



An Assessment of the State of Risk Capital Finance to the Micro, Small and Medium Enterprise Sectors in India

November 2018

ACKNOWLEDGEMENTS

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This assessment was conducted and document written for the International Finance Corporation (IFC) by Intellectual Capital Advisory Services Private Limited.

The assessment was undertaken with funding support from the Government of Japan.

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Executive Summary

It is estimated that promoters of more than 22 million micro, small and medium enterprises in India have to rely on their own funds, or loans from friends and family, for capital. These sources, however, are often inadequate or expensive, and act as a constraint on growth. Enterprises need access to institutional sources of debt and equity. However, debt from institutional sources such as banks and non-banking finance companies often requires collateral, which early stage MSMEs and entrepreneurs often struggle to provide. In such cases, there arises a need for equity or unsecured debt – collectively referred to as risk capital.

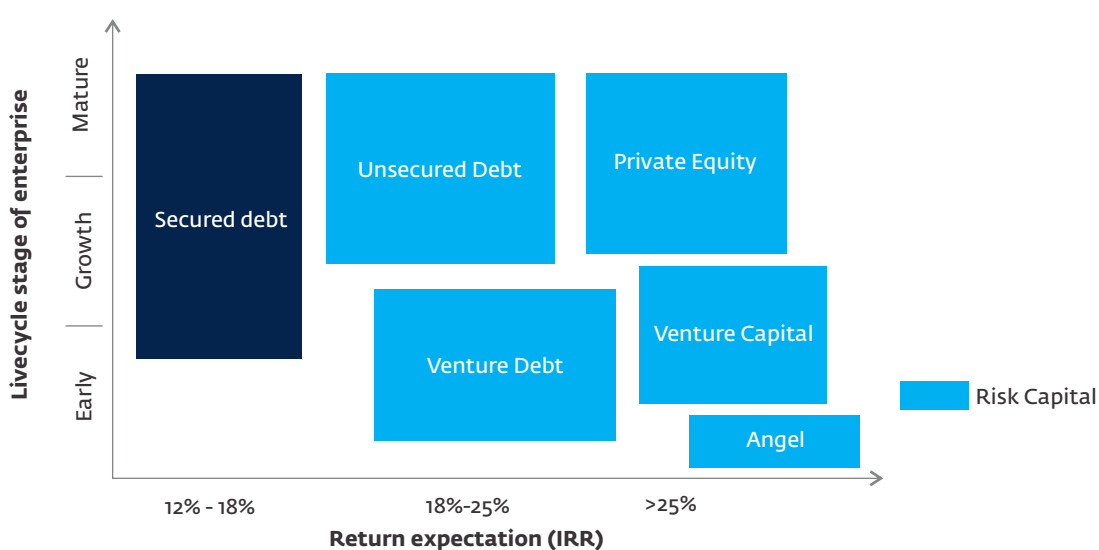
Executive Summary

It is estimated that promoters of more than 22 million micro, small and medium enterprises in India have to rely on their own funds, or loans from friends and family, for capital¹. These sources, however, are often inadequate or expensive, and act as a constraint on growth. Enterprises need access to institutional sources of debt and equity. However, debt from institutional sources such as banks and non-banking finance companies often requires collateral, which early stage MSMEs and entrepreneurs often struggle to provide. In such cases, there arises a need for equity or unsecured debt – collectively referred to as risk capital.

This study aims to assess the state of risk capital finance to the MSME sector in India. It focuses on analyzing the forms, sources and availability of risk capital products, such as equity, venture debt and unsecured debt to the sector.

It estimates the gap in the demand and supply of risk capital to the sector, with a focus on equity capital (in the form of private equity, venture capital and angel investments). It assesses the relevant enabling environment and supporting policy infrastructure, and in conclusion, provides recommendations and potential interventions to mitigate the demand-supply gap in MSME risk capital financing.

Generally, risk capital providers do not rely on the legal definition of MSMEs for their investment decisions. They place greater emphasis on the lifecycle stage of the enterprise. In addition to the lack of collateral, the absence of contractually agreed returns imparts an additional element of risk to risk capital investments. To compensate for this additional risk, the return expected by risk capital providers is usually higher than that of secured debt providers.



¹ Definition of Micro, Small and Medium Enterprise is based on a maximum cap on investment in plant and machinery and equipment, as defined in the MSMED Act, 2006, WBG - Intellectcap Analysis

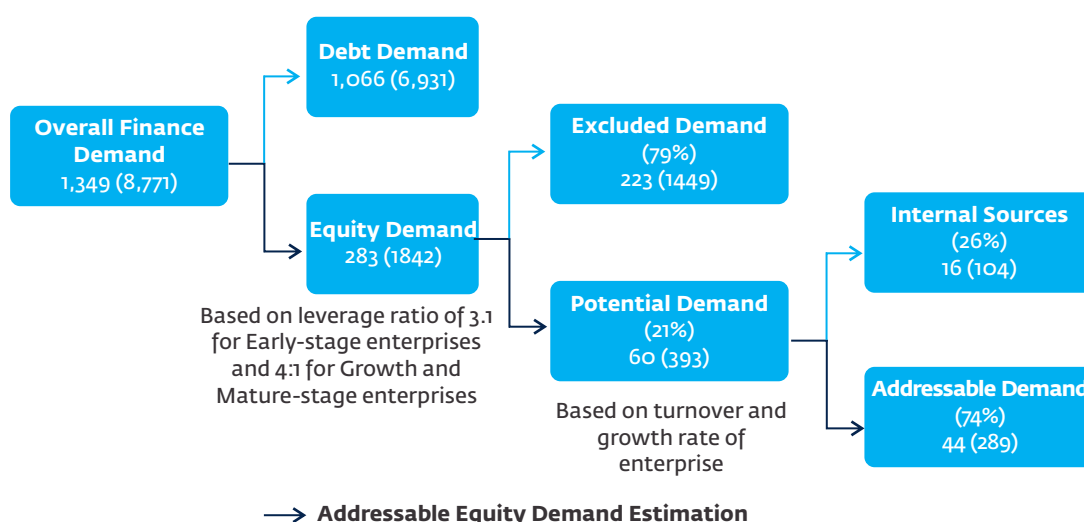
Demand from the MSME Sector

According to the Annual Report of the Ministry of MSME, there were 55.8 million MSMEs in India as of 2017². The overall demand for finance from the MSME sector in 2017 was estimated at USD 1,349 billion (INR 8,771 thousand crore), of which USD 283.3 billion (INR 1,842 thousand crore) was equity demand. Equity demand can be fulfilled by three broad sources – friends and family, retained earnings and external institutional equity capital infusion. However, demand from all MSMEs cannot be considered amenable to

equity infusion from external institutional sources. Primary research indicates that from a quantitative perspective, only MSMEs that exceed certain thresholds of turnover and annual growth rate can be considered potential enterprises for external institutional equity infusion.

Thresholds for estimating addressable demand	
Enterprise Turnover (INR)	Turnover Growth Rate (Y-o-Y)
25 lac	25%

The addressable equity demand from the MSME sector is roughly USD 44.4 billion (INR 289 thousand crore). The following flowchart indicates the process used to arrive at the addressable equity demand.



Since early-stage enterprises³ find it harder to access debt finance, they tend to depend more heavily on equity – which is often provided by informal sources. Growth-stage enterprises tend to have relationships with financial institutions which allow them to raise debt more easily than early-stage ones. Mature-stage enterprises tend to have a larger pool of internal accruals and are able to access debt capital more easily.

Consequently, a mature-stage enterprise demands less external equity infusion as compared to a growth-stage enterprise⁴. However, almost 50 percent of the MSME sector consists of mature enterprises. As a result, at an aggregate level, more than half the addressable equity demand – USD 23.4 billion (INR 152 thousand crore) – comes from enterprises in the mature stage.

² Ministry of MSME, Annual Report, 2016 - 17, WBG – Intelicap Analysis

³ For this study, a definition of enterprise lifecycle stage based on vintage of enterprise has been adopted. Early-stage: <5 years; Growth-stage: 5 - 10 years; Mature-stage: More than 10 years

⁴ Please refer to Table 8 in Chapter 2 – Overview of Risk Capital Finance

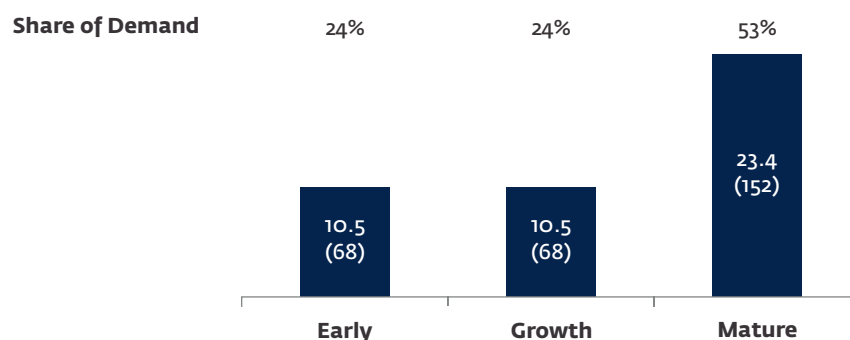


Figure in USD billion; figure in brackets in thousand crore Indian rupees
Source: MSME Census, WBG - Intelicap Research

Enterprises often need capital to meet short-term growth requirements. However, they often lack the collateral required to raise debt finance. Raising equity is typically a protracted process and may also not be the most cost-effective mode of financing for working capital in such cases. Venture debt and unsecured debt have emerged as products that help meet such short-term working capital requirements. It is estimated that working capital accounts for 30 to 40 percent of the addressable equity demand.

