintain a quarterly average balance in their current accounts. The transaction is permitted in cash, transfer and clearing. Banks also provide internet banking facility to MSME units on these accounts.
Savings Account	Commercial Banks	A few of the banks also provide savings accounts to the MSME units. An enterprise has the flexibility to choose the period of deposit from 1 year to 3 years. Surplus funds over a threshold limit with an initial deposit of certain amount is automatically swept (auto-sweep) to Corporate Liquid Term Deposit (CLTD). The rate of Interest for CLTD will be the card rate applicable for the contracted tenure of the deposit. No differential rate of interest is applicable. However, no Loan /Overdraft Facilities are available under the scheme.
Remittance	Commercial Banks	Most of the banks provide electronic modes of retail payment to the MSMEs through National Electronic Fund Transfer (NEFT) and large value settlements through the Real Time Gross Settlement (RTGS) application

Source: Primary Research, IFC – Intellecap Analysis

Primary research suggests that many entrepreneurs in the micro and small enterprise segment tend to use personal saving and credit accounts for enterprise needs. As a result, the entrepreneurs' individual accounts work as an enterprise account in many cases.

Current Practices

- Discussions with large banking institutions indicate that products and services are designed at the head office and later pushed out to the branch network for distribution. This observation is consistent across all bank groups – public, private and foreign.
- The product design parameters such as interest rate and collateral dictate the risk segments in which financial institutions choose to operate. For instance, many financial institutions are uncomfortable lending at rates higher than 16 percent a year, even on a risk-adjusted basis. Instead, financial institutions choose not to finance enterprises that require a higher risk premium.
- Analysis of product and service offerings of financial institutions shows that there is limited innovation with regard to products and services. Almost all financial institutions offer conventional fund-based products that are similar in nature, with some variations in interest rate and collateral requirement or type of collateral.
- Small financial institutions such as NBFCs are more flexible in their approach and tend to innovate. For example, some NBFCs will accept the client's 'reputation' as collateral while others focus on financing based on cash-flow in place of pure collateral–based lending.

Challenges

- Products and services for MSMEs often need significant collateral to back them up as a way to manage both the inherent risk in this sector, as well as the high transaction cost of serving this segment. However, the majority of enterprises/entrepreneurs do not have access to sufficient levels of collateral.
- Financial institutions have limited information required to determine the specific needs of enterprises for various products.

3.5.1.3 Sourcing

The cost of acquiring and serving MSMEs is high as these enterprises are small, geographically dispersed and have a low average demand per enterprise as compared to large enterprises. The effort and cost required to source a micro enterprise client is the same as that for a medium enterprise. As a result, financial institutions prefer to serve a larger number of small and medium enterprises than micro enterprises.

Current Practices

- The preferred customer acquisition strategies of financial institutions include: (a) targeting existing current account customers and converting them to credit customers, (b) sourcing referrals from existing customers, (c) instituting a dedicated sales team at a branch, (d) using direct sales agents (DSA) and, (e) mass marketing initiatives (Figure 31).
- What happens in many cases is that financial institutions repeatedly target the existing good customers with the result that same customers get access to multiple lines of credit. So in a way, there is no attempt to actually expand the market. In order to discourage this, priority sector lending guidelines require banks to increase the number of micro enterprise borrowers served each year, at the rate of 10 percent annually[102].
- Banks that do not have adequate branch outreach hire services of third-party-agencies (TPA) or direct-sales-agents (DSA) to source customers.
- Financial institutions also use mass marketing platforms such as seminars, workshops and trainings to reach enterprises; such fora also allow banks to gather information on potential customers.

Challenges

- The priority sector lending requirements compel banks to focus on increasing the number of unique enterprises served each year, instead of cross-selling newer products to existing customers.

[102] Prime Minister's Task Force on MSMEs Chairman: Shri. T.K.A.Nair, Principal Secretary, Government of India; Empowering MSMEs for Financial Inclusion and Growth – Role of Banks and Industry Associations, K C Chakrabarty, 2012

Figure 31: Sourcing and Underwriting in MSME Debt Process Flow

Delivery Process	Sourcing	Underwriting
Current Practices	• In-house information on existing customers is leveraged • Usage of technology platforms such as internet • Use Direct Sales Agents (DSA) to create physical outreach • Dedicated "fleet-on-street", sales team, call centre deployed	• Branch-based model – common sales and underwriting teams • Segregation of underwriting and sales teams • Focus on financial information for risk assessment ; limited focus for non-financial information • Small institutions leverage local knowledge to design innovative risk
Challenges	• Limited branch infrastructure • High cost of branch operations • Higher transaction cost in DSA model, limited avenues of customer relationship building, and poor quality of leads • Limited information on financial needs of enterprises • Limited capacity of existing branchless banking	• Underwriting process similar in length and complexity regardless of enterprise size or debt requirement • Information asymmetry in the enterprise data • Limited support of information infrastructure • Limited access to tailored assessment tools to overcome opaqueness in information

Source: IFC-Intellecap Analysis

- Limited branch banking infrastructure increases the cost of acquisition for financial institutions, particularly in rural areas that have almost half of the MSME enterprises.
- Branchless banking initiatives such as Business Correspondents are currently not skilled enough to support banks in sourcing micro and small enterprise accounts.
- While TPA/DSA channels increase outreach, these channels are expensive and cost financial institutions an estimated to 1-1.5 percent[103] of the loan value.
- TPA/DSA models limit the ability of financial institutions to build strong customer relations or control the quality of debt applications sourced.
- Technology channels such as internet, mobile and phone banking have potential, but the off take is negligible due to poor connectivity, low awareness among entrepreneurs and entrepreneur's preference for personalized banking service.

[103] Primary Research

3.5.1.4 Underwriting

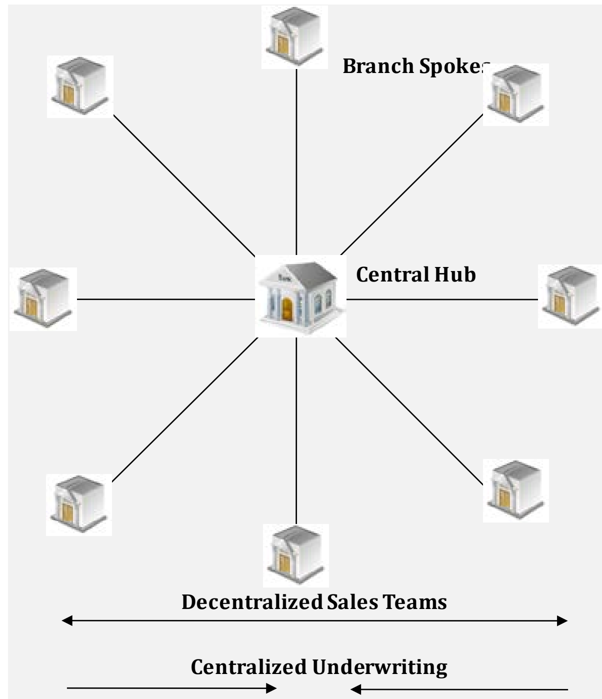
Underwriting involves diagnosis of financial performance of enterprises and assessment of risk associated with them. Information asymmetry in the MSME sector makes underwriting a challenging task for financial institutions.

- Financial institutions tend to assess MSMEs largely on the basis of financial performance. While this practice saves costs, it also increases the chances of rejecting the credit application.
- Instead of relying solely on financials to assess creditworthiness of enterprises, financial institutions can use assessments that incorporate softer parameters such as entrepreneur background, relationship with customers and suppliers, and the psychometric profile of entrepreneurs. However, it is worth noting that while soft information may address the issues of asymmetry, it also carries the risk of increasing the cost.

Current Practices

- Some of the approaches that financial institutions use to manage underwriting process are: (a) centralized underwriting – segregated sales and underwriting teams, (b) decentralized underwriting process and, (c) tiered underwriting process based on credit limits, i.e., each lower branch can approve credit up to a certain limit, everything above the specified limit is underwritten by the higher branch.
- Centralized underwriting (Figure 32) segregates the sales and assessment teams. This approach allows the sales teams to further prospect the market while underwriting is in progress and minimizes the chances of poor initial risk assessment by sales teams. A centralized approach could result in longer turnaround time, but financial institutions use simpler assessment frameworks to reduce the turnaround time.

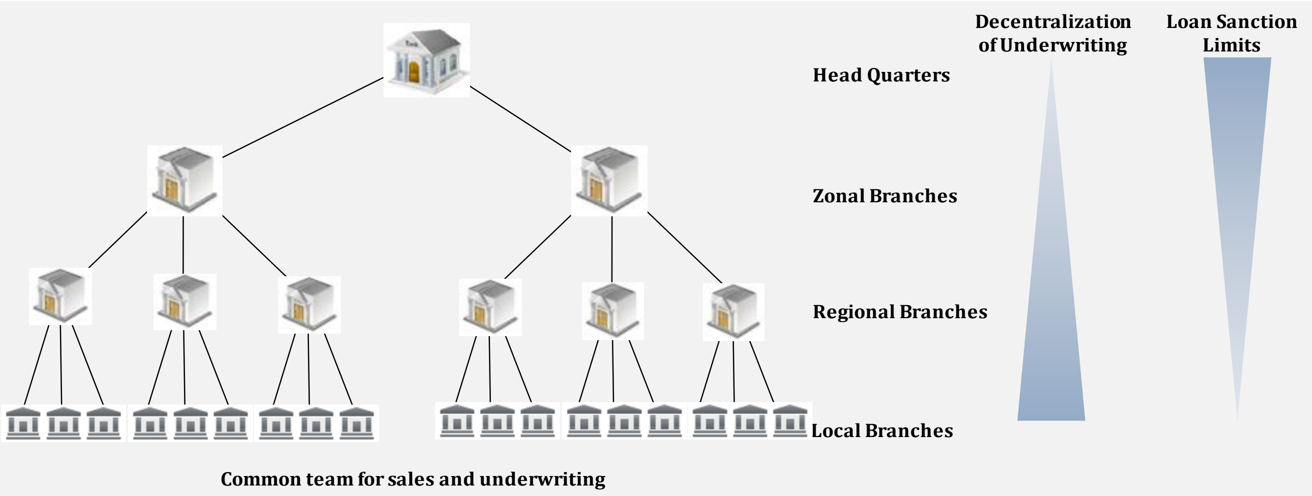
Figure 32: Schematic of Centralized Underwriting



Source: IFC-Intellecap Analysis

- In the decentralized approach (Figure 33), bank branches are responsible for both credit appraisal and sanction of loans of a particular size. The key assumption in this approach is that branches have better information on the local business environment, and are in a position to appraise applications quickly. This approach is most commonly followed by public banks and a few private banks.
- The tiered approach is similar to the decentralized approach, with the difference that bank branches at lower levels are allowed to approve credit up to a certain limit. For credit demand above a particular limit, the case is transferred to higher/larger branch, building in more scrutiny for higher value credit proposals.

Figure 33: Schematic of Decentralized Underwriting



Source: IFC-Intellecap Analysis

Challenges

- In many financial institutions the underwriting process is similar in length and complexity regardless of the size of enterprise or credit requirement.
- Lack of any documented financial information is one of the major challenges in the underwriting process. Financial institutions find it difficult to corroborate the financial information provided in credit proposals. In addition, non-financial and subjective psychometric information is used to a limited extent in risk assessment and underwriting.
- Financial institutions also have limited access to relevant credit information on MSMEs – the commercial credit bureau is still relatively nascent, particularly with regard to credit information on MSMEs. The collateral registry is currently focused on fixed property or real estate. In fact, the current collateral registry does not consider movable assets (other than receivables as part of factoring transactions), which are more readily available to small businesses in the services sector.
- In the absence of reliable credit information, financial institutions are unable to optimize the use of core banking technology infrastructure and customer-relationship management systems.
- Protracted and expensive default settlement also compels underwriters to take a more conservative approach in assessing risky assets. Although the legal framework is evolving to protect creditors through legislation such as the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI), which provides default protection, the enforcement process still tends to be prolonged and expensive.

3.5.1.5 Service Delivery

A financial institution begins the relationship with an enterprise at disbursement stage, which is either on-demand or in tranches, requiring multiple transactions.

Financial institutions find it challenging to manage transaction and operating costs (including manpower costs) as the credit size tends to be low.

Figure 34: Serving and Monitoring in MSME Debt Process Flow

	Delivery Process	
	Service Delivery	**Monitoring**
Current Practices	• Branch-based service model is dominant among large institutions • Branch managers or relationship managers are key touch points • ATMs deployed to limited extent – used sparingly • Technology channels such as internet, phone banking deployed • Small institutions rely more on "fleet-on-street", model for service	• Institutions have internal monitoring frameworks • Combination of technology and human intervention used • Institutions manage data on core-banking system • Core-banking systems monitors and flags irregularities in asset accounts
Challenges	• Branch outreach is limited – results in lost opportunity and/or increases cost of access for enterprises • Uptake of technology is limited • Capacity of branchless banking is limited • Transaction cost and operational cost of conventional delivery channels for banks is high	• Discipline at branch level to proactively manage poorly performing assets • Limited emphasis on data analytics • Time of branch level function is split across multiple business lines • Monitoring also tends to be weak due to intermediation of third parties such as TPA/DSA

Source: IFC-Intellecap Analysis

Current Practices

- Branches of financial institutions are where most of the transactions for enterprises take place; this requires entrepreneurs to make frequent visits to the branch.
- Several banks have set up branches and cells specifically for MSMEs to manage MSME relationships more proactively (Figure 34).
- Financial institutions also deploy technology by way of Automatic Teller Machines, Internet Banking, and Phone Banking so as to reduce the cost of transactions and the need to visit the branches.

Challenges

- As branch banking is the most expensive form of transactions, frequent transactions of small sizes makes these unviable for banks.
- Demand for relationship banking implies good branch outreach, however branch expansion involves significant capital cost.
- Conventional service channels such as bank branches and ATMs are expensive. Cost of one bank transaction works out to INR 50 – INR 60[104] ($1 – $1.2), and cost of one ATM transaction is estimated to be INR 20[105] (USD 0.2). MSMEs tend to need smaller and more frequent transactions, pushing up the cost of MSME financing.

3.5.1.6 Monitoring

Effective monitoring is essential to manage the asset quality and capture critical data that can be leveraged for future credit assessment of MSME clients. Through monitoring, financial institutions can positively impact portfolio quality, allowing for early warning of potential default.

Current Practices

- Financial institutions use information technology solutions such as core-banking to monitor disbursal and repayments. The system is designed to flag early warning signals in case of delayed payments and exceptional transactions.
- Based on the data warning, branch personnel are expected to work with enterprises to resolve issues ailing the enterprise.

Challenges

- The current monitoring process requires considerable amount of human intervention to supplement the technology platform; in many cases, lack of proactive portfolio monitoring by branch personnel prevents the detection of an asset turning into an NPA.
- Branch personnel are constrained for operational bandwidth which may result in oversight. Banks are experimenting with MSME-specific branches to ensure dedicated attention to this business.
- Monitoring also tends to be weak on many occasions due to intermediation by third-parties such as TPA/DSAs.

[104] Hindu business line, 2004

[105] ATM India.com

3.5.1 Equity Finance Process Flow and Challenges

The process for equity finance is similar to debt (Figure 35), comprising six stages: (a) screening (b) due-diligence (c) valuation & deal structuring (d) monitoring, and, (e) exit.

Figure 35: Equity Finance Process Flow[106]

Source: IFC-Intellecap Analysis

3.5.1.1 Screening

The screening stage mainly involves broad assessment of the enterprise's investment-worthiness, based on parameters such as market potential of the product or service, product and service differentiation, entrepreneur's profile and track record, management profile and fit with the investment philosophy of the investor. Enterprises that fit the investment criteria are then put through the due-diligence process.

Unlike large enterprise investments, the potential deal flow in the MSME sector is limited. A large number of enterprises, particularly micro and small enterprises, are not equipped to deal with the demands of equity investors. Legal challenges aside, other issues such as dilution of control, management freedom and vision also limit the number of enterprises that seek external equity. Primary research suggests that only mature small and medium enterprise have the ability and appetite to absorb external equity.

3.5.1.2 Due-diligence

The due-diligence process is similar to the underwriting process in banking institutions. It is an assessment of the enterprise's financial performance, growth potential and scalability. The process takes into account not only the current and expected future financial performance, but also the future growth potential, and the potential for upside that an investor could realize. Due-diligence is an expensive process as it consumes significant amounts of the fund managers' time and financial resources.

The potential deal size in the MSME sector tends to be smaller than in the large enterprise segment, as a result of which extensive due-diligence can be unviable.

[106] Equity investment funds are regulated by the Securities Exchange Board of India (SEBI).

3.5.1.3 Valuation and Deal Structuring

The equity value of an enterprise is determined through an extensive financial valuation process. The valuation process is followed by deal structuring that lays down the flow of funds, investor rights, control structure, and potential exit avenues, among many other clauses to cover the investor risk.

Valuation of MSMEs is challenging as the sector is heterogeneous in terms of geography, industry of operations and legal structure. In addition, there is a lack of reliable benchmarks to validate valuation of an enterprise.

3.5.1.4 Monitoring

Unlike banking institutions that adopt a hands-off approach once they have provided credit to an enterprise, most investment funds in the sector adopt a relatively hands-on approach. A fund typically nominates a director on the Board to monitor and participate in the strategic decision-making process of the enterprise, with a clear focus on supporting the growth of the enterprise and maximizing investment returns. Hence monitoring in the case of equity finance is far more rigorous than with debt finance for the MSME sector.

3.5.1.5 Exit

Owing to the small size and low maturity of MSMEs, equity investors tend to have limited options for exit. Field interviews with investors suggest that secondary sale is the most widely used exit route by investment funds. This is also a significant constraint to equity infusion in the sector.

In order to increase the avenues of equity financing for MSMEs, and provide potential exit opportunities for investors, government and regulators have facilitated the formation of the SME Stock Exchange. Both the Bombay Stock Exchange and the National Stock Exchange have set up SME exchanges expecting that at least ten enterprises list on the bourse.

Although setting up of the SME Stock Exchanges is a step in the right direction, the cost of initial public offer, valuation concerns and limited deal flows may continue to present challenge for equity investors.

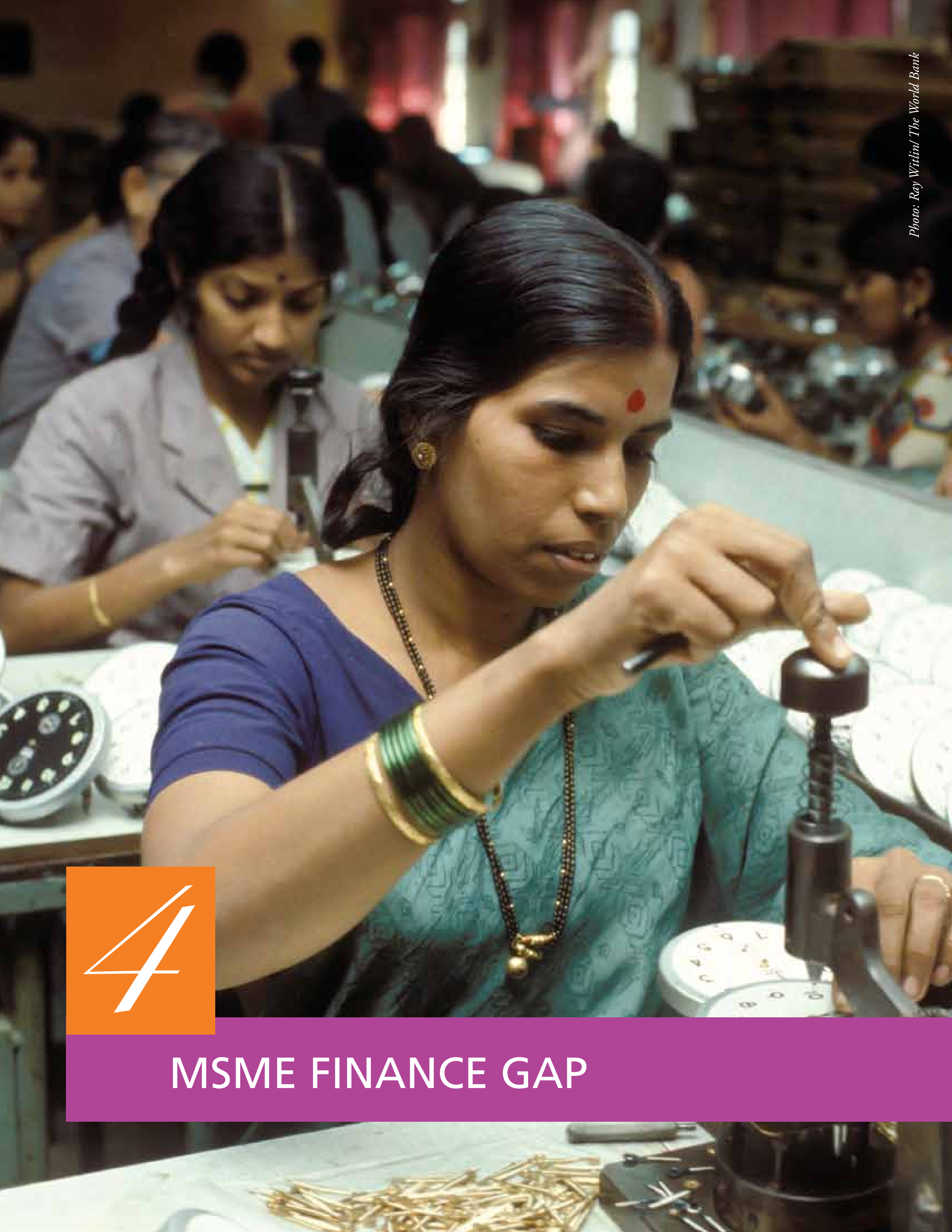


Photo: Ray Witlin/ The World Bank

4

MSME FINANCE GAP

FINANCE GAP IN THE MSME SECTOR

The overall finance gap in the MSME sector is estimated to be INR 20.9 trillion ($418 billion). The potential demand for external finance is estimated to be INR 27.9 trillion ($558 billion), while the total finance channeled by formal sources is estimated to be INR 7 trillion ($140 billion). The overall finance (debt and equity) gap of INR 20.9 trillion ($418 billion) is split into a debt gap of INR 19 trillion ($380 billion) and an equity gap of INR 1.9 trillion ($38 billion) (Figure 36).

The potential demand is estimated to be INR 27.9 trillion ($558 billion), after excluding entrepreneur's own contribution towards capital expenditure and working capital finance (INR 4.6 trillion; $92 billion). Entrepreneurs finance this need through internal accruals, or by leveraging personal resources. Studies[107] on the MSME sector suggest that entrepreneurs contribute approximately 25 percent of capital expenditure demand and 20 percent of the working capital finance demand.

Figure 36: Overall Finance Gap in MSME Sector (in INR Trillion)*

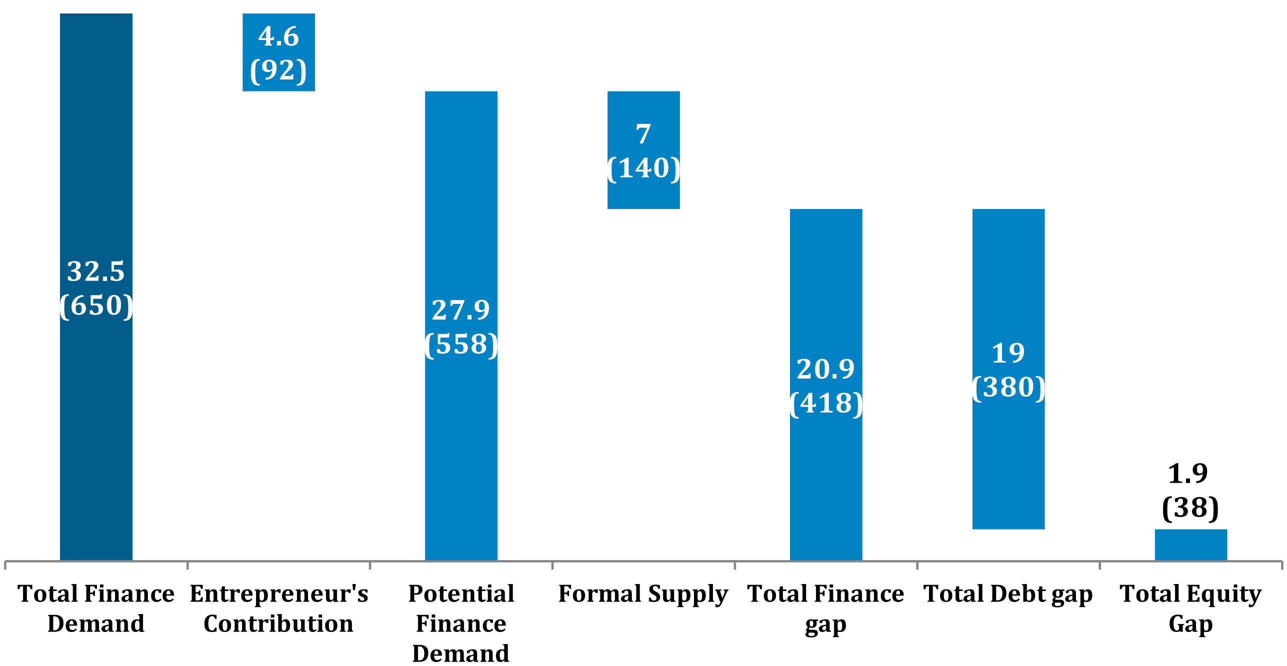


**Figure in brackets is in USD Billion*

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

[107] Financing Firms in India, Allen, Chakrabarti, De, Qain, 2007; Hundred Small Steps, Rajan R, 2009

The finance gap in micro, small and medium enterprise segments is estimated to be INR 16.2 trillion ($324 billion), INR 3.9 ($78 billion) and INR 0.8 trillion ($16 billion), respectively (Figure 37).

Figure 37: Finance Gap in Micro, Small and Medium Enterprise Segments (in INR Trillion)*

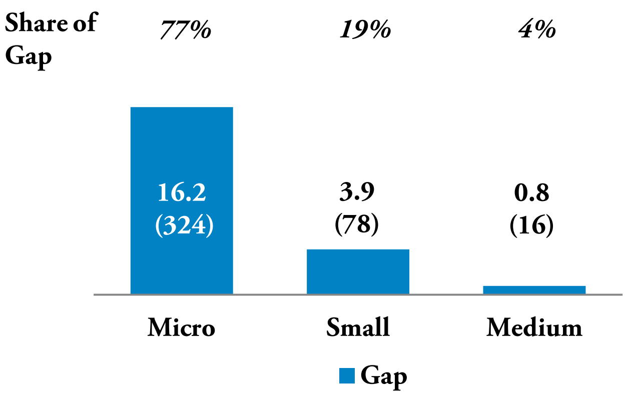


**Figure in brackets is in USD Billion*

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

4.1 Viable and Addressable[108] Gap in Debt and Equity

As already outlined in Figure 12, it may not be viable for formal financial institutions to serve all the demand in the sector. After the exclusions to the debt demand, the finance gap in the MSME sector that financial institutions consider viable and addressable in the near term is estimated to be INR 3.57 trillion ($71.4 billion). The viable and addressable debt and equity gap is estimated to be INR 2.93 trillion ($58.6 billion) and INR 0.64 trillion ($12.8 billion), respectively (Figure 38).

Figure 38: Viable and Addressable Finance Gap in the MSME Sector (in INR trillion)*

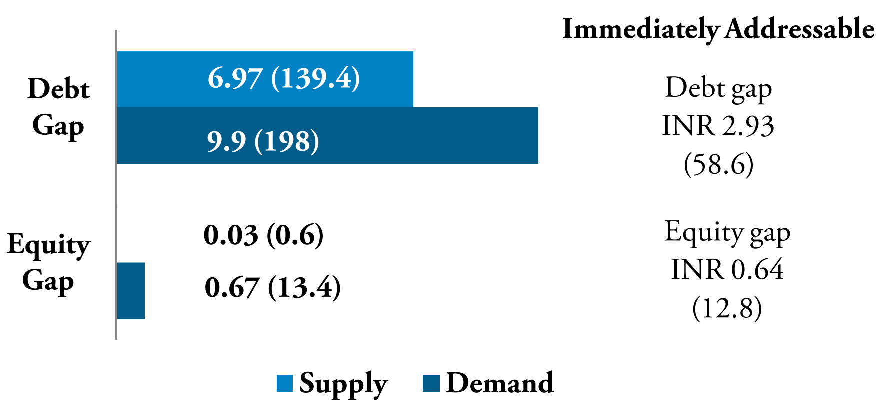


**Figure in brackets is in USD Billion*

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

[108] Demand that can be serviced by formal financial institutions over a one – two year time frame without undertaking additional effort of market building

Analysis of the finance gap in the MSME sector suggests that:

- The gap in debt is largely because of unserved micro enterprises and underserved small enterprises. The study estimates that financial institutions serve an estimated 10.3 million[109] (see Appendix A) micro, small and medium enterprises; however they meet only an estimated 40-70 percent of the demand of an enterprise on an average.
- The shortfall in equity is even larger with a gap-to-demand ratio of ~100 percent, suggesting that enterprises across the sector are constrained for both growth-stage as well as early-stage equity capital. This can be attributed partly to non-amenable legal structures (ownership structures) and partly to the low maturity levels of most MSMEs.

4.1.1 Demand-Supply Gap by Size of Enterprises

The micro, small, and medium enterprise segments respectively account for INR 2.25 trillion ($45 billion), INR 0.5 trillion ($10 billion) and INR 0.18 trillion ($3.6 billion), of the viable debt gap that can be addressed by financial institutions in the near term (Figure 39). The micro and small enterprise segments account for 97 percent of this debt gap.

[109] Statistical tables relating to Banks of India, RBI; IFC-Intellecap Analysis

Figure 39: Viable and Addressable Debt Gap in Micro, Small and Medium Enterprise Segments (In INR Trillion)*

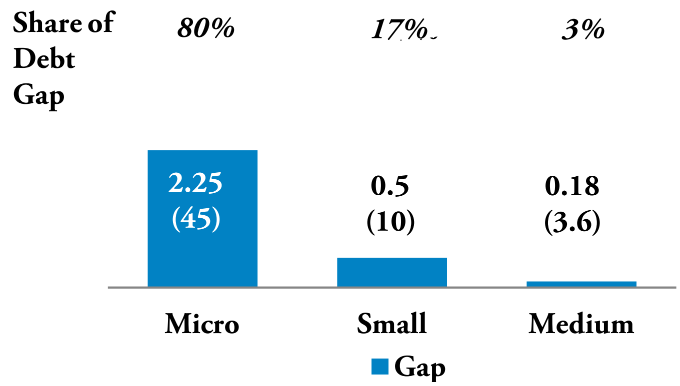


Figure in brackets is in USD Billion

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

4.1.1.1 Micro Enterprise Segment

The micro enterprise segment accounts for the largest share (80 percent) of the viable and addressable debt gap to the sector, with a gap-to-demand ratio of 51 percent. Analysis suggests that the gap in the segment is due to both unserved and underserved enterprises – approximately 1 million[110] addressable micro enterprises are unserved. For the micro enterprises that are served, the formal finance provided meets only 40-50 percent of their requirement. Some of the key constraints that explain the debt gap are as follows:

- Micro enterprises mostly operate in the service sector, and most entrepreneurs do not have access to immovable collateral to secure finance or get the sanctioned limits to be raised.
- Entrepreneurs have limited internal resources to capitalize (equity) the business and limited managerial experience, both of which make accessing debt capital from formal sources challenging. As a result, an enterprise is vulnerable to working capital strain.

[110] Refer to Annex A on demand estimation methodology

- Although both financial institutions and government agencies have several products and schemes for micro enterprises, there is little awareness about these among entrepreneurs, making it challenging for institutions to reach out to them.

- For financial institutions, sourcing and acquiring micro enterprises is extremely challenging and expensive. The branch walk-ins are very limited, and staff actively source potential customers themselves, which increases the cost of acquisition. Further, the third-party agencies sourced enterprise accounts are not only expensive, but also limit building of customer relationships.

- Financial institutions are constrained by the lack of readily available financial information on these enterprises. These enterprises mostly transact in cash and have little incentive to maintain proper financial records as book-keeping increases the cost of operations. Since financial institutions consider financial viability critical for risk assessment, poorly documented financial information compels them to either reject the enterprise or sanction lower than required credit limits.