Supply to the MSME Sector

Risk capital is supplied through various sources in India:

	Bank	NBFCs	SIDBI	Angels	VC/PEs
Equity			✓	✓	✓
Venture debt		✓	✓		
Unsecured debt	✓	✓	✓		

Equity:

It is estimated that USD 1.05 billion (INR 6,851 crore) was invested in MSMEs in India in 2017⁵. Almost 70 percent of this was in early-stage enterprises. While there is more risk associated with early-stage investments in enterprises with relatively less proven business models, the growth prospects and the ability of the investor to influence the business model are much higher. Consequently, investors tend to prefer early-stage enterprises to maximize returns.

⁵ Venture Intelligence, WBG - Intelicap Analysis



Share of investment

69% 19% 12%

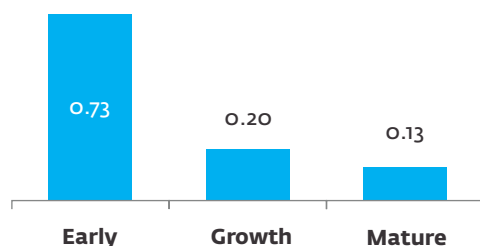


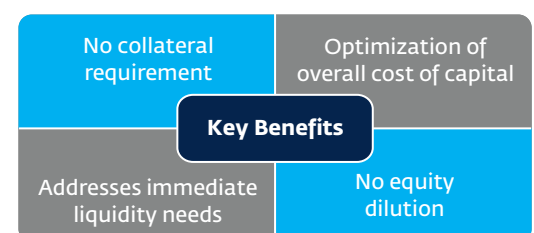
Figure in USD billion; figure in brackets in thousand crore Indian rupees
Source: Venture Intelligence, WBG - Intelicap Analysis

Within the early-stage, there is increasing investor interest in pre-revenue, proof-of-concept stage enterprises. This is partly owing to the emergence of a new class of investors – angel investors such as high net-worth individuals (HNIs), family offices and successful professionals who have a higher appetite for risk. A mushrooming of enabling infrastructure for start-ups, such as incubators, accelerators and angel networks, is encouraging and assisting such investments.

Venture Debt

Venture debt providers give unsecured structured loans to early-stage MSMEs. The terms and repayment schedule of

venture debt are customized to the requirement of the enterprise and the risk-return perception of the provider. Venture debt providers may also build financing structures that provide them with equity-like returns on a portion of their lending. The venture debt supply in 2017 was roughly USD 140 million (INR 910 crore).



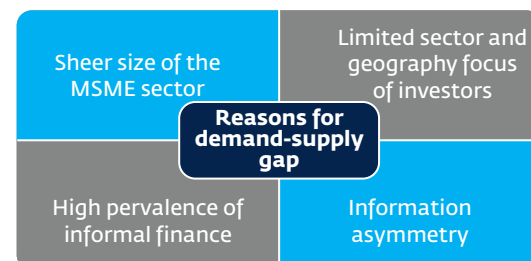
Unsecured Debt

Unsecured debt providers give short-to-medium term loans to MSMEs for working capital needs, purchase of equipment, business expansion, and more. Unsecured debt is popularly known as business installment loans or small business loan. The supply of unsecured debt in 2017 was roughly USD 6.5 billion (INR 42,000 crore).

Demand-supply Gap

At an overall level, formal equity invested in MSMEs was only around 2.3 percent of the addressable equity demand from the sector in 2017. The sheer size of the sector (55.8 million enterprises) is a major reason for the high demand-supply gap.

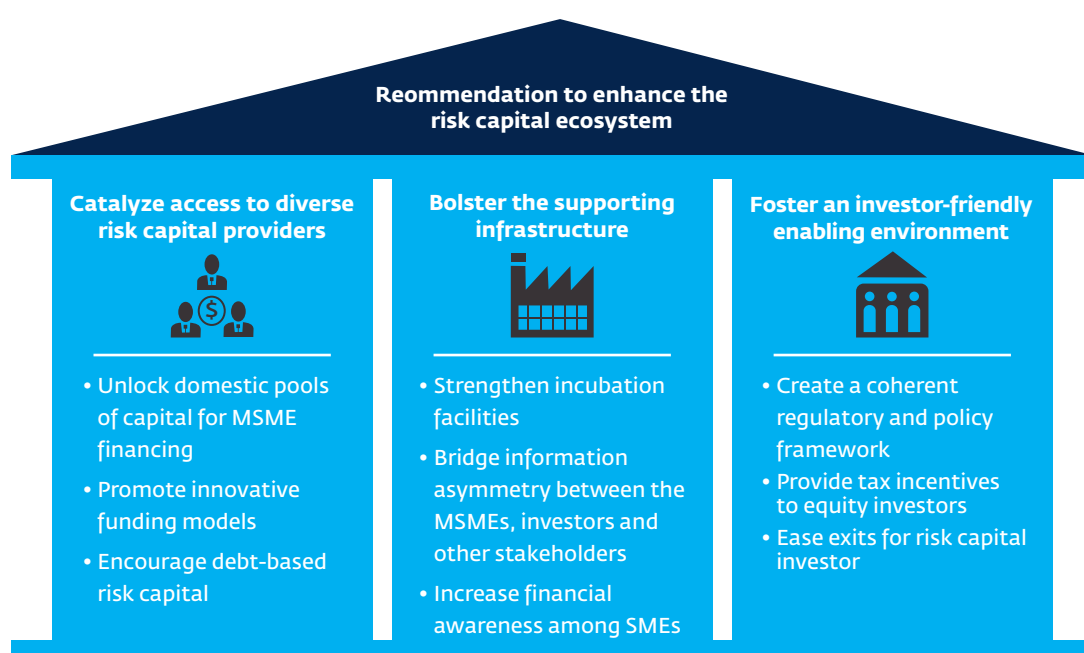
Since investors' focus is primarily on early-stage enterprises, the demand supply gap is marginally smaller in this segment as compared with the growth-stage and mature-stage segments. The gap is most pronounced in mature-stage enterprises, owing to the perception



among equity investors that mature-stage enterprises have comparatively lower growth prospects and would not provide the expected return on investment.

Recommendations and Potential Interventions

The large gap in demand and supply presents an opportunity for investors and financiers to expand their reach. But to achieve this, risk capital providers and enterprises will require sufficient support from regulatory/governing bodies and other ecosystem entities. This study highlights potential interventions to augment the various measures taken by policymakers to address the constraints of MSMEs in obtaining risk capital. Some of the interventions that could potentially improve the flow of risk capital to MSMEs are highlighted below.



1. Catalyze Access to Diverse Risk Capital Providers

It is estimated that only 10 to 15 percent of institutional equity capital flowing to enterprises is sourced domestically. While foreign capital is exposed to currency risk, country risk and other global economic factors⁶, domestic investor sentiment is not substantially affected by these. Domestic sources can provide long-term stable capital to MSMEs. Sophisticated domestic investors such as commercial banks, insurance companies, pension funds, endowment funds and HNIs could be encouraged to invest in the venture capital/private equity asset class. Additionally, innovative funding structures – such as patient capital, returnable capital and blended finance – that align the risk and return characteristics of MSMEs to those of investors could be explored.

Unsecured debt as a form of risk capital for MSMEs can also be expanded by an increased focus on cash-flow based lending. Financial institutions could be incentivized to increase lending to MSMEs by strengthening the existing Credit Guarantee Scheme and promoting robust risk management practices in the Micro Units Development Refinance Agency's recently implemented scheme. Venture debt can be adopted by lending institutions as a special instrument to lend to early-stage enterprises that are backed by venture capital.