- Yet another reason why institutional finance has had a limited reach is the use of traditional credit assessment tools to appraise micro enterprises, leading to conservative decision-making.

Since the cost is similar for acquiring a micro and a small enterprise account, financial institutions prefer to service more small enterprises as their average debt demand tends to be ten times[111] larger than that of micro enterprises. A lower gap-to-demand ratio of 18 percent suggests that the small enterprise segment is relatively better served than micro enterprises. Financial institutions find small enterprises more attractive also because entrepreneurs in the segment are more financially aware.

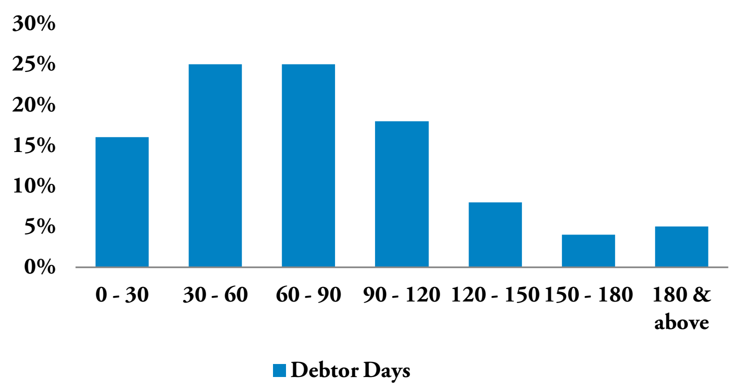
[111] Primary Research – Interviews with MSMEs/ MSME Associations

4.1.1.2 Small Enterprise Segment

The viable and addressable debt gap in the small enterprise segment is largely due to the fact that a large number of enterprises in the segment are underserved. Analysis of the gap suggests that on an average, INR 1.5 million – INR 3.5 million ($30,000 – $70,000 per enterprise) gets directed to an enterprise, which meets 40 – 70 percent of an average demand estimated at INR 4 million – 4.5 million ($80,000 – $90,000)[112]. Some of the key demand-side and supply-side constraints that explain the debt gap are as follows:

- The debt gap in the sector is attributed largely to a shortfall in working capital finance. Enterprises in the segment tend to have longer working capital cycles due to delayed realization of payments from buyers – median debtor days in the segment are estimated to be 90-100 days (Figure 40). The working capital limits sanctioned by banks do not meet the demand of the enterprises adequately, resulting in the gap.

Figure 40: Debtor Days in Small and Medium Enterprises Segment



Source: CRISIL Ratings 2011, N= 5000 enterprises

- Information asymmetry and opaqueness in the reported financial statements is one of the key reasons for financial institutions not sanctioning higher working capital limits.

[112] Primary Research – Interviews with Financial Institutions, MSMEs; IFC – Intellecap Analysis, Statistical tables relating to Banks of India

- Financial institutions report[113] that the opaqueness in the financial statements stems from inconsistency between reported past performance and projected future performance. A deeper assessment suggests that financial statements are often prepared for taxation purposes, and don't accurately reflect the performance of an enterprise.

4.1.1.3 Medium Enterprise Segment

Medium enterprises are the best served segment in the MSME sector, and account for only an INR 0.18 trillion ($3.6 billion) of the viable and addressable debt gap. In addition to debt, the medium enterprises are able to absorb equity and other hybrid instruments.

The debt gap in the segment is due to a shortfall in incremental working capital financing for manufacturing enterprises, and under-financing of service-oriented enterprises in the segment.

4.1.2 Demand-Supply Gap by Type of Enterprise

The study estimates that the viable debt gap that can be addressed by financial institutions in the near term in the manufacturing and services sector is INR 2.15 trillion ($42 billion) and INR 0.78 trillion ($16.6 billion), respectively (Figure 41).

The smaller debt gap in the services sector can be attributed, in part, to the RBI regulation that allows retail trade financing to be classified as priority sector lending. As the retail industry mostly has micro enterprises, banks increase the share of retail clients in their MSME portfolio to meet the priority sector obligations.

Figure 41: Viable and Addressable Debt Gap in Manufacturing and Services Sectors (In INR trillion)*

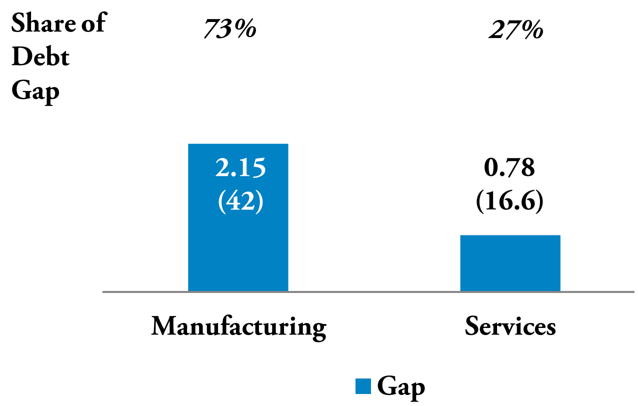


**Figure in brackets is in $billion*

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

4.1.2.1 Manufacturing Sector

Manufacturing enterprises account for 73 percent of the sector's viable and addressable debt gap. Some of the key reasons for the gap in the sector are:

- Manufacturing MSMEs often experience delays in payments, resulting in considerable capital being tied up in receivables. Such a situation increases the working capital requirement. For instance, if the working capital cycle of an enterprise increases from 60 days to 90 days, the working capital requirement too increases by approximately 50 percent[114]. Since suppliers' credit remains limited, the working capital demand of enterprises tends to far exceed the short-term credit limits allocated by financial institutions, resulting in a large financing gap.

[113] Primary research – Interviews with Schedule Commercial Banks

[114] Financing SMEs in India, T.S. Krishnaswamy, The SME Whitebook 2010-11

- The problem of working capital shortfall is more severe in export/import-oriented MSMEs. In addition to delayed payments, cash flows of the enterprise are also vulnerable to currency rate fluctuations, and with limited formal finance, such enterprises tend to be underserved.
- Enterprises in the sector also face challenges in financing growth. Most manufacturing enterprises plan growth around capacity expansion as opposed to productivity enhancement through process efficiencies. Financial institutions are wary of financing regular capacity expansion as they perceive MSMEs to be vulnerable to economic downturn, when capacity expansion goes underutilized.[115]

4.1.2.2 Services Sector

Services enterprises make up 27 percent of the overall viable and addressable debt gap. Financing is better in traditional services industries such as retail, small transport operators, and hospitality, as financial industries have a better understanding of these sectors. Some of the reasons for gap in the sector are:

- Traditional services experience a greater debt shortfall in capital expenditure financing compared to working capital requirements because there is a high level of cash transactions in business operations that can be used to finance working capital needs.
- Although traditional services enterprises often have access to primary security, they tend to transact mostly in cash, with limited records of their financial transactions. Due to inadequate information on financial behavior of the enterprise and entrepreneur; the sanctioned finance limits tend to be lower than what they need.
- Financial institutions do not have reliable financing benchmarks for the services sector unlike for the manufacturing sector, for which there are benchmarks based on the recommendations of the Nayak Committee[116]. As a result, there is greater difficulty in determining the actual financing needs of different types of enterprises in the services sector, leading to under-financing of the sector.

[115] Limited raw – material and market linkages make MSME vulnerable to bull-whip effect during economic downturns, consequently debt financed capital investment strains the cash flow and induces sickness – financial institutions perceive higher debt financed capital investment as risky

[116] In 1991, RBI constituted a committee under the chairmanship of PR Nayak to examine the obstacles confronting small-scale industries (now micro and small enterprise) in obtaining finance. The committee submitted its report in 1992 and the RBI accepted all the major recommendations made by the committee

4.1.3 Demand-Supply Gap by Geography

Low-Income States and North-eastern States account for 69 percent of the viable debt gap that can be addressed by financial institutions in the near term (Figure 42). As LIS and NES are largely agrarian economies, a large share of bank finance tends to be directed towards agriculture and allied activities. Low levels of industrialization have constrained the scale of MSMEs in LIS and NES, and bank financing to the sector is also lower as a result.

Figure 42: Debt Gap in LIS, NES and Rest of India (in INR Trillion)*

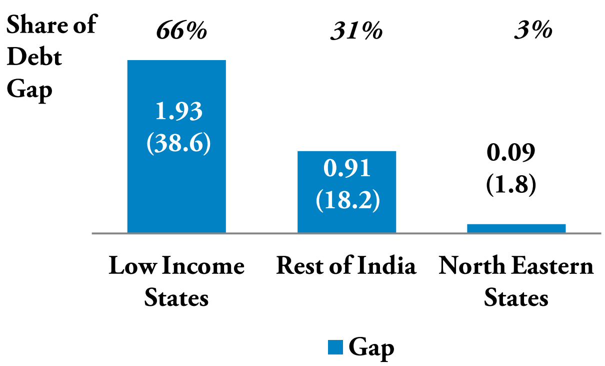


**Figure in brackets is in USD Billion*

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

4.1.3.1 Low – Income States

The viable and addressable debt gap in LIS is estimated to be INR 1.93 trillion ($38.6 billion), accounting for 66 percent of the overall debt financing shortfall in the MSME sector. Some of key reasons for the debt gap in the region are:

- Uttar Pradesh is the largest state in the LIS, and alone accounts for 40 percent[117] of the formal debt directed to the region on the back of an extensive bank branch network (9,658 branches[118]). However, exceptions like Uttar Pradesh aside, the region suffers from poor banking reach (Figure 28) and deficiencies in infrastructure such as electricity, communication and roads that make banking unviable in many cases, resulting in limited finance flow to MSMEs in the region.
- Low literacy also plays a significant role in explaining the gap. Because of low literacy levels, entrepreneurs of micro and small enterprises are not aware of formal sources of finance, and prefer self-financing or informal source of finance. The low awareness of formal finance also reflects in the savings behavior – low-income states account for only 14 percent share of bank deposits.

4.1.3.2 North-Eastern States

The viable and addressable debt gap in NES is estimated to be INR 0.09 trillion ($1.8 billion), accounting for 3 percent of the overall viable and addressable shortfall in the MSME sector. Some of key reasons for the debt gap in the region are:

- With the exception of Assam, which accounts for 72 percent [119] of the formal debt directed to the region, north-eastern states have even poorer banking infrastructure than the low-income states (Figure 28). The region accounts for only 1.4 percent of the overall debt disbursed in India. Operational challenges such as sparse settlements of population, infrastructural bottlenecks (particularly transport), frequent power outages and poor law-and-order conditions prevent penetration of banking in the region.
- Literacy levels in NES are also relatively low, and so is the consequent awareness of banking and payments services. North-Eastern states account for only 2 percent of bank deposits in the country.

[117] State Level Bankers Committee (SLBC)

[118] RBI

[119] State Level Bankers Committee (SLBC)

4.1.3.3 Rest of India

The viable and addressable debt gap in Rest-of-India is estimated to be INR 0.91 trillion ($18.2 billion), accounting for 31 percent of the overall viable and addressable debt gap in the MSME sector. Some of the characteristics of the region that explain the lower debt gap in region vis-à-vis LIS and NES are:

- Developed banking infrastructure and higher number of manufacturing MSMEs in the region translate into a higher share of debt financing in these states. Tamil Nadu, Maharashtra and Delhi alone account for 51 percent of the formal debt that is directed to the MSME sector in the country.
- Commercial banking presence in the region is directly proportional to the industrial activity in rest-of-India. The region accounts for 69 percent of the total bank branches in the country and 83 percent of the country's overall formal debt flow in the sector.
- Due to higher literacy, micro and small enterprises are relatively more aware of the formal sources of finance available to them.

4.2 Viable and Addressable Gap in Equity

The viable and addressable gap in equity is severe, with gap-to-demand ratio of ~95 percent estimated to be INR 0.64 trillion ($12.8 billion). The current flow of INR 0.03 trillion ($0.6 billion) is largely directed to mature small and medium enterprises (Figure 43).

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.

- Early-stage small enterprises, particularly in the services sector, have limited access to venture capital as the sector currently has few equity investments funds that focus on MSMEs.
- Although mature small and medium enterprises can access external equity for growth capital, concerns of management control and potential issues in aligning with the long-term goals of the external investors are often cited as constraints on the demand side.
- On the supply side, limited information on governance structures, transparency and valuation concerns are the key reasons for mature small and medium enterprises failing to receive external equity.
- In fact, equity financing to the sector itself is currently limited. In addition to investor constraints mentioned above, operational challenges of managing a small investment and limited avenues of exit make MSME equity financing unattractive for investors.

Figure 43: Viable and Addressable Equity Gap in MSME Sector (in INR Trillion)*

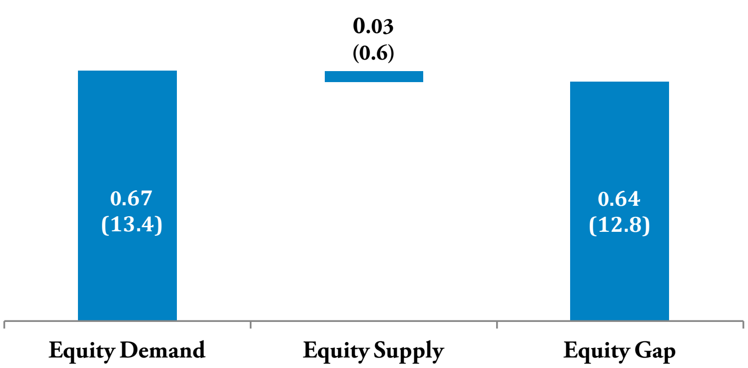


**Figure in brackets is in USD Billion*

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

Photo: Dilip Banerjee/IFC

5

ENABLING ENVIRONMENT FOR GROWTH OF MSME FINANCE

ENABLING ENVIRONMENT FOR GROWTH OF FINANCE TO THE MSME SECTOR

Growth of MSMEs needs to be reinforced by holistic fiscal support and enabling policies. Similarly, improving the policy framework and incentivizing financial institutions to innovate can increase the penetration of formal financial services to the MSME sector.

The three main pillars of the enabling environment that the study has analyzed are: (a) legal and regulatory framework (b) government support (c) financial infrastructure support (Figure 44).

There have been significant efforts to strengthen the enabling environment for MSMEs, which have had a positive impact on the sector as a whole. However, challenges in formulating and implementing effective policy continue to impede the growth of MSMEs and MSME finance.

There are several reports that address the overall policy environment for the MSME sector. For the purposes of this study, analysis has been restricted to policy and enabling environment as it relates to MSME finance specifically.

Figure 44: Schematic Key Elements of the Enabling Environment

Growth of MSME and MSME Finance

Legal and Regulatory Framework	Government Support	Financial Infrastructure Support
• Legal and regulatory framework to define the sector - MSMED Act, 2006 • Financial regulations to bolster supply of finance – SARFAESI 2002, Credit Information Companies (Regulation) Act 2005 • Inclusion of Micro, and Small Enterprises (MSE) in purview of Priority Sector Lending (PSL) • Master Circulars on Lending to MSME	• Policies to facilitate multi-pronged support – skill, development market linkage, technology adoption and infrastructure • Promotion of cluster development • Financial support through apex sector bodies like SIDBI • Funding support to credit guarantee schemes to enhance unsecured financing • Financial support to increase penetration of credit rating	• Credit bureaus to track credit history of enterprises • Collateral registry for immovable assets • Credit rating agencies • Asset reconstruction companies • Small and Medium (SME) Stock Exchange to facilitate primary and secondary transactions for SME securities

Source: IFC-Intellecap Analysis

5.1 Legal and Regulatory Framework

Given the importance of the MSME sector for economic growth, the government and regulators have instituted several policies to facilitate the growth of the sector and encourage participation by financial institutions. The current study assesses key legal and regulatory interventions that promote formal finance in the MSME sector.

While legal and regulatory frameworks are in place to reinforce sector development, policy objectives in most cases are far from accomplished. For instance, despite efforts to make the registration[120] process (formalization) simpler, many enterprises remain unregistered or unorganized.