2. Bolster the Supporting Infrastructure

Supporting ecosystem entities such as incubators, accelerators, angel networks and credit bureaus play an important

role in facilitating the risk capital infusion process. Incubation support for early-stage MSMEs can help in professionalizing their business and making them investment-ready. Government-driven initiatives focused on incubation such as the Atal Innovation Mission and the Self Employment and Talent Utilization (SETU) scheme can act as stimuli for private sector involvement. The Ministry of MSME can spearhead programs to support university incubators. Virtual incubation as a concept can be explored to reach entrepreneurs in remote locations.

Information asymmetry within the MSME sector also needs to be tackled using modern credit assessment methodologies, based on alternative enterprise data such as cash-flows, customer ratings and reviews and trade invoices. Credit information and rating agencies should be made more effective by expanding data streams for scoring, and providing detailed credit-worthiness reports to both banks and MSMEs.

Entrepreneurs' lack of financial awareness can deter them from exploring external institutional equity as a viable source of finance. Entrepreneurship development institutes such as the National Institute for Entrepreneurship and Small Business Development, Noida, the National Institute for Micro, Small and Medium Enterprises, Hyderabad or the Indian Institute of Entrepreneurship, Guwahati, could play an important role in educating them by conducting financial literacy campaigns, awareness programs and networking events for MSMEs, especially in Tier-II and Tier-III cities.

⁶ Concept note prepared by TVS Capital Funds Limited, 2014

Industry bodies like the Confederation of Indian Industry, the Federation of Indian Chambers of Commerce and Industry, the Associated Chambers of Commerce and Industry of India and the Federation of Indian Micro, Small and Medium Enterprises could also take similar initiatives.

3. Foster an Investment-friendly Enabling Environment

Enabling policy and a regulatory framework are critical to facilitating risk capital financing for MSMEs. This entails developing a favorable domestic investment climate for risk capital investors in terms of operational flexibility and regulatory clarity. Market regulator Securities and Exchange Board of India enacted the Alternative Investment Funds (AIF) Regulations in 2012 to delineate different pooling vehicles for equity investments and promote AIFs as a distinct asset class. The introduction of AIFs has created an opportunity for investors to explore new investment strategies through onshore funding structures. A greater flow of investments from AIFs into MSMEs can help boost local level entrepreneurship ecosystems and help unlock capital from domestic investors.

For AIFs to succeed, the regulatory regime for onshore pooling must be made favorable to foreign investors. This will give confidence to domestic institutional investors to co-invest and thus spur a robust localized fund management ecosystem. Liberalizing sectoral restrictions and enabling the automatic route for investments through SEBI's Foreign Venture Capital Investment regime would allow a greater number of foreign investors to register with SEBI and benefit from the relaxation of pricing norms under this regime. This would also enable SEBI to assess the quality of foreign investors and extend better oversight on systemic risks.

Tax incentives to risk capital providers could also boost early-stage investment. Rationalizing anomalies and hurdles in taxation would ease investor concerns significantly. A more efficient secondary market through SME exchanges and institutional trading platforms could mitigate liquidity risks for investors. In case of bankruptcy, a quicker procedure of insolvency resolution would also ease investor concerns over exits.

Chapter 1

MSME Landscape in India

MSME Landscape in India

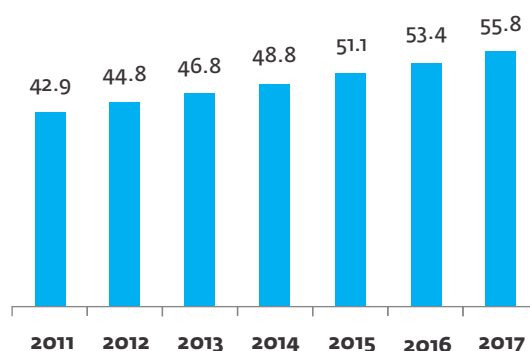
Key Takeaways

- The MSME sector in India comprises 55.8 million enterprises and employs over 124 million individuals.
- Enterprises are classified as Micro, Small or Medium based on their investment in plant and machinery and equipment.
- The MSME sector contributes to 39 percent of India's gross domestic product and 45 percent of its exports.
- Lack of sufficient infrastructure, limited access to technology, talent gap, institutional delays and lack of access to capital are the key challenges faced by the MSME sector.

1.1. Importance of the MSME Sector in India

The MSME sector in India has been widely recognized as a critical driver of growth of the Indian economy and vital for employment generation in both urban and rural areas. An IFC study in 2012 estimated the size of the sector at 29.8 million enterprises in 2010. That number has grown to 55.8 million enterprises in 2017 as per the MSME Ministry's annual report for that year⁷. The MSME sector is estimated to employ over 124 million individuals⁸. The 11th Five Year Plan refers to MSMEs as 'instruments of inclusive growth which touch upon the lives of the most vulnerable, the most marginalized people'⁹.

Figure: Growth of MSME Sector 2011–2017, million enterprises



Source: Ministry of MSME, Annual Report, 2016 - 17, WBG - Intelicap Analysis

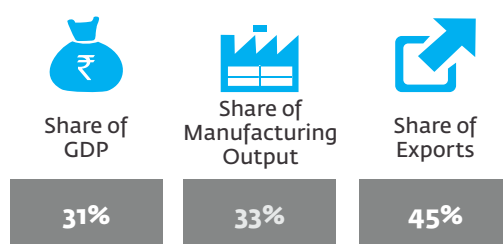
Micro, small and medium enterprises are spread throughout urban and rural India, and account for roughly 31 percent of the country's GDP¹⁰. According to the Sixth Economic Census, almost 60 percent of MSMEs are located in rural areas. The MSME Census notes that the employment intensity of MSMEs in rural areas is more than 1.5 times that in urban areas – indicating that rural MSMEs employ more people per unit fixed investment than urban ones. Focused development of rural MSMEs can thus help to reduce the growing rural-to-urban migration in India.

⁷ Including activities of wholesale/retail trade, legal, education & social services, hotel & restaurants, transports and storage & warehousing (except cold storage) for which data were extracted Economic Census 2005, Central Statistics Office, M/o SPI, and reported as part of the MSME sector starting 2012-13, Ministry of MSME, Annual Report, 2016-17, WBG-Intelicap Analysis

⁸ Ministry of MSME, Annual Report, 2016-17, WBG-Intelicap Analysis

⁹ http://planningcommission.nic.in/plans/planrel/fiveyr/11th/11_v3/11th_vol3.pdf

¹⁰ Ministry of MSME, Annual Report, 2016 - 17



population translates to a demographic dividend that has the potential to raise per capita income. Developing the MSMEs sector in low income states can generate many job opportunities to exploit this demographic dividend.

Additionally, as can be seen from Table 1, Low Income States account for more than 40 percent of MSMEs in the country. India has the world's largest youth population¹¹, but the share of children in the 0-6 age group has been reducing, especially in these states¹². The resulting fall in dependent

Table: MSMEs by Region

Region	Share of MSMEs (percent)
Low Income States ¹³	42
Northeastern States	3
Rest of India	55

Source: Department of MSME

MSME's contribution to economic growth – global experience

Globally, it is seen that there is a high correlation between SME share of GDP and development level of the country. Economic growth in developed countries such as Japan, Korea, Taiwan and many others, has been significantly generated by SME activities. The percentage contribution of SMEs to Gross Domestic Product (GDP)/total value added is 60.0% in China, 57.0% in Germany, 55.3% in Japan, and 50.0% in Korea. In China, SMEs contribute 60% of industrial output volume and 40% of the total taxes and profits realized.

SMEs are important drivers of employment generation as well. In the EU, SMEs comprise approximately 99% of an estimated 19.3 million firms and employ 65 million people. SMEs account for between 55% and 80% of total employment in Western Europe, Japan and USA. There are approximately 23 million SMEs in the US which employ more than 50% of the private workforce. In China, SMEs provide 75% of total urban employment.

Source: *The Role of SMEs in Employment Creation and Economic Growth in Selected Countries*
<http://www.ijern.com/journal/2014/December-2014/39.pdf>

1.2. MSME Sector – Definition

Micro, small and medium enterprises are defined differently in different countries. The typical criteria used for classification include number of employees, sales turnover and balance sheet size. The World Bank classifies an enterprise as an MSME when it meets two of the following three criteria:

Table 2: World Bank Group Definition of MSMEs

Enterprise Type / Enterprise Size	Micro	Small	Medium
Number of Employees	< 10	< 50	< 300
Turnover	≤ USD 10,000 (≤ INR 6.5 lac)	≤ USD 3 million (≤ INR 19.5 crore)	≤ USD 15 million (≤ INR 97.5 crore)
Assets	≤ USD 10,000 (≤ INR 6.5 lac)	≤ USD 3 million (≤ INR 19.5 crore)	≤ USD 15 million (≤ INR 97.5 crore)

¹¹ UNFPA's State of the World Population report

¹² Census of India

¹³ Low Income States include Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Odisha, Rajasthan, Uttar Pradesh and West Bengal

In India, MSMEs are defined according to the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006. The definitions are based on a maximum cap on investment in plant and machinery and equipment (Table 3). Since asset intensity of manufacturing sector enterprises is higher than of those in the service sector, the Act provides separate definitions for enterprises engaged in manufacturing and in services.

In 2015, the Ministry of MSME proposed amendments to the existing definitions to account for inflation and to ensure that the benefits of MSME-focused policy initiatives reached a wider array of enterprises. The proposed definition raised the capital limits of investment in plant and machinery and equipment to roughly twice the existing limits¹⁴.

The Union Cabinet in Feb, 2018 approved a proposal to change the definition of Micro, Small and Medium enterprises. According to the new definition, a micro enterprise is a unit where the annual turnover does not exceed INR 5 crore, a small enterprise is one where annual turnover is between INR 5 crore and INR 75 crore, and a medium enterprises is where the turnover is more than INR 75 crore but does not exceed INR 250 crore. In order to give this new MSME definition into effect, the Section 7 of the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 will be amended. Hence, for the purpose of this study, the MSME sector is considered as comprising of enterprises that comply with the definition set out in Table 3.

Table 3: MSMED Act Definition of MSMEs

Enterprise Type / Enterprise Size	Micro	Small	Medium
Investment in Plant, Machinery and Equipment (Manufacturing)	≤ USD 38,000 (≤ INR 25 lac)	USD 38,000 – 769,000 (INR 25 lac – INR 5 crore)	USD 769,000 – 1.54 million (INR 5 crore. – INR 10 crore)
Investment in Plant, Machinery and Equipment (Services)	≤ USD 15,000 (≤ INR 10 lac)	USD 15,000 – 308,000 (INR 1 crore – INR 2 crore)	USD 308,000 – 769,000 (INR 2 crore – INR 5 crore)

Source: MSMED Act

1.2.1. MSME Sector by Size of Enterprise (Micro, Small and Medium)

Almost 94.9 percent of MSMEs in the country are micro enterprises, while small and medium enterprises account for around 4.9 percent and 0.2 percent of the overall MSME sector, respectively (Table 4). Micro enterprises include a large number of proprietary firms engaged in the manufacture of food products, textile products, furniture, as well as in activities pertaining to wholesale/retail trade, legal, educational and social services, hotels and restaurants, transport, storage and warehousing¹⁵. While micro enterprises are present in other sectors as well, enterprises engaged in activities such as manufacture of chemicals and chemical products, fabricated metal products, machinery and equipment, tend to be small or medium enterprises.

¹⁴ Appendix C

¹⁵ MSME Census, 2007; Ministry of MSME, Annual Report, 2014 - 15

Table 4: MSME Sector by Size of Enterprise

	Micro	Small	Medium
Share of Enterprises	94.9 percent	4.9 percent	0.2 percent

Source: MSME Census

The MSME census, conducted with 2006-07 as the reference year, and the Annual Reports of the Ministry of MSME, are the most authoritative and detailed sources of data regarding the sector. These publications form the primary sources of data for this study. The methodology for estimating the equity demand from MSMEs draws upon the methodology and assumptions used during a similar exercise carried out in 2012, the results of which were published in IFC's report on MSME Enterprise Finance in India¹⁶.

1.3. Challenges Faced by the MSME Sector

The MSME sector's contribution to India's GDP has grown from around 35 percent in 2007 to around 39 percent in 2017.¹⁷ Over the years, the government of India has introduced various schemes and policy initiatives aimed at incentivizing the development and growth of the MSME sector. However, the sector continues to face significant challenges¹⁸, as it has over the past 20 years. The main ones are:

- **Lack of infrastructure:** More than two-thirds of MSMEs in India depend on electricity for their operations¹⁹. Irregular supply of electricity and a perennial power deficit, especially in rural and semi-rural areas, substantially limits the efficiency and output of enterprises. Additionally, poor transport infrastructure limits easy access to markets—especially affecting MSMEs engaged in the production of perishable items.

- **Limited access to technology:** To stay competitive, MSMEs need to modernize and upgrade technologically to enhance competitiveness. However, MSMEs have been constrained by low awareness, low access to emerging technologies and limited investment in research and development. It is estimated that MSMEs spend less than 1 percent of their turnover on R&D²⁰.
- **Talent gap:** Industrial training institutes and industrial training centers in the country lack adequate facilities, and there is a shortage of skilled labor available to MSMEs. Unorganized hiring and a large informal workforce limit internal skill development and creation of management expertise within MSMEs.
- **Institutional delays:** India was ranked 77 out of 190 economies in 2018 on the World Bank Group's Ease of Doing Business rankings. Although a significant improvement from the earlier rank of 130 in 2016, there is still a lack of sufficient aggregated information, portals and efficient processes to secure statutory clearances related to power, environment, and labor in India. Additionally, enforcing contracts remains a big pain point. The Bank Group ranked India at 163 out of 190 economies in the category 'Enforcing Contracts'. Enterprises face institutional delays right from starting a business through their entire lifecycle.

¹⁶ http://www.ifc.org/wps/wcm/connect/region_ext_content/regions/south+asia/publications/msme+report

¹⁷ Ministry of MSME, Annual Report, 2016 - 17

¹⁸ <http://pib.nic.in/newsite/PrintRelease.aspx?relid=123934>

¹⁹ MSME Census

²⁰ According to National Science & Technology Management Information System, Department of Science and Technology, Government of India

- **Lack of access to capital:** Lack of access to adequate and timely capital, often caused by insufficient financial information, has been identified as a major challenge for MSMEs²¹. Formal sources of finance cater to roughly

60 percent of MSMEs. This implies that more than 22 million MSME entrepreneurs have to rely on themselves, their friends and families for capital²² (Table 5).

Table 5: Share of Enterprises covered by formal sources of finance

	Micro	Small	Medium	Overall
Share of Enterprises	48.7%	76.4%	76.4%	60.6%

Source: WBG - Intellect Analysis, MSME Census

- **Information asymmetry:** The difficulty for MSMEs in accessing formal sources of capital is largely because of information asymmetry between capital providers and enterprises, the lack of adherence to formal accounting standards by MSMEs and the lack of adequate collateral with MSMEs. Information asymmetry results from the lack of depth of credit information about MSMEs with financial institutions. The reluctance of MSMEs to approach formal financing institutions also arises from their apprehensions about the complicated documentation procedures that such institutions require²³. Additionally, a vast majority of MSMEs are organized as proprietorships and partnerships²⁴ and often do not maintain financial records that comply with accounting best practices. This creates a perception of risk and constrains the supply of formal finance to the sector. According to IFC's 2012 report on MSME Enterprise Finance in India, debt from formal sources caters to less than 30 percent of the debt demand from the MSME sector²⁵. More than 75 percent of MSMEs are service sector enterprises and often operate asset light

businesses. They thus lack the physical assets that are accepted by formal financial institutions as collateral.

To supplement the supply of debt capital, the MSME sector also needs an adequate supply of capital that is subordinate to secured debt, and is willing to bear a different risk-return profile. This study focuses on analyzing

- The forms, sources and availability of such 'risk capital', with a focus on equity capital.
- The demand for risk capital from MSMEs at different stages in their growth journey.
- The gap in the demand and supply of risk capital, with a focus on equity capital.
- The enabling environment (regulatory framework, government plans and supporting infrastructure).

²¹ MSME Census; Prime Minister's Task Force on MSMEs, January 2010; Report of the The Working Group on MSME Growth for 12th Five Year Plan

²² WBG - Intellect Analysis, MSME Census 2006-07

²³ Report of the Committee on Medium-term Path on Financial Inclusion, December 2015

²⁴ ~95percent according to the MSME Census

²⁵ http://www.ifc.org/wps/wcm/connect/region_ext_content/regional/south+asia/publications/msme+report

Chapter 2

Overview of Risk Capital Finance

Overview of Risk Capital Finance

Key Takeaways

- Equity, venture debt and unsecured debt are three broad sources of external risk capital finance available to MSMEs.
- The returns expected by risk capital providers are usually higher than that of secured debt providers owing to an absence of any form of explicit collateral and, in the case of equity, an absence of contractually agreed returns.
- Risk capital providers place emphasis on an enterprise's lifecycle stage when making investment decisions.

2.1. Sources of Finance for MSMEs

Every MSME needs to raise capital from external sources at various points in its lifespan to sustain itself and thrive. The capital raised can be utilized to either invest in assets and/or meet working capital requirements. When a new venture is started, the entrepreneur uses personal savings and often borrows from friends and family to meet initial needs. As the enterprise grows, retained earnings can meet a part of the increasing need for capital. However,

at some point in the growth journey, capital available through internal accruals could prove inadequate and act as a constraint on growth. At such times, the enterprise may need to tap into various institutional and non-institutional sources to raise capital in the form of either debt or equity²⁶. The particular source and form of finance accessed by an enterprise depends on various factors such as lifecycle stage of the enterprise, cost of capital, ease of access, and the quantum of finance demand.