Key Measures and Challenges

5.1.1 Micro, Small, Medium Enterprise Development Act, 2006

- The Micro, Small, Medium Enterprise Development Act, 2006 (MSMED Act) defines the micro, small and medium enterprise segments, and promotes focused and coordinated development of policy for the sector.
- The MSMED Act led to the setting up of policymaking and monitoring bodies – the National Board for Micro, Small and Medium Enterprises and MSME Advisory Committee – which facilitate coordination and inter-institutional linkages among various government departments related to the MSME sector.
- To ensure that the proposed development schemes such as scheme for capacity building, financial assistance for bar-code etc. receive adequate financing, the MSMED Act proposes setting up of dedicated government funds.
- The MSMED Act also has provisions to address the endemic problems of delayed payments to MSMEs by large enterprises. Section 15 specifies that buyers make payments to the MSMEs on mutually agreed dates, and in case dates are not specified, the debtor is required to pay within 45 days. Section 16 elaborates the penalty in case of delayed payments i.e. buyers are liable to pay compound interest to the MSME on the payment amount that is three times the bank rate specified by the RBI (interest is to be paid from the day immediately after the mutually-agreed date.)

Gaps and Challenges for greater financial access

- The definition of MSME in the MSMED Act provides no information on financial maturity or scale of MSMEs. Financial institutions therefore find it difficult to target units on the basis of this definition and prefer to use size of annual sales as a metric to identify MSMEs. These definitions tend to vary across financial institutions.
- Due to inconsistency in the definition of MSME across financial institutions and government, the data on the MSME sector collected and collated by the government agencies does not always help in segmenting enterprises and providing targeted services and products.
- While the MSMED Act attempts to address the issue of delayed payments through specific provisions, strict enforcement of these provisions is often not observed in the sector.

[120] Primary research – Interviews with individual entrepreneurs and MSME associations suggest that registration is a cumbersome process which involves a lot of documentation, and the process takes around 3-6 months

5.1.2 Credit Information Companies (Regulation) Act 2005

The government has enacted the Credit Information Companies (Regulation) Act 2005 (CIC Act) to facilitate the formation of credit bureaus and strengthen the finance information infrastructure.

- The CIC Act led to the formation of four credit bureaus in the country. Experiences in developed countries suggest that access to credit information on historic conduct of the enterprises tends to reduce the information asymmetry and increases the flow of formal finance.
- The Act regulates the information that credit bureaus can collect and process, however it also provides RBI the flexibility to expand the type of information captured.

Gaps and Challenges for greater financial access

While setting up of credit bureaus is a step in the right direction, there are gaps in the current structure and depth of credit bureaus.

- Current bureaus operate on the principle of reciprocity and commercial banks have limited incentive to share data on MSME customers, as a result of which the number of customer records in credit bureaus continues to be low[121].
- Currently, credit bureaus record information only on the financial transactions of enterprises and individuals. However many MSMEs and MSME entrepreneurs do not have any financial history and no information on such enterprises and individuals is therefore available with credit bureaus.
- The government currently has multiple identification numbers for enterprises and individuals e.g. Permanent Account Number, Tax-Deduction Account Number or Aadhar Number (Unique Identification Number), which makes it challenging to reconcile data from multiple sources.

5.1.3 Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

The SARFAESI Act is a legal framework that protects creditor rights and facilitates recovery of non-performing assets without the intervention of the judicial system. The Act is applicable to all loan assets created by a commercial bank, and broadly provides three alternative methods of recovering non-performing assets, namely, (a) securitization (b) asset reconstruction and (c) enforcement of security.

- As the MSME sector is considered to be relatively riskier, limited credit protection can severely impede supply of finance to the sector; the SARFAESI Act provides a framework to financial institutions to recover non-performing assets, reducing the risk of non-recovery of dues.
- The Act also provides guidance on formation of Asset Reconstruction Companies (ARCs) to provide support to commercial banks in managing the sale of non-performing assets. SIDBI along with other leading commercial banks has set up the India SME Asset Reconstruction Company Limited (ISARC) to manage non-performing MSME assets of commercial banks.
- Many commercial banks have also instituted One-Time-Settlement (OTS) mechanisms that allow banks to settle transactions with non-performing assets without going into a long-drawn process as prescribed in the SARFAESI Act.

[121] The Credit Information Bureau (India) Limited (CIBIL) is the primary credit information company in India. The database of credit information at CIBIL is based on the principle of reciprocity, i.e. only members who submit data to the database can assess information from the database. Currently, 146 credit guarantors, including 77 commercial banks, have membership in the bureau. Interviews with Financial Institutions suggest that the number of customer records in credit bureaus is low.

- The government has also set up a centralized collateral registry (CERSAI), under the auspices of the SARFAESI Act to track immovable assets against which loans are advanced. The objective of CERSAI is to prevent fraud and multiple lending by different banks on the same immovable asset.
- In a recent development, the government enacted the Regulation of Factor (Assignment of Receivables) Bill, 2011 to promote and regulate factoring activities in the financial sector. The Act also requires all factoring transactions to be registered with CERSAI. Growth in factoring services can play an important role in addressing the working capital needs of MSMEs that do not have access to sufficient immovable collateral to access credit easily.

Gaps and Challenges for greater financial access

Although the SARFAESI Act provides the much required credit protection for lenders, there is room to expand the coverage of the Act to make it more effective:

- While the SARFAESI Act provides protection for commercial banks, there is no creditor protection for NBFCs under the Act. As NBFCs play an important role in MSME financing and financial inclusion, some kind of credit protection can boost their ability to expand reach to the MSME segment. Recognizing this, the Usha Thorat Committee on NBFC Sector has recommended that NBFCs be covered under the SARFAESI Act.
- Commercial banks prefer one-time settlement, as borrower protection clauses in SARFAESI Act can sometimes make the prescribed process for recovery long drawn and expensive.

5.1.4 Policies of Financial Regulator

- To ensure formal finance to priority sectors such as agriculture and MSME, Priority Sector Lending guidelines have been in place for commercial banks since 1972. Under these guidelines, domestic commercial banks are required to allocate 40 percent of the net bank credit for priority sectors (32 percent norm for foreign banks[122]).
- Lending to micro and small enterprises is covered under priority sector. While domestic public and private banks do not have any sub-targets, foreign banks are required to allocate 10 percent of the net bank credit to these enterprises[123].
- With regards to PSL in MSE, the RBI has accepted all the recommendations of the Prime Minister's Task Force Report. Key measures include: (a) commercial banks to achieve 20 percent annual growth in credit to the sector, (b) 60 percent of the portfolio to be allocated to micro enterprise segment, and (c) 10 percent annual growth in unique micro-enterprise accounts.
- In a recent development, the Nair Committee on Priority Sector Lending has recommended that 7 percent of net bank credit should be allocated to micro enterprises (applicable for both domestic and foreign banks). The Committee has also recommended that banks should increase micro enterprise customers at the rate of 15 percent per annum.
- In order to ensure that banks adhere to the priority sector lending guidelines, the RBI requires banks to deposit unutilized priority sector funds with a special fund managed by SIDBI and NABARD. The provision works as penalty because the yield on the special fund is much lower than the potential yield on other PSL-approved sectors.
- In order to ensure the flow of equity to the sector, capital markets regulator Securities and Exchange Board of India (SEBI), in consultation with the Ministry of Finance, has framed a set of guidelines to set up a dedicated stock exchange for small and medium enterprises. Both Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) have set up and launched SME stock exchanges in 2011.

[122] Nair Committee on Priority Sector Lending has recommended that share of PSL for foreign banks be increased to 40% of net bank credit, at par with domestic banks

[123] Master Circular on Priority Sector Lending, RBI, July 2011

Gaps and Challenges for greater financial access

- Not all banks are able to meet the PSL target sets by the RBI due to challenges of limited outreach, limited understanding of the sector, and higher risk perception.
- Large private and foreign banks have traditionally met their priority sector lending targets indirectly through NBFCs. However, this option was closed in 2011 with the implementation of new Master Circular on PSL; commercial banks are now being pushed to explore direct lending approaches.
- As NBFCs rely on banks for financing, closure of the indirect route has limited the expansion of formal finance through NBFCs in the MSME sector. Although, the Nair Committee recommendation allows banks to lend 5 percent of net bank credit indirectly through NBFCs, MSMEs are unlikely to benefit in the short term as a large portion of indirect finance might flow to the microfinance sector.

5.1.5 The Regulation of Factor (Assignment of Receivables) Bill, 2011

- The Regulation of Factor Bill provides guidelines on the rights and obligations of entities involved in factoring transactions. It also provides a framework for regulating factoring in India by the RBI.
- The Bill mandates factoring service providers to register every new factor transaction with the central registry (CERSAI). Leveraging CERSAI will not only make factoring efficient but also increase the depth of CERSAI and the quality of credit information in the financial sector.
- With a single industry framework, many financial institutions will be encouraged to set up factoring entities, expanding available collateral options that MSMEs can use to access credit.
- As MSMEs experience delays in realizing payments, factoring services can effectively improve the liquidity of MSMEs, without imposing the burden of significant immovable collateral on the enterprises.

Gaps and Challenges for greater financial access

- While the current form of the Bill is very encouraging, it also requires certain amendments in the Indian Stamp Act, 1889, to resolve the issues of varying stamp duty across states and make the Bill more effective.

5.1.6 Rehabilitation, Insolvency Management and Closure in MSME Sector

- Although the MSME sector has been critical in promoting entrepreneurship in India, the sector also experiences significant levels of sickness and closure every year.
- The current insolvency and rehabilitation framework comprises the Company Law Board, Sick Industrial Companies Act 1965, Board for Industrial and Financial Reconstruction and Debt Recovery Tribunals. Despite the availability of several institutions, the overall framework is somewhat fragmented, and many of the above listed entities are more accessible to larger and mature enterprises than smaller enterprises.

Gaps and Challenges for greater financial access

- The most common legal structure in the MSME sector – proprietorships and partnerships – is still governed by the archaic Provincial Insolvency Act, 1920. Gaps in the insolvency framework limit the options of revival and turnaround for entrepreneurs.
- The closure process of MSMEs is fairly complex, particularly because of archaic labor laws. Although the MSMED Act indicates that MSME-specific closure laws will be developed, there has been limited progress in this regard.

5.2 Government Support

Recognizing the importance of the MSME sector, the government has instituted various schemes and funding facilities for the development of the sector. For the purposes of this study however, only those activities have been considered that are likely promote financial access on the part of both financial institutions and enterprises.

Key Measures and Challenges

Government interventions are aimed at improving the competitiveness and financial health of MSMEs. Among the programs that are seen to have impacted access to finance are those for skill development, market linkage, technology adoption, cluster development and finance availability[124].

5.2.1 Skill Development

To support the growth of technology-based enterprises, the government plans to set up 100 incubators under the auspices of engineering and technology institutions by 2015. There is also a proposal to expand the services of MSME Development Institutes and technology incubators to provide hand-holding and advisory support to enterprises. This would provide confidence to financial institutions about the viability of an enterprise.

5.2.2 Market Linkages

Inadequate market linkages are considered one of the key constraints for MSME enterprises, eventually leading to enterprise sickness[125]. There are several government policies to enhance market linkages of enterprises, ensuring better management of irregular revenue cycles.

- The government has appointed National Small Industries Corporation Limited (NSIC) as the key implementation agency to manage electronic platforms that will foster business-to-business market linkages for MSMEs.
- The government is also formulating a policy that could require different ministries and public sector enterprises to source 20 percent of raw material from MSMEs. In one of the first measures, the recently cleared foreign direct investment in multi-brand retail requires multi-brand retailers to source 30 percent of the products from small and medium enterprises.

5.2.3 Technology Adoption

The MSME sector is characterized by low adoption of technology, which impacts the sector's competitiveness. In order to encourage enterprises to invest in technology, the government also provides Credit-Linked Capital Subsidies (CLCS) for technology investments. The government leverages the credit infrastructure of the public sector banking network to make the subsidy available to MSMEs.

5.2.4 Cluster Development

A cluster is a location-based agglomeration of micro, small and medium enterprises that are faced with similar opportunities and challenges. Clusters tend to provide an ecosystem support.

Drawing lessons from the success of clusters in the past, the government has identified cluster development as one of the key approaches to make MSMEs more competitive. In a cluster approach, government provides support for skill development, market-linkage, technology improvement and access to finance for specific clusters.

[124] Strategic Plan of Ministry of Micro, Small and Medium Enterprises

[125] Report of the Working Group on Rehabilitation of SICK MSMEs; Fourth All India Census of MSME

5.2.5 Finance Availability

- The government provides financing support to the sector through the Small Industries Development Bank of India (SIDBI).
    - SIDBI provides wholesale financing support to small financial institutions such as NBFCs that operate in the MSME sector.
    - SIDBI also provides retail finance support to MSMEs, particularly in the growth stage through schemes such as Growth capital and Equity assistance for MSME (GEMS).
    - In addition to providing debt finance, SIDBI has also set up SIDBI Venture Capital Limited to supply equity to the MSME sector.
- To minimize the effect of immovable collateral on access to finance for MSMEs, the government and SIDBI have co-funded a credit guarantee fund, Credit Guarantee Trust for Micro and Small Enterprises[126] (CGTMSE). As of March 31, 2010, the CGTMSE had approved approximately 300,000 proposals from micro and small enterprises. These proposals cumulatively account for INR 111.9 billion ($2.2 billion), and 85 lending-member institutions have financed these across 35 States/ Union Territories.
- To encourage book-keeping and improve financial awareness of enterprises, the government has instituted a credit rating scheme for the MSME sector with NSIC as the coordinating agency. The rating scheme offers subsidized credit rating services to enterprises with the intention of supporting market development in this regard and encouraging more enterprises to get rated[127]. Given the right momentum, availability of a credible rating could have a positive impact in terms of financial institutions' willingness to finance certain enterprises, as well as in terms of reducing turnaround time eventually, by using the rating to substitute some parts of the credit risk assessment process.

Gaps and Challenges

- The credit guarantee scheme has been in existence for more than a decade, yet the penetration of CGTMSE has been low when compared to the overall debt channeled to the MSME sector. This can be attributed to several factors at the level of both the enterprise and financial institutions. On the demand side, the lower-than-expected uptake of the scheme is because of the poor awareness about the scheme among entrepreneurs as well as the reluctance on the part of entrepreneurs to service an annual guarantee fee. From a financial institution perspective, lower penetration is largely due to the lack of complete cover 119, lengthy process for filing claims, the need to book assets as non-performing before filing claims and the length of the lock-in period of 18 months prior to filing claims.
- The current scheme allows only commercial banks to enlist as member institutions. Other key players such as NBFCs and MFIs are excluded.
- Although credit rating could positively impact financial management in MSMEs, the uptake remains limited primarily because of lack of proper understanding of the rating process and its benefits. There have been instances of enterprises demanding a favorable rating, or an interest subsidy to get rated.
- Debt in the capital structure of enterprises can be counter-productive beyond a certain threshold, and that is when infusion of equity becomes essential. Private equity funds have limited incentives from government to operate in the MSME sector.

[126] Details in Appendix C
[127] Detail in Appendix D

5.3 Financial Infrastructure Support

In order to expand formal finance in the MSME sector, financial institutions require the support of a financial support infrastructure, including credit bureau, collateral registry, platform to settle non-performing assets and platforms to raise equity. While both financial institutions and the government have undertaken several finance-support mechanisms, most of these interventions are in their infancy and have significant potential to scale up.

Key Measures and Challenges

5.3.1 Credit Bureau

- Studies in developed countries suggest that there is a strong correlation between the presence of credit bureaus and the penetration of formal finance[128] in an economy. The enactment of the CIC Act has facilitated the formation of credit bureaus in India.
- The Credit Information Bureau (India) Limited[129] (CIBIL) is the leading credit information company in the country. CIBIL's database of credit information is based on the principle of reciprocity, i.e. only members who submit data to the database can access information. Currently, 146 credit guarantors, including 77 commercial banks (out of 169 commercial banks), are member of the bureau.
- CIBIL is segregated into two distinct bureaus: consumer and commercial. The consumer bureau tracks the individual finance data, while the commercial bureau tracks the finance data of enterprises. The other credit bureaus in the country are still relatively nascent.

Gaps and Challenges

- The current credit bureaus in the country are still developing, with only a limited data on the MSMEs currently available. Due to lack of any historic credit data, information on many enterprises or entrepreneurs is not recorded in the current credit bureaus.
- With the database of the credit bureaus gradually growing it is essential to manage data integrity. Currently, the absence of a single unique identification and non-standard reporting format is affecting the integrity and accuracy of the credit information database[130], making it difficult to reconcile the different data.