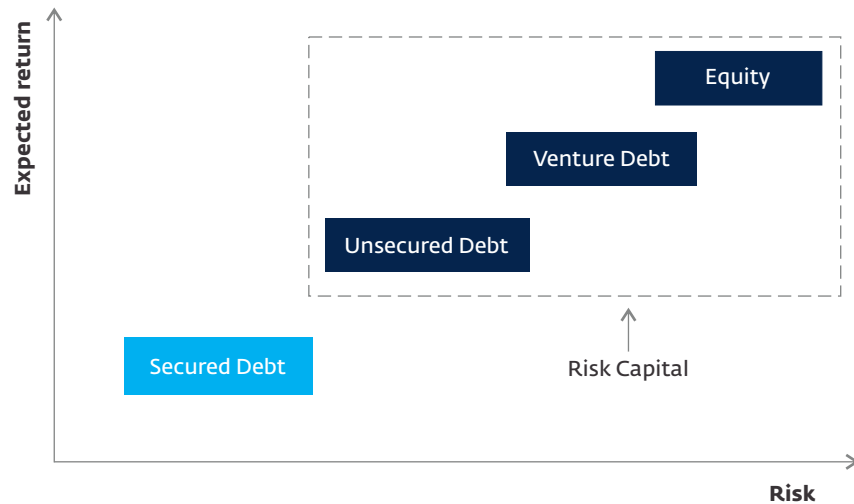
Table 6: Sources of financing for an enterprise

Form	Institutional sources	Non-institutional sources
Debt	Banks, Non-Banking Financial Companies	Friends, family, chit funds, private moneylenders, trade credit from suppliers
Equity	Angel investors, venture capital funds, private equity funds, public markets	Entrepreneur savings, retained earnings

Capital providers adopt different criteria to make their financing decisions. These criteria are influenced by the differing degrees of risk that the provider is willing to bear and the corresponding return expectations. Broadly, there are two modes of financing – secured debt and risk capital.

²⁶ For operational reasons, equity investments are often structured to have a component of debt, or convertible debt. Such a hybrid structure is also called mezzanine finance

Figure 2: Risk-return profile of different modes of financing²⁷



Equity finance is generally more expensive than debt finance; however, a high reliance on debt increases the financial risk for the enterprise by way of creating an obligation for repayment and exposing the business to the risk of default. Consequently, most MSMEs seek a balance of debt and equity finance.

2.1.1. Secured Debt

In this financing mode, capital is provided by formal sources to enterprises against an asset as security (collateral) and recovered through regular coupon (interest) payments. This form of finance carries a relatively low degree of risk for the provider. The expected return is in the range of 12 to 18 percent²⁸. Secured debt is provided by financial institutions such as banks and non-banking finance companies in the form of term loans against property or any other asset. Banks also provide working capital finance through products such as cash credit and overdraft, which are generally secured against business inventory, financial investments made by enterprises or fixed assets. Some non-institutional sources may also

provide secured debt against the personal assets of the promoter as collateral.

2.1.2. Risk Capital

Equity and collateral-free debt (both plain-vanilla and structured) are collectively referred to as risk capital. The distinguishing feature of risk capital is the absence of any form of explicit security. In the case of equity, there is an additional element of risk due to the absence of contractually agreed returns. As a result, risk capital providers are exposed to an additional degree of uncertainty in terms of both principal repayment and effective return on capital. To compensate for this additional risk, the return expected by risk capital providers is usually higher than that of secured debt providers. There are three broad sources of external risk capital finance²⁹ available to MSMEs – equity, venture debt and unsecured debt³⁰.

Figure 3 sets out an indicative landscape of the various risk capital products available for funding at different lifecycle stages of the enterprise:

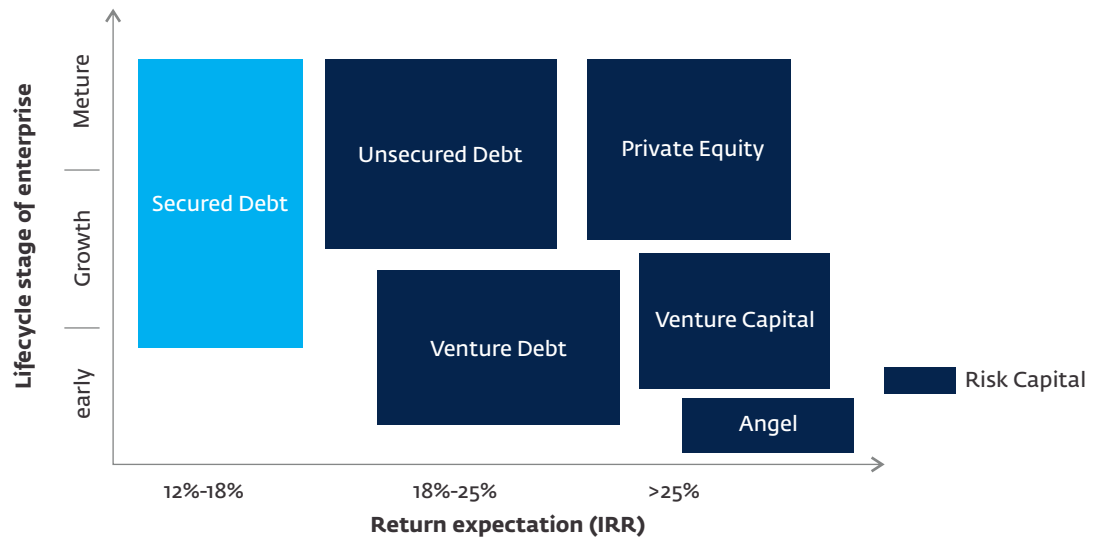
²⁷ The graph is indicative and not drawn to scale

²⁸ Primary research with banks and NBFCs

²⁹ Internal sources such as promoter's personal capital and reinvested retained earnings are forms of risk capital too. However, this study focuses on mapping the external sources of risk capital only

³⁰ A structured unsecured debt product for funding early-stage enterprises

Figure 3: Type of funding by lifecycle stage of enterprise³¹



1. Equity

Equity financing refers to supplying capital to an enterprise in return for an ownership share in it. Equity holders hold the residual or junior-most claim against the assets of the MSME. If the MSME is liquidated (goes bankrupt) equity holders are paid out only after all other claims against the enterprise have been settled. Thus, equity holders are exposed to the highest degree of risk and consequently expect the highest degree of return for the capital invested.

Equity investors can be broadly classified into three categories, based on the lifecycle stage of the MSME they invest in:

- **Angel investors:** These are mostly HNI investors, generally successful professionals or experienced entrepreneurs, who invest their personal capital in early-stage MSMEs. The ticket sizes of angel investments are relatively small (less than USD 1 million or INR 6.5 crore). Angel investors typically invest as part of a network to ensure both better due diligence and spreading of risk. Angel

investors are generally the earliest sources of external equity and often invest even before the MSME starts generating revenues. In addition to capital, angel investors also add value by providing mentorship and management support to the MSMEs they invest in. Angel investments take place either through networks/groups or via a fund mechanism. In the former the transaction is directly from an individual to an enterprise, and hence unregulated. In the latter, angel funds are privately pooled from HNIs and governed by the SEBI AIF³² Regulations, 2012.

- **Venture Capital firms (VCs):** VCs pool capital from different institutional/non-institutional investors into a fund and this fund makes investments in MSMEs. The professionals who manage the fund are called General Partners and the investors who pool capital are referred to as Limited Partners. VCs typically raise capital with the mandate of focusing on certain sectors that are closely aligned with the expertise possessed by the General Partners.

³¹ The chart is indicative and not drawn to scale. There may be overlaps too, which have not been shown for ease of representation

³² Alternative Investment Funds

VCs make equity investments in early and growth stage MSMEs. Generally, VCs fund an MSME after it has received angel funding and/or has started generating revenues. The ticket sizes of investments by VCs (at roughly USD 3 million i.e. INR 19.5 crore) are larger than those of angel investors, but smaller than those of PE firms. VCs generally insist on representation on the board of directors of the MSME and are usually involved in strategic decision making.

- **Private Equity firms (PEs)³³**: These are similar to VC firms in structure and form. The key difference is that they generally make investments in the growth and mature stages and invest a larger ticket size (more than USD 3 million i.e. INR 19.5 crore). Since PEs generally fund established businesses, they are exposed to a different type of risk as compared to VCs.

2. Venture Debt

Venture debt providers give unsecured structured debt capital to early-stage MSMEs. The terms and repayment schedule of the capital provided are customized to the requirement of each enterprise and risk-return perception of the provider. Venture debt providers may also insist on structures that provide them equity - like returns on a portion of their investment. This mode of

funding is also known as quasi - equity finance. Although the nature of investment and lifecycle stage of the MSMEs funded makes the risk similar to equity investments, the defined repayment structure of venture debt reduces the uncertainty of returns. Consequently, the return expected (18 to 30 percent) by venture debt providers is lower than that expected by equity investors.

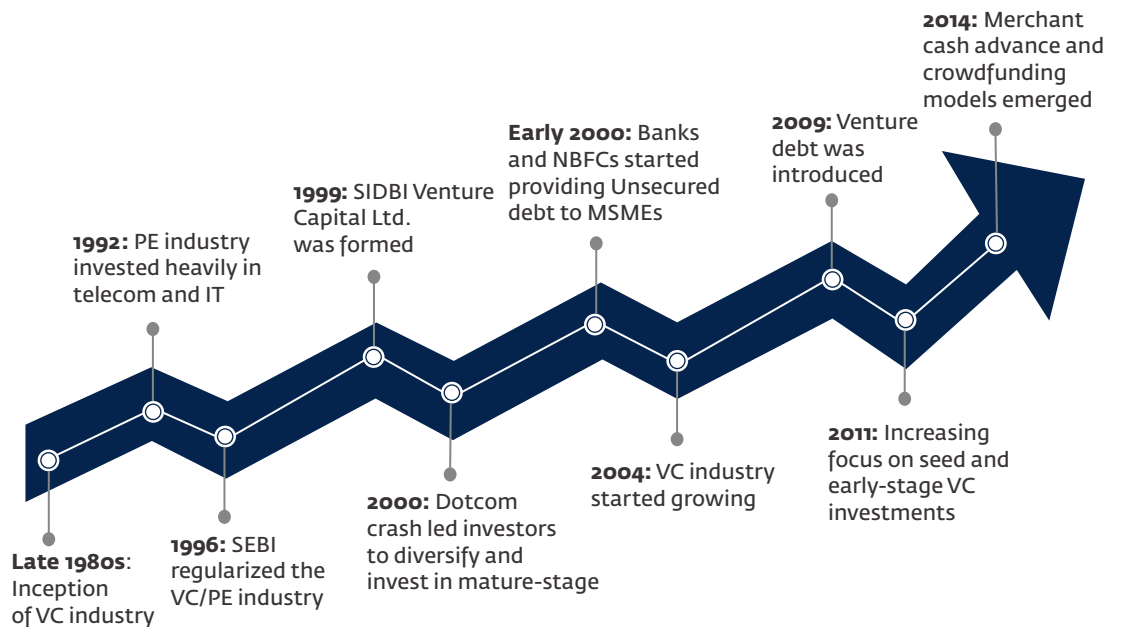
3. Unsecured Debt

A few banks and NBFCs provide collateral-free debt funding to MSMEs. This form of debt is commonly known as business installment loan and has a plain - vanilla repayment structure with a fixed coupon and term. Banks and NBFCs provide unsecured debt to enterprises based on criteria such as the profitability track record of the enterprise and its existing relationship with the bank or NBFC. An existing relationship – in the form of a current account, overdraft facility or a regular term loan advance – provides a degree of security to the lender, though it is not specifically for the unsecured advance. This makes unsecured debt less risky than venture debt and equity. Thus, unsecured debt has lower return expectations than venture debt and equity.

³³ Note that venture capital is technically a special form of private equity

2.2. Evolution of Risk Capital in India

Figure 4: Evolution of risk capital in India



In India, the need for venture capital was recognized in the Seventh Five Year Plan and long term fiscal policy of the government. In 1973 a committee on Development of Small and Medium Enterprises highlighted the need to foster venture capital as a source of funding new entrepreneurs and technology. The formation of the Technology Development and Information Company of India Ltd. (TDICI), promoted by ICICI and UTI, marked the beginning of VC funding in India. The first VC fund was sponsored by Credit Capital Finance Corporation and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation. At the same time, Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were financial institutions, foreign institutional investors or pension funds and high net-worth individuals.

Till 1992, however, there were only a handful of funds, with very little private participation, and driven mainly by the government and the World Bank Group. The nature of risk capital providers in India has evolved greatly in the post-liberalization era. In the mid-1990s, SEBI provided regulatory clarity on Indian venture funds and the government of India issued guidelines for entry of overseas venture investments into India. Many foreign private equity funds entered India thereafter. The boom in the information technology sector in the late 1990s and the subsequent telecom revolution provided a significant boost to risk capital providers in India.

Although investments dropped dramatically after the dot com crash in 2000, global macro-economic conditions stabilized by 2004 and fund-raising too picked up momentum. Post 2005 there was the concurrent development of growth-stage private equity investments and early-stage venture capital

investments leading to a growth both in quantity and diversity of capital sources, resulting in investments peaking in 2007. The global financial crisis substantially reduced private equity investments in India in the subsequent couple of years; however, the trend has been upwards since 2012. The past few years have seen a rise of early-stage focused VC funds and investment in IT and IT Enabled Services, the banking, financial services and insurance sector, and in health care. In addition to traditional equity investments, new models of risk capital such as merchant cash advance and crowdfunding have evolved in the past few years.

The Government of India has also stepped in to support early stage enterprises. The Department of Science and Technology (DST) and the Department of Bio-Technology (DBT), have launched schemes in tandem with the spirit of 'Start-Up India'. The DST has recently launched the National Initiative for Development and Harnessing Innovations (NIDHI) Scheme as an umbrella program for nurturing ideas and innovations. Technology Business Incubators (TBIs) have been empowered to channelize risk capital to startups through programs such as the Seed Support System and 'Aspire'.

The Biotechnology Industry Research Assistance Council (BIRAC) has been set up as a nodal funding agency for the biotechnology industry under the ambit of the DBT. BIRAC has launched the SEED (Sustainable Entrepreneurship and Enterprise Development) Fund to provide equity capital to start-ups and enterprises through bio-incubators.

2.3. Enterprise Lifecycle Framework

Risk capital providers do not rely on the legal definition of MSMEs, in terms of investment in plant and machinery, to base their investment decisions. Interviews with equity investors³⁴ suggest that they place greater emphasis on the lifecycle stage of the MSME. However, there is no definitive classification of enterprises by lifecycle stage. Factors such as vintage of the enterprise, profitability track record and round of investments all contribute to defining the stage. Deal databases that track private equity investments also typically use enterprise lifecycle stage classifications in their reporting³⁵. For the purpose of this study, a definition of enterprise lifecycle stage based on vintage of enterprise has been adopted (Table 7)³⁶.

Table 7: Enterprise Lifecycle Stage Framework

Enterprise Lifecycle Stage	Vintage of Enterprise (Years)
Early	< 5
Growth	5 – 10
Mature	> 10

Source: Venture Intelligence, WBG - Intellect Analysis

³⁴ Refer to Appendix D

³⁵ Details about investments made by HNIs and by corporates are often not available in public the domain. The analysis presented in this study is based on information sourced from deal databases which track reported deals

³⁶ Venture Intelligence deal database

Analysis of the MSME Census reveals that almost 50 percent of existing enterprises are mature enterprises (Table 8).

Table 8: Enterprises by Lifecycle Stage

Enterprise Lifecycle Stage	No. of MSMEs (million)	Share of MSMEs
Early	14.3	25.7%
Growth	13.6	24.4%
Mature	27.8	49.9%

Source: MSME Census, WBG - Intelicap Analysis

The classification of enterprises according to lifecycle stage is the primary classification used in the subsequent chapters of this report to segment the demand and supply of risk capital to MSMEs.

The following chapter focuses on analyzing the demand for risk capital from MSMEs at different stages in their growth journey – with a focus on equity demand.

Chapter 3

Demand For Risk Capital Finance From MSMEs

Demand For Risk Capital Finance From MSMEs

Key Takeaways

- The overall demand for equity finance from the MSME sector in 2017 has been estimated at **USD 283 billion** (INR 1,842 thousand crore*), out of which **16 percent** (USD 44.4 billion or INR 289 thousand crore) is addressable†.
- **< 1 percent** of enterprises in the MSME universe account for the addressable equity demand.
- **53 percent** of the addressable equity demand comes from mature-stage enterprises.
- While small enterprises constitute only about **5 percent** of the MSME universe, they account for **50 percent** of the addressable equity demand.
- While manufacturing sector enterprises constitute only **21 percent** of the MSME universe, they account for **75 percent** of the addressable equity demand.