5.3.2 Collateral Registry

- As a large share of current debt financing tends to be secured, access to information on collateral ownership, pledge history and seniority of charge in case of default minimizes the occurrences of adverse selection for financial institutions. The current asset registration regime is governed by multiple laws and regulations based on the type of the enterprise or the asset type. Some examples of registration regime include: The Companies Act 1956, The Registration Act 1908, Motor Vehicles Act 1988, The Patents Act 1970, and The Depositories Act 1996.
- The Ministry of Finance has spearheaded the establishment of a Centralized Collateral Registry for India, currently placed within the National Housing Bank (NHB). The Central Registry of Securitization Asset Reconstruction and Security Interest of India[131] (CERSAI[132]) has been established under the provisions of the SARFAESI Act. Alongside, the RBI mandated in March 2011 that all financial institutions covered by the SARFAESI Act would be required to register any mortgages with CERSAI. Although CERSAI was focused on mortgages when established, its scope is now being broadened with the passing of the new Factoring Law. The registry will be expanded to include receivables as well.

[128] Quoted in "A Hundred Small Steps", Report of the Committee on Financial Sector Reforms, Miller 2003; Djankov, McLiesh and Shleifer, 2005; Fourth All India Census of MSME, 2007

[129] Refer Appendix F

[130] A Hundred Small Steps, Report of the Committee on Financial Sector Reforms, R. Rajan,

[131] A company registered under the Companies Act 1956

[132] Refer Appendix E

Gaps and Challenges

- The land registry system in the country remains fragmented with limited information sharing between state registries. Hence there is still a significant gap in the information available through CERSAI from a creditor's perspective.
- Only institutions covered under SARFAESI are required to register collateral with CERSAI. Hence those financial institutions not included in the remit of SARFAESI (e.g. NBFCs) still remain outside of this critical information infrastructure.
- As MSMEs often lack access to immovable collateral, financial institutions are exploring options to use movable collateral against advances; however, the current collateral registry measures do not allow recording and tracking of information on movable collaterals, although this is being amended for receivables.

5.3.3 Asset Reconstruction Company for SME

- SIDBI has promoted the India SME Asset Reconstruction Company Limited (ISARC) to assist commercial banks in managing liquidation of non-performing assets. As non-performing assets management can be cumbersome, commercial banks seek the support of special entities such as the asset reconstruction companies to facilitate this process. This initiative is in partnership with 12 public sector banks, three state financial corporations, the Life Insurance Corporation of India and APITCO Limited.
- The objective of ISARC-like initiatives is to minimize the cost of managing non-performing assets. ISARC plans to acquire, manage and recover illiquid or non-performing portfolios of scheduled commercial banks and financial institutions.

Gaps and Challenges

- Although the setting up of ISARC is an important development, investor interest and appetite for securitized MSME assets is not known. While the transaction cost incurred by an SME Asset Reconstruction Company and that incurred by a non-SME Asset Reconstruction Company is similar, the value realized on liquidation or sale of assets in SME is comparatively lower.

5.3.4 SME Stock Exchange

In order to facilitate the flow of equity capital to the small and medium enterprises, and offer potential investors a platform for exit, the government and the Securities and Exchange Board of India (SEBI) proposed the formation of the SME Stock Exchange. Currently, two mainstream stock exchanges – the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) – have started SME stock exchanges in India. Both the exchanges expect at least ten small and medium enterprises to list over a period of twelve months.

Gaps and Challenges

- The key challenge for stock exchanges is to generate considerable investor and market interest so that the listing and trading volumes provide a viable market.

Photo: Curt Carnemark/The World Bank

6

POTENTIAL INTERVENTIONS TO INCREASE ACCESS TO MSME FINANCE

POTENTIAL INTERVENTIONS TO INCREASE ACCESS TO MSME FINANCE

Formal financing to the MSME sector has multiple constraints on both the demand and the supply side. Among the multiple challenges that the sector experiences there are a few common factors such as: (a) inadequate capacity – building support for enterprises (b) financial asymmetry, or inadequate information infrastructure support (c) gaps in the legal and regulatory framework and, (d) conservative mindset of the financial institutions (particularly the large financial institutions).

While policymakers are taking numerous steps to mitigate constraints experienced by MSMEs, this study proposes interventions that could reinforce some of these measures for reducing the financing gap in the sector. The proposed policy and institutional interventions address the following domains: (a) enabling infrastructure (b) liquidity management and (c) risk management. An overview of the key potential interventions is provided in Table 19.

Table 19: Overview of Potential Interventions in Enabling Infrastructure, Liquidity Management and Risk Management

	Potential Intervention	Segment
Enabling Infrastructure		
1	Build capacities of small financial institutions through training and financial investments, with a particular focus on building financial awareness and financial training	Micro and Small
2	Evaluate the feasibility of leveraging NBFCs as business facilitators	Micro and Small
3	Promote enterprises that syndicate/facilitate finance and provide advisory support to MSMEs under private or public-private initiatives	Micro, Small and Medium
4	Encourage factoring and securitization of trade receivables in the sector by introducing comprehensive set of regulations	Small and Medium
5	Incentivize formation of new MSME-specific venture funds by allowing existing government equity funds to make anchor investment in venture funds – encourage participation of private sector through initiatives such as the India Opportunity Fund (IOF) set up by the government and SIDBI	Small and Medium
6	Institute comprehensive and uniform laws on insolvency, rehabilitation and creditor protection for both enterprises and financial institutions in the sector	Micro, Small and Medium
Liquidity Management		
1	Improve access of debt funds to non-MFI NBFCs and provide such institutions regulatory incentives to continue operating in the sector	Micro and Small
2	Develop an IT-enabled platform to track receivables in MSME, facilitate factoring, reverse factoring and securitization of trade receivables – scope of existing initiatives such as SIDBI's NTREES can be expanded to track MSME receivables	Small and Medium
Risk Management		
1	Undertake further research activities to develop better understanding of financing patterns of services enterprises in the MSME sector	Micro, Small and Medium
2	Strengthen the MSME credit information bureau and expand the scope of the information bureau to collate and process important transaction data (e.g. utility bill payment)	Micro, Small and Medium

Source: IFC-Intellecap Analysis, Primary Research

6.1 Potential Interventions

The current financing gap in the MSME market presents a huge potential opportunity for formal financial institutions to expand their market reach. However, to achieve this, both the financial institutions and enterprises require substantial support from government and private sector. Some of the key interventions that could potentially improve supply of formal financing to the sector are discussed below.

6.1.1 Enabling Infrastructure

6.1.1.1 Build capacities of small financial institutions through training and financial investments

While large financial institutions are moving downstream to the MSME sector, the risk appetite of large institutions is limited, and they tend to operate in relatively low-risk segments within the MSME market. Also, the physical outreach of many large financial institutions is limited, making sourcing, servicing, and monitoring a challenge, particularly for outreach to the micro and small enterprises.

Small financial institutions may be better placed to serve this segment, as these institutions tend to have more nimble structures, an extensive outreach, and have a stronger sense of the local context in which the MSMEs are operating.

Potential Interventions

- A potential effort can be made to re-evaluate the long-term strategy of Regional Rural Banks and Urban Cooperatives. The eco-system of RRBs and UCBs could potentially be revitalized by rationalizing manpower and reducing manpower cost, conducting specialized training of staff to build their skills and capacity, instituting simple risk – management structures specifically for agri-finance and MSME finance.
- Government institutions such as State Finance Corporations can also be used to potentially expand MSME financing. The state governments could partner with MSME-focused private financial institutions and funds, to revitalize financing through State Finance Corporations.
- The government can consider facilitating one-time-settlement of existing non-performing assets through liquidation or write-off.

6.1.1.2 Consider leveraging NBFCs as business facilitators

Financial institutions incur significant costs in sourcing potential customers from the micro and small enterprise segment. Financial institutions have deployed branchless-banking initiatives through business correspondents (BC) and business facilitators (BF) in the retail segment. However, leveraging the branchless banking infrastructure for financing MSMEs is challenging due to the limited capacity of Business Correspondent and Business Facilitators.

Potential Interventions

An intervention to evaluate the feasibility of leveraging NBFCs as business facilitators for large financing institutions could be considered.

Currently NBFCs are not allowed to offer payment and settlement services such as cheque, demand drafts, fund transfer, however, banks can leverage these institutions to distribute non-fund services such as fund transfer products and savings products to MSMEs. In order to avoid conflict of interest of institutions engaged in the same business, deposit-taking NBFCs can be excluded from offering BF services for large financial institutions.

6.1.1.3 Promote enterprises that syndicate/facilitate finance and provide advisory support to MSMEs under private or a public-private initiative

Micro and small enterprises have limited awareness of financial institutions and poor information on financial products that suit their needs. Documentation of finance for example can be onerous, and enterprises require significant amount of handholding during the process.

Potential Interventions

Promote an entity that can operate as a 'finance mall' i.e. offers financing options from multiple large financial institutions and upstream non-MFI NBFCs.

- The finance mall entity can match small financing demands with relevant suppliers, and also syndicate large finance requirement across financial institutions based on their risk appetite. The entity could also tie up with technical consultancy organizations such as the Andhra Pradesh Industrial and Technical Consultancy Organization (APITCO) Limited and offer value-added advisory services.
- The proposed entity can be set up by a private entity or under a public-private arrangement with a development finance institution. As an alternative to setting up a new entity, development finance institutions could also provide financing support to existing entities so as to expand operations in additional geographies.

Some such initiatives are already in early stages of development, for example Biz2Credit. These can be significantly supported and expanded.

6.1.1.4 Encourage factoring and securitization of trade receivables in the sector by introducing comprehensive set of regulations

Delayed realization of receivables increases the working capital needs of MSMEs and strains their financial position. Mechanisms to leverage other sources such as factoring can potentially help MSMEs liquidate receivables faster, and possibly afford them an opportunity to leverage their creditworthiness to avail financing.

Earlier this year, the government enacted the Regulation of Factoring (Assignment of Receivables) Bill 2011 to regulate and encourage factoring in the country. While the current Bill makes references to factoring in MSMEs, provisions regarding MSMEs can be further strengthened to track receivables from large enterprises.

Potential Interventions

The existing legal framework could be expanded to include provisions specific to MSMEs so that financial institutions are incentivized to offer MSME-specific solutions. Some of the potential interventions are as follows:

- Incentivize participation of financial institutions by extending guarantee cover under CGTMSE for recourse factoring across value chains of MSMEs i.e. factoring receivables, in which both the trading entities are MSMEs.
- Expand existing provisions of factor registration with the Central Registry (CERSAI) to track receivables due from large enterprises, and facilitate reverse factoring on the lines of Nacional Financiera (NAFIN) in Mexico[133]. All the proposed provisions in the regulations must be consistent with Section 15 (delayed payments to micro and small enterprises) of the MSMED Act.

[133] Nacional Financiera (NAFIN) was established in 1934 by the Mexican Government as a Development Banking Institution. It offers online factoring services to MSMEs through its productive chains program. The NAFIN program allows the MSMEs to use their receivables from the buyers to obtain working capital financing

6.1.1.5 Incentivize formation of new MSME-specific venture funds by allowing existing government equity funds to make anchor investment in venture funds

The current finance flow is dominated by debt while the external equity financing is mostly limited to a few medium enterprises. Equity financing in the sector is led by SIDBI through SIDBI Venture Capital Limited (SVCL), and a few other private investment funds such as Gujarat Venture Finance Limited (GVFL). In early 2012, the government set up an India Opportunities Fund (IOF), along with SIDBI, to finance both early and growth-stage MSMEs. The IOF already has capital commitments from leading public sector banks in India.

Although there is significant government equity capital in the sector, participation of private investment funds has been limited due to challenges in fund raising, lack of skilled manpower and limited exit avenues.

Potential Interventions

The mandate of IOF and similar funds can be gradually expanded to include investments and promotion of MSME-specific equity funds. Initiatives similar to IOF could also act as anchor funds[134] to encourage the private sector to set up venture funds in the sector.

- Government-promoted funds could be a limited partner or an anchor investor in a private MSME-focused fund. Subsequently, co-investment by a government can be leveraged to invite other domestic and foreign investors to join the fund as limited partners
- Additional fiscal incentive such as tax incentives on investment exit for MSME focused venture funds could also be considered.

As a prerequisite to allowing smooth exit for government-backed MSME venture funds, the government would have to include necessary provisions in other regulations and guidelines such as SME Exchange Guidelines, Income Tax Act, 1961 among others.

[134] Comparable initiative: Korea Venture Investment Corporation, South Korea

6.1.1.6 Institute comprehensive and uniform insolvency, rehabilitation and creditor protection laws for enterprises and financial institutions in the sector

The MSME sector experiences significant level of enterprise sickness and closures every year. The process of rehabilitation or closure needs to be quick, easy to access and cost-effective for all the stakeholders involved.

- The current insolvency and rehabilitation framework, comprising the Company Law Board, Sick Industrial Companies Act 1965, Board for Industrial and Financial Reconstruction, Debt Recovery Tribunals, is somewhat fragmented with judicial bodies not operating at optimal levels.
- A large number of enterprises – proprietorships and partnerships – in the sector are still governed by an archaic framework (the Provincial Insolvency Act 1920). According to this, liabilities of such enterprises are unlimited. Without an appropriate legal framework, the responsibility of insolvency and rehabilitation is that of the commercial banks e.g. One-Time-Settlement (OTS) mechanism. Even the SARFAESI Act does not provide a framework for asset size less than INR 1 million ($20,000). Also, with regard to the judicial process, the seniority of claims is not clearly defined, leading to challenges in claim settlement.

Potential Interventions

Taking into account the most prevalent legal structure adopted by entrepreneurs, a sector-specific insolvency and rehabilitation framework could be developed. Some of the potential interventions are as follows:

- Regulation is needed to provide both, a rehabilitation framework for an enterprise to tide over short-term crisis as well as a business closure framework to ensure smooth exit from business. The rehabilitation framework could facilitate a process to negotiate with both financial lenders and statutory lenders (e.g. utilities.) to design a rehabilitation package. The closure framework on the other hand could clearly articulate a method for liquidating the enterprise, repaying all lenders in a timely manner, and discharging the remaining assets, if any.
- The regulation could propose a separate quasi-judicial body on the lines of the Debt Recovery Tribunals to fast-track the rehabilitation, liquidation and settlement.

6.1.2 Liquidity Management

6.1.2.1 Improve access of debt funds to non-MFI NBFCs and provide such institutions regulatory incentives to continue operating the sector

Non-MFI NBFCs play a key role in financing the high-risk segments of the MSME sector. However, as per the current Priority Sector Lending guidelines, indirect lending by banks to MSMEs through NBFCs does not qualify under priority sector targets.

This has arrested the expansion of formal finance in the MSME sector because NBFCs mostly rely on banks for financing. Although, the Nair Committee recommendations propose that banks should be able to lend 5 percent of ANBC indirectly through NBFCs, other attractive sectors such microfinance could compete for the same pool of funds, crowding out funds to the MSME sector[135].

[135] Validation with sector experts

Potential Interventions

- Policymakers could conduct a detailed study to evaluate the merits of allowing a separate category of MSME-focused NBFCs, i.e. non-MFI NBFCs with MSE assets accounting 80 percent – 85 percent of the portfolio). It could also be considered whether assets generated by these NBFCs would potentially be classified as priority sector.
- The proposed study could also assess the mechanisms to track the assets generated by such MSME-focused NBFCs to ensure that the funds are utilized appropriately

6.1.2.2 Develop an IT-enabled platform to track receivables in MSME, facilitate factoring, reverse factoring and securitization of trade receivables

Financial institutions require significant infrastructure support to effectively extend new financial services such as factoring and reverse factoring. Comparable international initiatives, such as Nacional Financiera (NAFIN) in Mexico, suggest that IT-enabled infrastructure support can be effective in facilitating factoring transactions, while also tracking the receivables of large enterprises. An effective IT-enabled platform could promote trade relationships between small and large enterprises and increase liquidity at the enterprise-level.

Potential Interventions

The new factoring regulation could also guide the setting up of an IT-enabled platform under a government-funded institution. The proposed platform could function as a virtual common ground for MSMEs, financial institutions and large enterprises.

- Through the proposed platform, all public sector undertakings (PSUs) could be mandated to route all transactions under the new Public Procurement Policy for Micro and Small Enterprise[136].