3.1. Overall Equity Demand from the MSME Sector

The overall demand for finance from the MSME sector (in 2017) has been estimated to be USD 1,349.4 billion (INR 8,771 thousand crore), of which USD 283.3 billion (INR 1,842 thousand crore) is equity demand³⁷. The equity demand can be interpreted as the amount of annual capital accretion required by the 55.8 million MSMEs to fund operational requirements, invest in fixed assets and raise additional debt.

Overall demand for equity finance from the MSME sector in 2017:
USD 283.3 billion

Primary interviews³⁸ with financial institutions and MSMEs reveal that typically, equity accounts for 20 to 30 percent of the overall finance demand of MSMEs. Research also shows that for early-stage enterprises, this proportion is higher than that for growth and mature-stage enterprises³⁹.

Figure 5: Overall Finance Demand in MSME Sector, 2017 (USD billion)

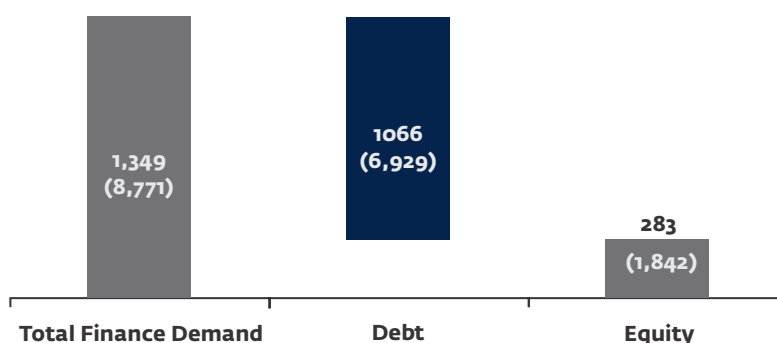


Figure in brackets is in thousand crore Indian rupees
Source: MSME Census, WBG - Intelicap Research

³⁷ WBG - Intelicap Analysis

³⁸ USD 1 = INR 65

† Please refer to Section 3.2 – Addressable equity demand from the MSME sector. Estimation of the demand takes into account the leverage ratio for the stage at which the enterprise is. A certain minimum turnover and growth rate is considered to estimate the addressable demand. Please see Appendix A for a detailed description of the demand estimation methodology.

³⁸ Refer to Appendix D

³⁹ Annual finance demand is fulfilled by debt and equity by early-stage enterprises in the ratio of 3:1 and by growth and mature-stage enterprises in the ratio 4:1

3.2. Addressable Equity Demand from the MSME Sector

Equity demand can be fulfilled from three broad sources – friends and family, retained earnings and external institutional equity capital infusion (both public and private). However, demand from all MSMEs cannot be considered amenable to equity infusion from external institutional sources. Investors make investment decisions based on numerous criteria – both quantitative and qualitative. Primary research indicates that from a quantitative perspective, only MSMEs that exceed certain thresholds of turnover and annual growth rate are considered potential enterprises for external institutional equity infusion. It also reveals that, in most cases, investors of equity capital tend to evaluate only MSMEs with an annual turnover greater than USD 40,000 (INR 25 lac) and an annual growth rate higher than 25 percent^{40,41} as deserving of external institutional equity.

An analysis of the MSME universe indicates that less than 1 percent of enterprises meet the above criteria. Owing to their larger size and high growth rate, these 1 percent enterprises, however, demand a larger quantum of equity per enterprise as compared to the average demand from the entire MSME sector. These 1 percent enterprises accounted for 21 percent of the overall equity demand from the MSME sector in 2017 – amounting to USD 60.4 billion (INR 393 thousand crore). Further, part of this equity demand is fulfilled by internal sources – entrepreneur's equity or retained earnings or both.

An analysis of the capital structure of MSMEs suggests that roughly 26 percent of the equity demand is met by internal accruals⁴². This accounts for roughly USD 16 billion (INR 104 thousand crore) of the potential equity demand of USD 60.4 billion (INR 393 thousand crore). The balance portion of the potential equity demand, i.e. roughly USD 44.4 billion (INR 289 thousand crore) presents an addressable opportunity for equity investors.

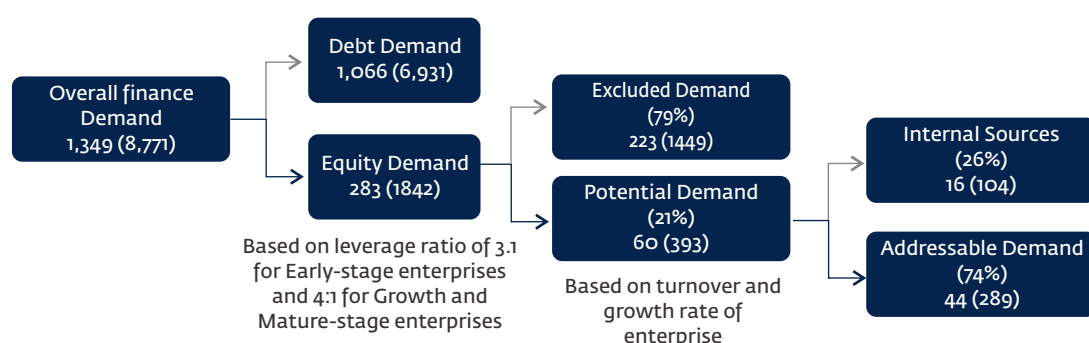
⁴⁰ Although angel investors often invest in pre-revenue startups, for the purpose of demand estimation from the MSME universe as a whole, certain minimum cut-offs have been assumed based on primary inputs

⁴¹ Roughly 94 percent of MSMEs are structured as proprietorships and partnerships and hence are not amenable for external equity infusion. However, interactions with equity investors suggest that legal structure is not a major factor in evaluating an enterprise, and conversion to a private limited enterprise is pre-supposed. Legal structure is thus not considered a factor in determining the potential demand for equity.

⁴² Financing Firms in India, Allen, Chakrabarti, De, Qain, 2007

**Addressable
demand for
equity in 2017:
USD 44.4 billion**

Figure 6: Addressable Equity Demand Estimation Process



→ **Addressable Equity Demand Estimation**

Figure in USD billion (Figure in brackets is in thousand crore Indian rupees)

Figure 7: Addressable Equity Demand from MSME Sector, 2017 (USD billion)

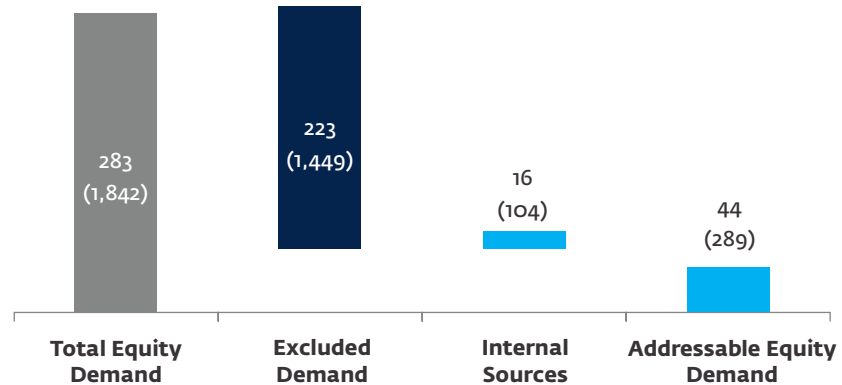
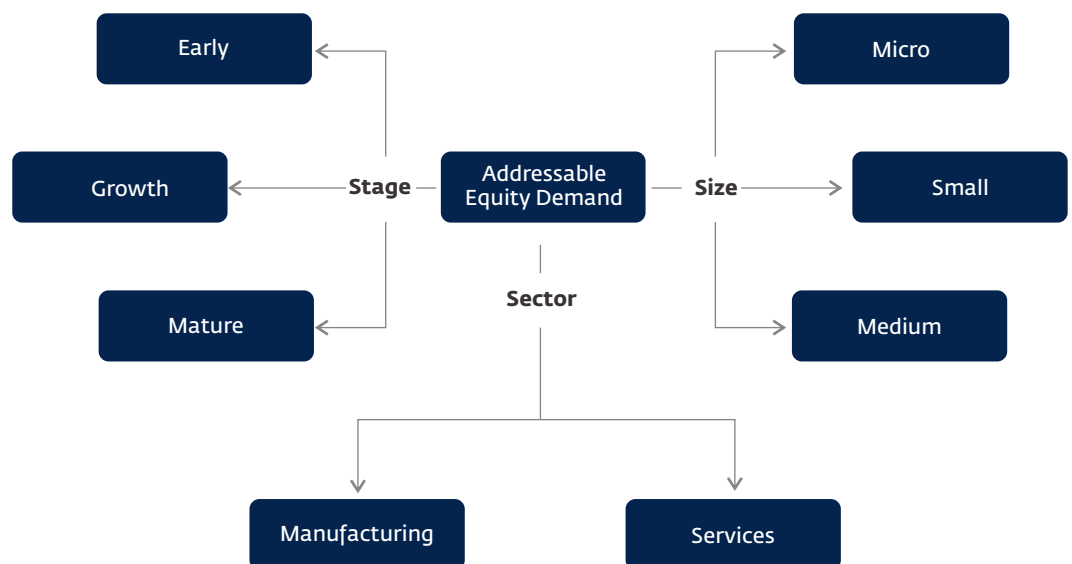


Figure in brackets is in thousand crore Indian rupees
Source: MSME Census, WBG - Intelicap Research

3.3. Segmentation of Addressable Equity Demand

The 55.8 million MSMEs vary significantly in terms of lifecycle stage, size and sector of operation. Their equity requirements, challenges and their addressability also vary accordingly. This section attempts to segment the equity demand according to these characteristics.