[136] The Public Procurement Policy requires all central ministries and public sector units to purchase at least 20 percent of their total annual purchases from the MSME sector

- Large private enterprises could be incentivized through tax breaks to use the platform increasingly.
- Alternatively, the scope of the current SIDBI initiative, NSE Trade Receivables Engine for E-discounting with SIDBI (NTREES), can be expanded to facilitate factoring in the MSME sector.

6.1.3 Risk Management

6.1.3.1 Undertake further research activities to develop better understanding of financing patterns of service enterprises in the MSME sector

Assessing services enterprise is challenging because their business operations are relatively intangible, no assets are necessarily created out of service activity, and the ability of the entrepreneur to offer any immovable collateral is limited. Lack of understanding of services sector leads to financial institutions using manufacturing sector benchmarks (Nayak Committee, RBI) to assess the finance absorption capacity of services sector enterprises; this does not accurately reflect either the credit needs or the repayment capability of these enterprises.

Potential Interventions

A research intervention for detailed assessment of financing patterns in key traditional and knowledge-based services enterprises could be undertaken. The research could focus on: challenges in start-up financing, financing instruments suited for the sector, working capital benchmarks for key sectors, capital expenditure cycles, and use of non-fund financial products and services.

6.1.3.2 Strengthen MSME credit information bureau and expand the scope of the information bureau to collate and process important transaction data

Studies have confirmed that introducing credit information bureaus is positively correlated with increase in financing[137]. These can minimize the financial information asymmetry and help reduce the perception of risk.

- The credit information infrastructure in the country, particularly for the MSME segment, is at a relatively nascent stage with limited records in the bureau. The CIBIL commercial bureau has an estimated 1.5 million records, while an estimated 9 million MSME enterprises are financed by commercial banks. Data management is also a challenge for these bureaus in the absence of a standard format in which to make data available them.
- An effective information infrastructure for financial and transaction information can reduce the perception of risk and cost of serving the MSME sector

Potential Interventions

In order to address the data consistency issue, the regulator could consider developing a uniform format for reporting data to a credit bureau under the auspices of the CIC Act. This will ensure consistency and accuracy of the data collated. Further, there is no unique identifier for data entries; many institutions prefer using the permanent account number (PAN) or tax account number (TAN) as unique identifiers, but several MSME clients do not have either. With the introduction of the Unique Identity Number, it is now possible to use the UID to identify all entries.

The available financial information on most enterprises in the MSME sector is limited because many enterprises tend to be unbanked and do not pay income tax. However, many enterprises have transactions in other government managed services, such as utilities. There is potential to track this data and use it to populate credit information available on these enterprises through the credit bureau.

[137] Miller 2003; Djankov, McLiesh and Shleifer, 2005, quoted in A Hundred Small Steps, Report of the Committee on Financial Sector Reforms; Love and Mylenko, 2003, *Credit Reporting and Financing Constraints*

6.2 Other Interventions

Other areas where finance flow to the MSME sector could be increased include:

6.2.1 Sales turnover as one of the parameter to segment the MSME market

The current definition in the MSMED Act uses enterprise investment in plant and machinery to segment the market into micro, small and medium enterprise segments. The MSMED Act adopted the current definition with the objective of having a segmentation parameter that is both verifiable and consistent with earlier regulations. Financial institutions tend to adopt internal definitions such as enterprise sales turnover, as the MSMED Act definition provides limited information on the finance absorption capacity of enterprises. Also, the current government data on sector does not track sales revenues, making it difficult for financial institutions to use the data for any strategic purposes.

To address this issue, the Ministry of MSME could consider gradual expansion of the MSME definition by including other globally accepted parameters such as sales turnover. This would increase the information available about the enterprise and allow for consistency with internal definitions of the financial institutions to some extent[138].

6.2.2 Inclusion of non-MFI NBFCs under the CGTMSE scheme to incentivize unsecured finance

A dominant share (~80 percent) of the portfolio of non-microfinance NBFCs that have limited access to collateral is unsecured. Such NBFCs need regulatory incentives, such as refinancing or credit insurance, to continue supporting MSME enterprises.

Financial stakeholders, including regulators and industry bodies should evaluate the potential and feasibility of NBFCs under the credit guarantee scheme, CGTMSE. Coverage under the credit guarantee could allow MSME-focused NBFCs to access additional debt funds from large financial institutions. A similar cover can be extended to RRBs, UCBs and revitalized SFCs (in case they are restructured as NBFCs).

6.2.3 Promote intermediary entities to provide advisory support to enterprises during rehabilitation

Enterprises in the sector have limited external support during sickness and rehabilitation. An external independent intermediary could be established to provide advisory support to enterprises in negotiating with financial and statutory stakeholders. The entity could offer services such as debt consolidation and restructuring of package terms and customized financial support. Financial institutions could also use the intermediary's services to assess the viability of sick enterprises and to design rehabilitation packages.

6.2.4 Greater alignment among MSME associations for policy advocacy

A sector as strategically important as the MSME section requires an aligned group on the lines of NASSCOM for effective policy advocacy. Currently, the sector is represented by multiple industry bodies such as MSME-Cell of FICCI and the Federation of Indian Micro & Small and Medium Enterprises (FISME).The crucial efforts already being undertaken by these institutions could potentially be consolidated to some extent in the form of a self-regulatory organization (SRO) created to work for policy advocacy as well as internal capacity building.

[138] Discussions among Industry Associations with regard to expansion of the MSME definition have been ongoing, however, no specific movement has been made in this direction

6.2.5 Role of Financial Institutions

In addition to an effective enabling environment, there is also a need for financial institutions to proactively reach out to the MSME segment. Some of the key measures that can potentially increase penetration in the MSME sector include:

- Tailor business and delivery models to tackle the MSME market by evaluating strengths and weaknesses of the segment.
- Recognize the heterogeneity in the MSME sector, and invest capital and manpower to better understand its various sub-segments. Knowledge on risk and opportunities in these sub-segments will help financial institutions prioritize them and serve them profitably.
- Invest in creating financial awareness of issues that include benefits of enterprise registration, legal structure, financial products and services, and technology-based channels. Target these products and services at particular sub-segments of the MSME market, experiment with flexible forms of collateral to increase financing off-take.
- Develop underwriting tools that are more suited to assess MSMEs and categorize them by size of enterprise and credit requirement.
- Proactively monitor existing MSME assets to prevent them from turning non-performing. Engage regularly with MSMEs to revive them from any signs of sickness through renegotiations of long-term loans, infusion of fresh funds, business restructuring.

Photo: IFC

APPENDICES

Appendix A

Estimation Methodology: MSME Finance Demand

The current study draws on multiple sources of data including the Ministry of MSME, Government of India, Reserve Bank of India (RBI), Small Industries Development Bank of India (SIDBI), existing research literature, IFC publications, industry publications, other government publications and interviews with various stakeholders to size the market opportunity of MSME finance in India.

The current information on the MSME sector is limited and in many cases uneven/non-uniform, particularly in the case of the unorganized sector. Further, there is very limited enterprise level information on the sector. Similar information gaps also exist in the assessment of the supply of formal finance to the sector. An exercise in assessing the market size experiences significant constraints in the absence of any sector-level and enterprise-level data. As a result, the current assessment of the MSME finance market required a number of assumptions[139] and validation of these assumptions. The research team ensured that the assumptions made and the data points mentioned were validated with key stakeholders in the sector such as MSME officials of RBI, SIDBI, public and private sector banks, venture capital firms, credit rating agencies and incubators, through in-person interviews.

Estimation of MSME Finance Demand

The major source of information for the estimation of finance demand is the Fourth All India Census on MSME 2007 (MSME Census), Annual Reports of Ministry of MSME, SIDBI Report on MSME 2010, SIDBI MSME Database 2010, National Accounts Statistics (NAS) Ministry Of Statistics and Program Implementation (MOSPI).

The methodology for estimating MSME finance demand involves five stages as exhibited in Figure 45. The detailed description of each stage is provided in the following text.

Figure 45: Key Steps in the Estimation of MSME Finance Demand

Estimation of average finance demand per enterprise

The underlying data for assessment is derived from the Fourth All India Census on MSME 2007. Trends in key financial metrics, namely, gross output per enterprise and average enterprise asset turnover ratio are used to derive the average enterprise finance demand in 2010.

Average finance demand is the sum of the capital expenditure or long term finance demand and the working capital or short term finance demand of an enterprise.

- The long term finance demand is defined as the annual demand to finance the increase in fixed asset per enterprise
- Working capital or short term finance demand is defined as 25% (3 months) of operating expenses per enterprise across manufacturing and services enterprise

[139] All the assumptions are highlighted across Annex A

The key steps involved in estimation of average finance demand include the following:

- Enterprises have been segregated by type of industry i.e. manufacturing and services sector, further, the top ten industries in each manufacturing and services sector are considered for demand estimation as they account for 80% of the gross output of the sector
- The key financial metrics, namely gross output per enterprise, fixed asset per enterprise, asset turnover ratio, and average operating margins are estimated for each of the top ten industries in manufacturing and services. Average long term and short term finance demand per enterprise is estimated for each of the top ten manufacturing and services industry

Estimation for long term finance / capital expenditure

- The gross output per enterprise for 2010 is derived by extrapolating the estimation base (gross output per enterprise in 2007, MSME Census 2007) using industry level growth rates from National Accounts Statistics[140]
- The fixed asset per enterprise for 2010 is derived from the product of fixed asset turnover ratio (refer Table 20) and average gross output per enterprise in 2010
- The effective annual capital expenditure per enterprise in 2010 is adjusted for depreciation[141]

[140] Ministry Of Statistics and Programme Implementation

[141] Straight Line Method depreciation rates as provided in the Companies Act 1956

Appendix A

Estimation for short term finance / working capital

- Effective working capital per enterprise is the product of average operating margins[142] in each industry and gross output per enterprise (Table 20)
- The operating margin ranges between 8% – 20%, for instance food products and beverages has smallest operating margin of 8% and supporting & auxiliary transport & travel agents activities has highest operating margin of 20 percent

Table 20: Tables representing Gross output, Fixed Asset per enterprise, Operating Margin and Asset Turnover Ratio for Top 10 Manufacturing and Services Industries*

	S. No.	Top 20 Industries	Share of Gross Output of MSME Sector	Fixed Asset per Enterprise (INR Million)	Average Operating Margin	Asset Turnover Ratio
Manufacturing	1	Food products & beverages	19%	4 (0.08)	8%	2.08
	2	Textiles	10%	6 (0.12)	8%	1.24
	3	Basic metals	10%	15 (0.3)	15%	2.47
	4	Chemicals & chemical products	8%	11 (0.22)	10%	1.48
	5	Fabricated metal products	7%	4 (0.08)	8%	1.18
	6	Machinery & equipment	6%	7 (0.14)	10%	1.15
	7	Wearing apparel	5%	2 (0.04)	8%	1.04
	8	Rubber & plastic products	4%	10 (0.2)	12%	1.46
	9	Other transport equipment	3%	6 (0.12)	10%	2.67
	10	Other non-metallic mineral products	3%	6 (0.12)	15%	0.91
Services	11	Retail	0.7%	1 (0.02)	8%	0.38
	12	Repair & maintenance of motor vehicles	1.1%	2 (0.04)	10%	0.67
	13	Agriculture, hunting and related service activities	1.3%	5 (0.1)	8%	2.00
	14	Other business activities	0.6%	3 (0.06)	10%	0.90
	15	Computer and related activities	0.3%	4 (0.08)	15%	0.37
	16	Supporting & auxiliary transport & travel agents activities	0.3%	17 (0.34)	20%	0.57
	17	Forestry, logging and related service activities	0.3%	7 (0.14)	10%	2.90
	18	Other service activities	0.2%	2 (0.04)	10%	1.55
	19	Electricity, gas, steam & hot water supply	0.2%	41 (0.82)	10%	0.68
	20	Post & telecommunications	0.1%	5 (0.1)	10%	0.19

**Figure in brackets is in USD Million*

Source: MSME Census, 2007

[142] ISI Emerging Markets Database

Key assumptions in estimation of average finance demand:

The key assumptions include:

- Average finance demand in the registered and unregistered enterprises is similar
- Asset turnover ratio of enterprises remains constant over 2007-10[143]

Estimation of overall debt and equity demand

Discussions with financial institutions, MSME associations and enterprises suggest that MSMEs prefer debt to meet 80 percent of their finance demand, while the balance is met through equity. The sources of both debt and equity could be formal or informal.

Key assumptions in estimation of overall debt and equity demand:

The average debt to equity ratio in the sector is estimated to be ~4:1 (leverage ratios in the sector range from 2:1 to 4:1), validated through primary interviews with MSME associations and financial institutions such as banks, NBFCs, venture capitalists etc.

[143] MSME Census, 2007

Appendix A

Estimation of viable and addressable debt demand

The total quantum of debt demand cannot be considered viable and addressable by formal financial institutions. Assessment of viable and addressable debt demand requires enterprise level assessment as conducted by the financial institutions. As enterprise level information on the sector is not available, the study uses sector level proxies such as sickness in enterprises, vintage of enterprises, voluntary exclusions for the assessment.

The assessment assumes that all enterprises in the sector need finance and access external finance from formal or informal sources. The viable and addressable enterprises are defined as sum of enterprises currently served by the formal financial institutions and additional addressable enterprises (Table 21).

Table 21: Table Representing the Estimation of Viable and Addressable Enterprises

S. No.	Particulars	In Million	Share of Enterprises
A	Total number of MSMEs that need finance	29.8	100%
B	Number of enterprises which approach formal sources to access finance	14.7	
C	Number of enterprises which access finance through formal sources	10.3	35%
D	Number of enterprises which access finance through informal sources[144]	12.0	
D (i)	Number of enterprises rejected by formal financial institutions (B – C)	4.4	
D (ii)	50% of micro enterprises in the services sector voluntarily choose to access informal sources	7.5	
E	Number of enterprises excluded to arrive at additional addressable enterprises	11.0	
E (i)	New enterprises excluded based on effective growth rate and closure rate	7.0	
E (ii)	Sick enterprises excluded based on the incidence of sickness in the sector	4.0	
F	Number of additional addressable enterprises	1.0	3%
G	Total number of viable and addressable enterprises (C+F)	11.3	38%

[144] 50 percent of the micro services enterprises (~7.5 million) do not access finance through external sources of finance but self-finance their enterprises

- The number of enterprises that approach formal sources is estimated to be 14.7 Million, back calculated from the number of enterprises in the formal banking system (10.3 Million enterprises with a 70 percent acceptance rate[145])
- Total number of accounts of micro and small enterprises for 2010 is 7.4 Million[146] for Public Sector Banks. The share of micro accounts for 2010 is assumed to follow the same trend as observed in 2008[147] for Public Sector Banks.
- To arrive at the number of enterprises that access finance, the data on number of accounts is adjusted for account multiplicity i.e. enterprise holding accounts in multiple banks. Micro enterprises are found to have a finance relationship with a single bank, while small and medium enterprises are found to have finance relationships with more than one bank (average of two financial institutions per enterprise)
- Average per enterprise supply is calculated based on the total supply to micro and small enterprises and the number of enterprises financed respectively by Public Sector Banks in 2010.
- Due to lack of data on the accounts of medium enterprises, average per enterprise supply for medium enterprises is estimated based on primary interviews with financial institutions such as banks, NBFCs, etc.
- Total enterprises financed were calculated based on the total supply[148] and the average per enterprise supply to the micro, small and medium enterprises respectively. The following table depicts the total number of enterprises financed (~10.3 Million) (Table 22)

[145] Acceptance rate of 70 percent estimated based on discussion with Public Sector Banks and Private Banks

[146] Reserve Bank of India, 2010

[147] Reserve Bank of India, 2008

[148] Reserve Bank of India, SIDBI, Primary Research

Table 22: Estimation on Number of Enterprises Currently Served by Financial Institutions

Sector	Type of enterprise	Estimated number of enterprises financed (in Million)
Manufacturing	Micro	4.0
	Small	0.6
	Medium	0.03
Services	Micro	5.4
	Small	0.2
	Medium	0.02
Total		10.3

Source: Data on number of micro and small enterprises accounts is taken from Statistical Tables Relating to Banks in India, RBI

Estimation on number of enterprises excluded to arrive at additional addressable enterprises

- 7 Million new enterprises: Estimated based on the effective enterprise growth rate of 4 percent and closure rate of enterprises (accounting 23 percent of the overall debt demand).
- 4 Million sick enterprises: The incidence of sickness in the sector is indicated to be ~12-13 percent[149] and hence the number of sick enterprises is estimated to be 4 Million (accounting ~13 percent of the overall debt demand)

[149] SIDBI Report on MSME 2010

Appendix A

Key Assumptions in estimation of viable and addressable enterprises:

The key assumptions include:

- The assessment assumes that all enterprises in the MSME sector desire access to external finance, from formal or informal sources
- The share of micro enterprise accounts in the banking system for 2010 is assumed to follow the same trend as observed in 2008[150] for Public Sector Banks
- Micro enterprises are found to have a finance relationship with a single bank, while small and medium enterprises are found to have finance relationships with more than one bank
- The average debt supply per enterprise by financial institution to micro, small enterprise segments and manufacturing, services sectors is assumed to follow the trend observed in Public Sector Banks. Average debt supply per enterprise in Public Sector Banks is calculated as a ratio of total debt supply to the segment and estimated number of enterprises served in that segment. The above calculated ratio is used to determine the number of enterprises served by other banking and non-banking institutions
- Due to lack of data on the accounts of medium enterprises, average per enterprise supply for medium enterprises is estimated based on primary interviews with financial institutions such as banks, NBFCs, etc.
- The approach assumes[151] that 50 percent of micro enterprises (~7.5 Million) in the services sector voluntarily choose to access informal sources

[150] Reserve Bank of India, 2008

[151] Primary Interviews with MSME associations, banks, NBFCs

Disaggregation of viable and addressable enterprises into micro, small and medium enterprises

Information from primary research with financial institutions and subject-experts suggests that 90 percent (0.05 Million) of the medium enterprises and 50 percent (0.7 Million) of the small enterprises can be served in the near term. Excluding the above 0.75 Million enterprises from the addressable ~11.3 Million enterprises, ~10.5 Million micro enterprises can be served over the near term.

Disaggregation of viable and addressable debt demand

The viable and addressable debt demand is disaggregated by (a) enterprise size i.e. micro, small and medium enterprises (b) industry type i.e. manufacturing and services sectors (c) geography of operation.

Disaggregation based on enterprise size

- The viable and addressable debt demand in each sub-segment is defined as the product of average debt demand and the number of addressable enterprises in each segment
- Based on primary interviews with financial institutions and assessment of secondary data the average debt demand is estimated to be INR 0.3-0.4 Million (USD 6,000 – 8,000) for micro enterprises, INR 4-4.5 Million (USD 80,000 – 90,000) for small enterprises and INR 40-55 Million (USD 0.8 – 1.1 Million) for medium enterprises

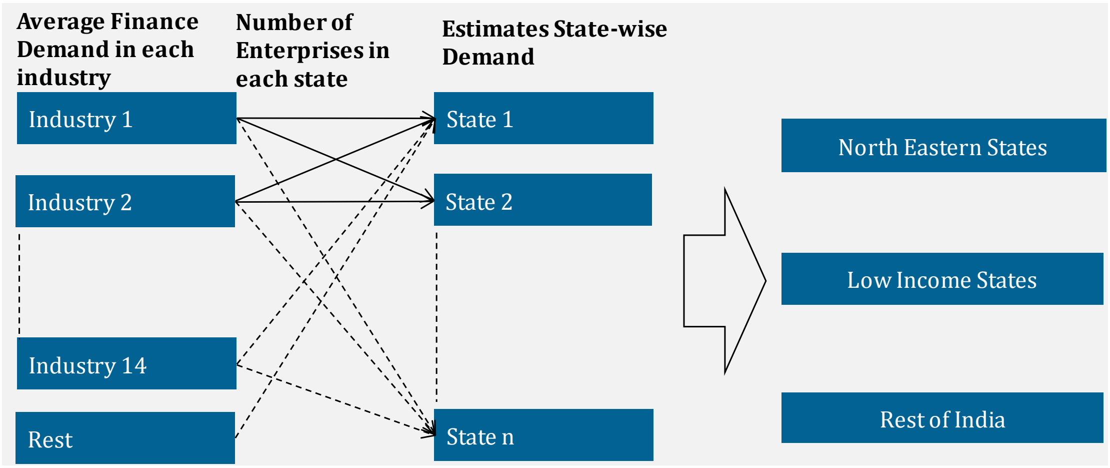
Disaggregation based on industry type

Based on the assessment of average debt demand, the manufacturing sector accounts for 60 percent of the viable and addressable debt demand, while the services sector accounts for the balance 40 percent

Disaggregation based on geography

The debt demand in each state is derived from the sum of all the debt demand from each industry in that state (Figure 46).

Figure 46: Disaggregating the Debt Demand by Geography of Operation



Source: IFC-Intellecap Analysis

The state wise debt demand is segregated into three main regions (a) Rest of India (RoI) (b) Low Income States (LIS) – Bihar, Uttar Pradesh, Rajasthan, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa and (c) North Eastern States (NES) – Assam, Meghalaya, Arunachal Pradesh, Tripura, Nagaland, Manipur, Mizoram. The distribution of viable and addressable debt demand is estimated to be in the same proportion as the overall distribution of debt demand (Table 23).

Table 23: Geography-wise Distribution of Viable and Addressable Debt Demand

Geography-wise Distribution of Viable and Addressable Debt Demand	
Region	**Estimated Share**
Rest of India	67.7%
Low Income States	32.3%
North Eastern States	2%

Source: Fourth All India Census on MSME 2007, IFC – Intellecap Analysis

Key Assumptions on disaggregation of viable and addressable debt demand:

The key assumptions include:

- Table 24 indicates the enterprise level assumptions which were validated in primary interviews with financial institutions such as banks, NBFCs , venture capitalists etc.:

Table 24: Table Representing the Enterprise Level Assumptions*

Average Debt Demand	Value (INR Million)
Micro enterprises	INR 0.3-0.4 Million (USD 6,000 – 8,000)
Small enterprises	INR 4-4.5 Million (USD 80,000 – 90,000)
Medium enterprises	INR 40-55 Million (USD 0.8 – 1.1 Million)

Source: Primary interviews with MSME Associations, MSMEs and industry experts

**Figure in brackets is in USD*

- The distribution of viable and addressable debt demand is assumed to be in the same proportion as the overall distribution of debt demand.

Appendix A

Estimation of viable and addressable equity demand

The overall equity demand is the sum of the equity portion of long term finance demand and the short term finance demand. The average debt-to-equity ratio in both long term and short term finance is estimated to be 4:1. The overall equity demand cannot be considered viable and addressable by financial institutions. Assessment of viable and addressable equity demand is depicted in Table 25.

Table 25: Table Representing the Estimation of Viable and Addressable Equity Demand*

S. No.	Particulars	In INR Trillion
A	Overall equity demand	6.5 (130)
A (i)	Long term equity demand	2.5 (50)
A (ii)	Short term equity demand (Entrepreneur's contribution)	4 (80)
B	Entrepreneurs contribution of the long term equity demand	0.6 (12)
C	Addressable long term equity demand (A – (A (ii)+B))	1.9 (38)
D	Long term equity demand excluded based on legal structure of the enterprises	1.23 (24.6)
E	Effective viable and addressable long term equity demand (C-D)	(13.4)

**Figure in brackets is in USD Billion*

- Primary research with the MSME association and industry bodies suggests that enterprises tend to self-finance their short term equity requirements
- Long term equity demand is estimated to account for 39 percent of the total equity demand, of which 25 percent[152] is estimated to be the entrepreneur's contribution
- Enterprise structures such as proprietorships or partnerships are not amenable to external equity investments; the equity demand from these enterprises is not considered in the viable and addressable equity demand. Hence the equity demand from all the micro enterprises and the proprietorship/ partnership enterprises from the small enterprise segment is excluded to estimate the viable and addressable equity demand

[152] Hundred Small Steps, Rajan R. 2009

The total long term equity demand is further segmented into equity demand by early stage and growth stage enterprises (Table 26).

- According to the MSME census, new enterprises are estimated to account for 23 percent of the long term equity demand which is considered as early stage equity demand
- Entrepreneur's contribute to the 25 percent[153] of the long term equity demand
- The balance is required for established enterprises as growth stage equity capital

Table 26: Table Representing Estimation on Total Long Term Equity Demand by Early Stage and Growth Stage Enterprises

S. No.	Particulars	In INR Trillion
A	Total long term equity demand	2.5 (50)
A (i)	Long term equity demand by early stage enterprises	0.58 (11.6)
A (ii)	Entrepreneur's contribution to the long term equity demand	0.6 (12)
A (ii)	Long term equity demand by growth stage enterprises	1.32 (26.4)

**Figure in brackets is in USD Billion*

Key Assumptions in estimation of viable and addressable equity demand:

The key assumptions include:

- The average debt to equity ratio in the sector is estimated to be ~4:1 (leverage ratios in the sector range from 2:1 to 4:1) through primary interviews with MSME associations and financial institutions such as banks, NBFCs, venture capitalists etc.
- All micro enterprises are considered to be either proprietorship or partnership firms

[153] Hundred Small Steps, Rajan R. 2009

Estimation Methodology: Supply of Formal Finance

The databases and publications of the Reserve Bank of India (RBI), Small Industries Development Bank of India (SIDBI), Ministry of MSME have been used extensively for data on the supply of formal finance to the MSME sector.

Estimation of Supply from Commercial Banks and Other Government Institutions

The micro and small enterprise segments are part of the priority sector and loans to these segments are reported separately to the RBI. The RBI database[154] provides information on supply of debt to the micro and small enterprises segments. Further, the same database also provides information on manufacturing and services sector in the micro and small enterprise segments.

The data on medium enterprise segment is partially available, as the current database provides information on supply of debt to medium enterprises in the manufacturing sector. In the study, the services sector contribution is estimated based on medium enterprise portfolio of few large commercial banks (3 Public Sector Banks and 1 Private Sector Banks). Based on the primary research on the medium enterprises portfolio, the contribution of services sector is assumed to be ~35 percent.

The pattern of portfolio distribution across other financial institutions is assumed to be similar to that of the commercial banks.

[154] Reserve Bank of India, 2010

Estimation of Supply from NBFCs

The data on NBFCs is not available for public consumption and hence the study draws on the information from primary interviews and secondary sources. The study attempts to triangulate the size of the NBFC market using various methods.

Primary interviews[155] with the financial institutions indicate that the size of NBFC market is 10 percent of the outstanding portfolio of commercial banks (INR 5.7 Trillion[156]; USD 114 Billion), the NBFC market is estimated to be INR 0.57 Trillion (USD 11.4 Billion). Also, assuming that 15 percent portfolio of asset financing and loans of NBFCs (estimated to be INR 3.8 Trillion[157]; USD 76 Billion) is in the MSME sector, the potential market for MSMEs is estimated to be INR 0.57 Trillion (USD 11.4 Billion).

Based on the assessment of primary and secondary data, the study estimates the market share of NBFCs in the MSME sector to be INR 0.57 Trillion.

Estimation of Geography-wise Supply

The study used information on priority sector lending for each state from the State Level Banker's Committee (SLBC). Since the data available from SLBC was not consistent with the aggregate data available from the RBI; the percentage share of MSE lending by each state, derived from the SLBC data was used to disaggregate the overall debt supply of commercial banks (Table 27).

[155] Refer Annex H

[156] Reserve Bank of India

[157] Working Group on the Issues and Concerns in the NBFC Sector, Reserve Bank of India

Table 27: Geography-wise Distribution of Debt Supply by Commercial Banks 2009-10

Geography-wise Distribution of Debt Supply by Commercial Banks	
Region	Estimated Share
Bihar	0.28%
Chhattisgarh	0.82%
Jharkhand	0.58%
Madhya Pradesh	2.23%
Orissa	2.53%
Rajasthan	3.48%
Uttar Pradesh	5.60%
Arunachal Pradesh	0.18%
Assam	1.00%
Manipur	0.03%
Meghalaya	0.08%
Mizoram	0.01%
Nagaland	0.06%
Tripura	0.04%
Delhi	12.49%
Uttarakhand	1.57%
Andhra Pradesh	5.19%
Goa	0.52%
Gujarat	5.23%
Haryana	2.42%
Himachal Pradesh	0.17%
Jammu and Kashmir	0.70%
Karnataka	6.18%
Kerala	3.82%
Maharashtra	26.48%
Punjab	3.97%
Sikkim	0.03%
Tamil Nadu	12.82%
West Bengal	1.51%
Total	100%

Source: SLBC, RBI, IFC-Intellecap Analysis

The geography-wise portfolio distribution of other financial institutions is assumed to follow a trend similar to commercial banks.

Appendix C

Credit Guarantee Trust Scheme for Micro and Small Enterprises (CGTMSE)

Enterprises in the micro and small enterprise (MSE) segment experience challenges in accessing credit from banks due to the lack of adequate secondary collateral or third-party guarantees. In order to catalyze the flow of credit to the MSE sector without the burden of collateral, the government and SIDBI set up the credit guarantee scheme (CGS) for the micro and small enterprise segments. The CGS provides default cover for MSE credits in case of enterprise default. The scheme encourages member financial institutions of the trust to finance credit applications based on the viability of enterprise and a primary security (i.e. asset created out of the finance support).

Scheme Structure

The corpus for the scheme is contributed by the Government and SIDBI in the ratio of 4:1, the corpus as on February 2012 was estimated to be INR 33 Billion[158] (USD 0.66 Billion). The corpus is managed by a trust – the Credit Guarantee Trust Scheme for Micro and Small Enterprises (CGTMSE).

CGTMSE leverages the network of member lending institutions to distribute the CGS. All commercial banks and institutions notified by the government can be member lending institutions. However, the subscription to and usage of the CGS by commercial banks is voluntary. As on March 2010, an estimated 100 financial institutions subscribed to the membership of the trust.

The beneficiaries of the scheme are MSEs as defined by the MSMED Act 2006.

Scheme Features

The scheme encourages member institutions to extend collateral free financing (both fund-based and non-fund-based) to the MSE segment with maximum limit of INR 10 Million (USD 0.2 Million). For credit applications covered under the scheme, the trust extends guarantee cover up to 85 percent of outstanding amount on default (Table 28).

[158] SME Times, 2012

Table 28: Overview of the Outstanding Amount Covered on Default by the CGS

CGTMSE Cover Limits			
Beneficiary Category	Value of the Credit Disbursed		
	Maximum of INR 0.5 Million (USD 10,000)	INR 0.5 –INR 5 Million (USD 10,000 – 0.1 Million)	INR 5 –INR 10 Million (USD 0.1 – 0.2 Million)
Micro Enterprise Segment	85 percent of amount in default with maximum limit of INR 0.45 Million (USD 9000)	75 percent of amount in default with maximum limit of INR 3.75 Million (USD 75,000)	INR 3.75 Million (USD 75000) with 50 percent of amount in default above INR 5 Million (USD 0.1 Million) with a maximum limit of INR 6.25 Million (USD 0.125 Million)
Women entrepreneurs and Enterprises in North East	80 percent of amount in default with maximum limit of INR 4 Million (USD 80,000)		INR 4 Million (USD 80,000) with 50 percent of amount in default above INR 5 Million (USD 0.1 Million) with a maximum limit of INR 6.5 Million (USD 0.13 Million)
Other Category	75 percent of amount in default with maximum limit of INR 3.75Million (USD 75,000)		INR 3.75 Million (USD 75,000) with 50 percent of amount in default above INR 5 Million (USD 0.1 Million) with a maximum limit of INR 6.25 Million (USD 0.125 Million)

Source: Reserve Bank of India

The trust charges a member institution a one-time guarantee fee at the rate of 1 percent for a credit facility with a limit of INR 0.5 Million (USD 10,000) and 1.5 percent for a credit facility of more than INR 0.5 Million (USD 10,000). Further, the trust also charges the member institutions an annual service fee of 0.5– 0.75 percent of the credit facility sanctioned. Currently, member institutions pass on the service fee to the beneficiaries.

The member institutions can invoke the guarantee within a maximum period of one year from the date of borrower account becoming a non-performing asset.

Latest update on the Scheme

As of March 2012, the scheme has approved approximately 790,000 guarantees for MSEs for an accumulative amount of INR 370 billion (USD 6.7 billion) extended by over 130 member institutions across 35 States/Union Territories. However, there is significant scope for the Guarantee Scheme to further expand, since the current coverage of CGTMSE accounts for between 7-10 percent of the micro and small enterprise portfolio of SCBs based on 2011 data from the RBI.

Appendix D

Performance & Credit Scheme for Rating of Small Scale Industries

Entrepreneurs in the micro and small enterprise segment have limited access to best practices in resources planning and reporting. Poor resource planning and record-keeping impacts the chances of accessing finance from formal financial institutions. The external rating process is considered to be a good mechanism to address some of the capacity gaps experienced by entrepreneurs. The rating process is expected to create awareness among micro and small enterprises on the strengths and weaknesses of the existing operations and avenues to improve productivity and organizational strength.

Scheme Structure

The government designed the scheme in discussion with Indian Banker's Association (IBA) and various rating agencies. The National Small Scale Industries Corporation (NSIC) is the nodal implementing agency for the scheme. The NSIC empanels external rating agencies to carry out the rating process and maintains a database of rated enterprises.

Scheme Features

The rating process provides an independent assessment of operations, finance, business and management/ entrepreneur risk. In order to ensure consistency in rating across various agencies, all the emplaned rating agencies use a uniform rating scale.

While the NSIC empanels the rating agencies, the enterprises have the freedom to choose a rating agency for the process. The fee structure for rating is linked to enterprise turnover and NSIC partially reimburses the rating fee (Table 29). The government funds the NSIC for the fee reimbursement.

Many financial institutions extend interest rate concessions to enterprises based on the credit rating provided by the empanelled agencies.

Latest update on the Performance

The empanelled agencies have rated an estimated 40,000-50,000 MSMEs as of March 2012.

Table 29: Turnover Based Fee Structure for MSE Credit Rating

Partial fee Reimbursement by NSIC	
Turnover Limits	**Fee Reimbursed by NSIC**
Maximum of INR 5Million (USD 0.1 Million)	75 percent of the fee or INR 25,000 (USD 500) whichever is lower
INR 5 – INR 20 Million (USD 0.1 – 4 Million)	75 percent of the fee or INR 30,000 (USD 600) whichever is lower
More than INR 20 Million (USD 4 Million)	75 percent of the fee or INR 40,000 (USD 800) whichever is lower

Source: NSIC

Central Registry of Securitization Asset Reconstruction and Security Interest of India (CERSAI)

The government, select nationalized banks and National Housing Board (NHB) have set up the Centralized Collateral Registry to maintain and operate a registration system for immovable property as collateral, reconstruction of financial assets and securitization transactions. The Registry has been set up under the SARFAESI Act 2002.The Company is structured as not-for-profit enterprise under Section 25 of the Companies Act 1956. The government owns 51 percent of company[159].

The operating rules for the company are provided in the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (Central Registry) Rules, 2011 (Central Registry Rules).

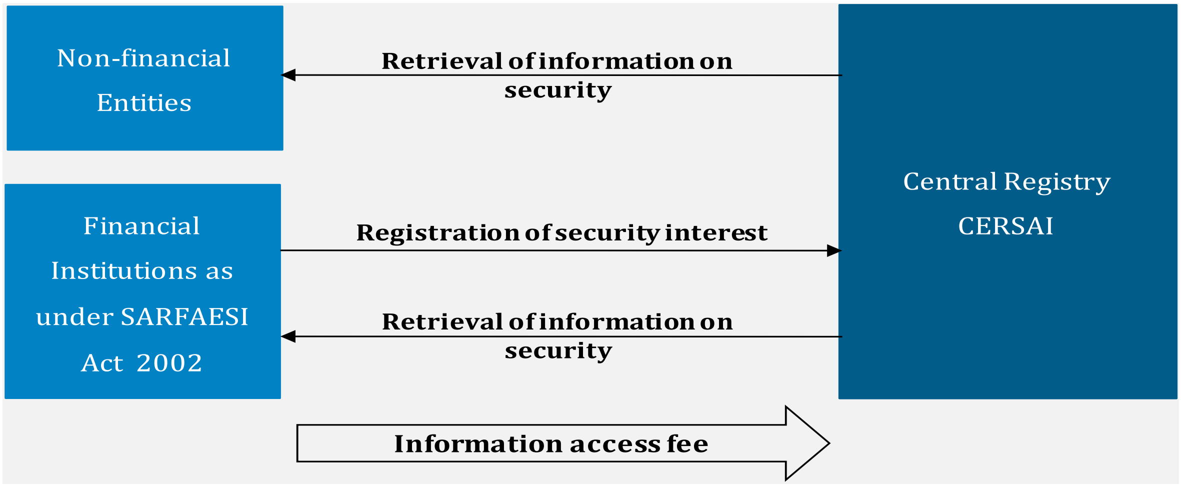
Details of the Registry

CERSAI provides an IT-enabled platform for all the stakeholders to register secured transactions. The potential users of the IT-enabled registry system include commercial banks, housing finance companies, other government financial institutions, debenture trustees appointed by a financial institution, securitization companies, reconstruction companies and other trustee holding companies. The financial institutions register title deeds on the assets in favor of the financial institutions.

The Registry follows a subscription model of operation, in which both the financial and non-financial entities can access information for a cost. The information can be accessed through the website of the Registry or through empanelled members such as commercial banks, depositary participants among others (Figure 47).

The Registry commenced operations on the 31st March, 2011 and is currently in the early stages of development. In a recent development, the Reserve Bank of India from March 2012 has mandated all financial institutions covered under the SARFAESI Act to record all their secured transactions (new and subsisting mortgages) with the Registry. Further, the Regulation of Factor (Assignment of Receivables) Bill, 2011 also requires all factoring transactions managed by financial institutions to be recorded with the Registry.

Figure 47: Overview of the Operations of the Central Registry



Source: NHB

[159] www.cersai.org.in

Appendix F

Credit Information Bureau (India) Limited (CIBIL)

CIBIL is a repository of credit information that is pooled from leading commercial banks and other financial institutions. The CIBIL provides credit information on both consumer and commercial customers of the member institutions.

CIBIL is public limited company registered under the Companies Act 1956. The key stakeholders in the company include commercial banks, rating agencies and other financial institutions.

Details of the Bureau[160]

The current number of members of the bureau is estimated to be 500 institutions comprising commercial banks, non-banking finance companies, credit card companies, housing finance companies and state financial corporations.

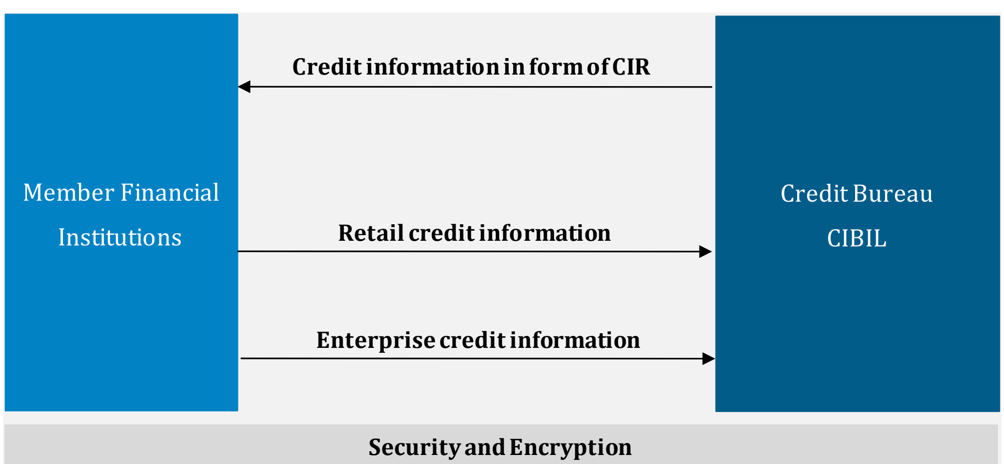
The bureau is composed of a consumer bureau i.e. for retail customers and a company bureau i.e. for enterprise customers. The consumer bureau has an estimated 170 Million records while the company bureau has an estimated 6.5 Million records[161].

The bureau operates on the principle of reciprocity, whereby data contributing members get access to the information from the database. CIBIL collates and processes information from various member institutions and provides information on the customer in form of a Credit Information Report (CIR). In addition to CIR, the CIBIL offers additional services such as scoring and fraud detection (Figure 48).

Company Bureau and MSME

The current company bureau is in a nascent stage, the bureau contains information accounts with assets of INR 2.5 Million and above. A large number of enterprises in the micro and small enterprise segment are not covered by the bureau.

Figure 48: Overview of Information Transactions with CIBIL



Source: CIBIL

[160] CIBIL

[161] http://www.cibil.com/about-us

Summary of Challenges in MSME Finance

The supply of formal finance to the MSME sector is constrained by multiple challenges on both the supply and demand sides. The demand-side is constrained by factors such as limited access to collateral that directly impact access to finance, as well as factors such as limited capacity of the entrepreneurs that indirectly impact access to finance. The supply-side is constrained by internal institutional challenges such as limited branch outreach and external operating environment challenges such as changes in macroeconomic scenario. Also, the demand and supply side challenges tend to be different for the addressable segment and not addressable segment[162] (Figure 49) in the MSME finance market.

Figure 49: Summary of Challenges that Constrain Financing to the MSME Sector

	Demand-side	Supply-side
Addressable Segment	• **Factors that directly impact financing** • Inadequate access to debt finance • Limited information on financial sources and products • Inadequate collateral • Limited access to alternate source of finance • **Factors that indirectly impact financing** • Inefficiency in business operations; limited entrepreneur capacity • Inadequate access to infrastructure • Inadequate market linkages • Inadequate access to technical assistance	• **Internal factors that constrain supply** • Limited information on enterprises in the sector • High cost of servicing high frequency, small size transactions in branch banking mode • Poor historic performance of the sector – higher NPA • Limited understanding of sub-segments in the • **External factors that constrain supply** • Changes in macroeconomic environment • Changes in legal and regulatory environment
Not Addressable Segment	• **Sick enterprises in the sector** • Limited access to rehabilitation support and archaic insolvency laws (proprietorships and partnerships) • Inadequate access to finance during sickness • Limited restructuring support for statutory payments • **New enterprises in the sector** • Inadequate access to finance during seed-stage of new enterprises • Limited access to technical assistance for new enterprises	• **Sick enterprise financing and restructuring** • Expensive and protracted process of default settlement mechanism • Limited clarity on seniority of claims during default settlement • **New enterprise financing** • Limited appetite for new venture investment at the branch level • Inadequate access to finance support infrastructure

Source: IFC – Intellecap Analysis

[162] Defined in Chapter 3

Appendix G

While the sector experiences multiple challenges, the existence of these challenges can be attributed to few common themes including (a) inadequate capacity building support for enterprises (b) financial information asymmetry, inadequate information infrastructure support (c) gaps in the legal and regulatory framework and (d) conservative mindset of the financial institutions (particularly the large financial institutions).

A sizeable number of enterprises in the sector are set up and managed by first generation entrepreneurs with limited managerial training, particularly in the micro and small enterprise segments. With limited training and capacity building of entrepreneurs, such enterprises experience significant challenges in resource management, technology adoption and financial planning. In addition, limited understanding of and information on financial products and services from formal financial institutions presents significant challenges in accessing finance.

Past experience of formal financing to the sector has a poor record, with high levels of non-performing assets. The financial information asymmetry makes risk assessment challenging. Further, transactions in this segment are typically small in size, yet cost of service is disproportionately high. As a result many large financial institutions tend to shy away from operating in this sector. In order to aid financial institutions in accurate risk assessment and cost effective servicing of enterprises, access to financial information through a strong financial infrastructure, including credit bureaus, collateral registry etc. is essential. While there are initiatives in the direction of setting up this information infrastructure, gaps still exist and there is scope for widening the data collection efforts.

While the government and financial regulators have instituted many policies and regulations that support the growth of the sector, gaps and implementation challenges in the existing legal and regulatory landscape negatively impact both development of enterprises and development of financial services. For example, absence of a modern legal framework for insolvency management in the MSME sector (particularly for enterprises structured as proprietorship and partnership) negatively impacts smooth closure of enterprises, and a lacunae in the legal and regulatory framework for factoring services has restricted the growth of factoring services in the country.

The financing demand varies across sub-segments in the MSME sector, requiring financial institutions to innovate on both the product design and risk management mechanisms. Conservative or risk-averse mindset of financial institutions in addition to the impact of factors mentioned above has constrained supply of finance to the sector. As large financial institutions continue to move downstream, a significant level of innovation and mindset change is required to operate profitably in the sector. With large financial institutions continuing growth downstream to the MSME sector, the small financial institutions need to continue innovating to sustain the growth traction.

Appendix H

Details of Primary Research

The study extensively draws on information from primary interviews and validation discussions with various stakeholders in the MSME sector. The two sets of stakeholders leveraged for the study include (a) enterprises and enterprise association (b) financial institutions.

The demand-side entities interviewed for primary data include MSMEs, MSME Associations, and MSME Business Development Service providers among others (Table 30)

Table 30: List of Primary Contacts

List of Primary Research Contacts	
S. No.	**Institution**
1	Coimbatore Business Development Services
2	Coimbatore District Small Scale Industries Association
3	Tamil Nadu Association of Cottage and Micro Enterprises
4	Tirupur Business Development Services
5	Tirupur Exports Association
6	Panipat Business Development Services
7	Dehradun Business Development Services
8	Panipat Exporters Association
9	Ludhiana Business Development Services
10	Drug Manufacturing Association
11	Rourkela Business Development Services
12	All India Carpet Yarn Spinners and Dealers Association
13	Bhadodhi Business Development Services
14	Bhadodhi Business Development Services
15	Pithampur Audhogik Sangathan
16	Indore Business Development Services
17	Indian Industries Association
18	Indian Industries Association/Entrepreneur
19	All India Carpet manufacturing association
20	Kanpur Business Development Services
21	Rourkela Chamber of Commerce & Industry, (RCCI)
22	Indian Institute of Entrepreneurship
23	North Eastern Small Scale Industries Association (NESSIA)
24	Federation of Industry & Commerce of North Eastern Region

Appendix H

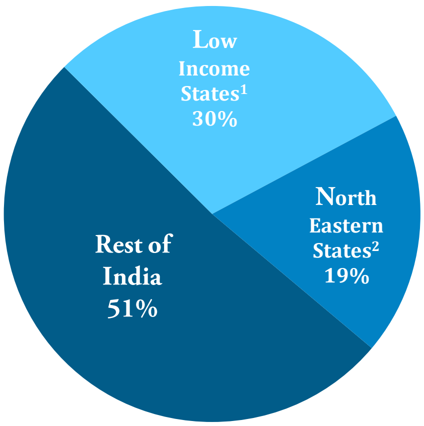
Table 30: Cond...

List of Primary Research Contacts	
S. No.	**Institution**
25	All Assam Small Scale Industries Association
26	Paper bag manufacturer(Micro Entrepreneur)
27	Pharmaceuticals(Micro Entrepreneur)
28	Machine Products
29	Supa Hinduma Products
30	SKS Accessories
31	Home Creations (India)
32	SS Sleeves(Micro Entrepreneur)
33	Pumps(Micro Entrepreneur)
34	Cyano Pharma
35	Furniture (Micro Entrepreneur)
37	Paper bag manufacturer(Micro Entrepreneur)
38	Pharmaceuticals(Micro Entrepreneur)

Although the list enumerates 38 contact points, the number of interviews is a lot higher because the team conducted primary interviews with cluster heads and entrepreneurs who represented multiple enterprises. The regional distribution of primary interviewees is as given in Figure 50.

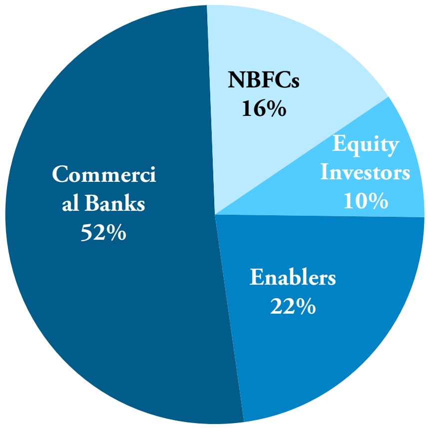
The supply-side entities interviewed for the study include RBI, SIDBI, commercial banks, NBFCs, equity investors, and enablers such as credit rating agencies, asset reconstruction companies, government agencies and CGTMSE. In total 31 supply side entities were interviewed and the distribution of supply-side entities is provided in Figure 51.

Figure 50: Regional Distribution of Primary Interviewees



(N=38)

Figure 51: Distribution of Key Supply-side Entities Interviewed for the Study



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