Figure 8: Segmentation of Addressable Equity Demand



3.3.1. Breakdown of Equity Demand by Enterprise Lifecycle Stage

Risk capital providers usually consider the lifecycle stage of the MSME while making investment decisions. An analysis of the demand for equity from enterprises at various stages is thus

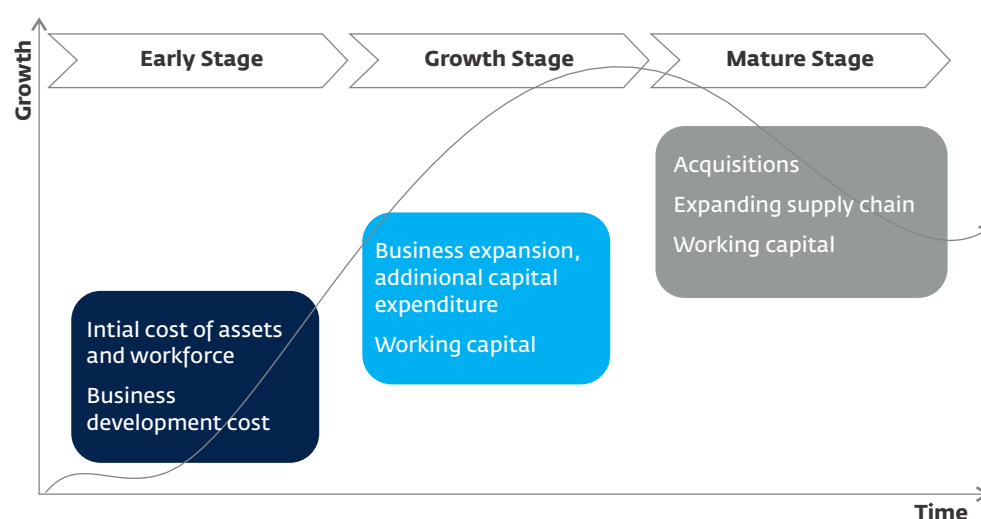
critical to identifying demand-supply gaps and interventions needed.

Enterprises require equity for different purposes at different stages in their lifecycle. In the early-stage, MSMEs rely almost exclusively on equity capital to finance their setup cost and initial working capital requirements. This initial

equity investment allows enterprises to generate revenues, establish profitability and acquire assets that would enable the enterprises to raise debt at later stages of the business.

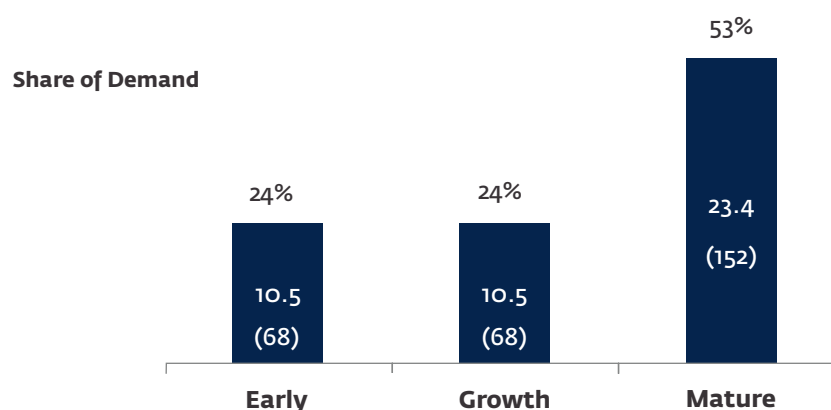
In the growth and mature stages, enterprises need to infuse additional equity to make capital investments for business expansion and fulfill the margin requirements in raising debt⁴³.

Figure 9: Reasons for Equity infusion⁴⁴



As mentioned earlier less than 1 percent of enterprises in the MSME universe account for the addressable equity demand (i.e. have an annual turnover greater than USD 40,000 (INR 25 lac) and an annual growth rate higher than 25 percent). This proportion of enterprises is similar across enterprise lifecycle stages i.e. around 1 percent of early-stage enterprises, 1 percent of growth-stage enterprises and 1 percent of mature stage enterprises account for the addressable demand. The MSME universe comprises largely of mature enterprises⁴⁵. As a result, more than half the addressable equity demand — USD 23.4 billion (INR 152 thousand crore)- comes from enterprises in the mature-stage (Figure 10).

Figure 10: Addressable Equity Demand by Enterprise Lifecycle Stage, 2017 (USD billion)



⁴³ Financial institutions, when providing debt, generally require enterprises to partially fund their financing need through equity. This equity is called margin money. Generally, the margin money required by financial institutions is 15 to 25 percent of the total financing need.

⁴⁴ Early-stage enterprises have been defined as enterprises having a tenure of 0–5 years, Growth-stage as 6–10 years and Mature-stage as >10 years. Please refer to Table 7 in Chapter 2.

⁴⁵ Please refer to Table 8 in Chapter 2 – Overview of Risk Capital Finance

Figure in brackets is in thousand crore Indian rupees
Source: MSME Census, WBG - Intelicap Research

3.3.1.1. Early-stage Enterprise Segment

Enterprises that are five years old or less have been considered early-stage enterprises in this report. Early stage enterprises account for roughly a quarter of the MSME universe.

- Early stage enterprises account for around 24 percent of the addressable equity demand, amounting to USD 10.5 billion (INR 68,000 crore) (Figure 10).
- Analysis suggests that the average annual demand for equity per enterprise from early-stage enterprises is roughly USD 93,000 (INR 60 lac).
- Since early-stage enterprises find it harder to access debt finance, they tend to depend more heavily on equity.
- Equity is often provided by informal sources in the early stage of an enterprise. Friends and family or allied/similar businesses in the community or social group often provide initial equity with little or no formal arrangement.
- There is, however, a growing class of entrepreneurs who are trying to access formal external equity in exchange for dilution of stake, although they typically prefer to retain operational and strategic control of the business.

The average annual demand for equity from an early stage enterprise is roughly USD 0.09 billion

- Intermediaries such as business networks, entrepreneurs' associations, incubators and accelerators have mushroomed to assist first time entrepreneurs. These intermediaries provide support in terms of mentorship and connections with investors and angel networks⁴⁶.

3.3.1.2. Growth-stage Enterprise Segment

Enterprises having a vintage of more than five, but less than 10 years, are considered growth-stage enterprises. Almost a quarter of the MSME universe consists of such enterprises.

- Growth-stage enterprises account for about 24 percent of the addressable equity demand, amounting to USD 10.5 billion (INR 68,500 crore) (Figure 10).
- Growth-stage enterprises incur higher capital expenditure for business expansion and have an increased working capital requirement. Such enterprises tend to have relationships with financial institutions which allow them to raise debt more easily than early-stage enterprises.
- Primary research indicates that there is often a mismatch in the investors' and promoters' perception of the valuation of an enterprise in the growth stage. Such mismatch causes delays in the assessment process and is a challenge while investing in growth-stage enterprises.
- Intermediaries such as boutique advisory firms and chartered accountants are often engaged by growth-stage enterprises to assist them in raising capital.

⁴⁶ Please refer chapter on Enabling Environment for details

3.3.1.3. Mature-stage Enterprise Segment

Enterprises having a vintage of more than 10 years are considered mature-stage enterprises. Almost half the MSME universe consists of mature enterprises.

- Mature-stage enterprises account for around 53 percent of the addressable equity demand, amounting to USD 23.4 billion (INR 152,400 crore) (Figure 10).
- Analysis reveals that a typical mature-stage enterprise demands less external equity infusion as compared to a growth-stage enterprise. This is because mature-stage enterprises tend to have a larger pool of internal accruals, and are able to access debt capital more easily. However, given that mature-stage enterprises account for a large majority of the MSME sector, this segment accounts for more than 50 percent of the addressable equity demand at an aggregate level.

More than 50 percent of the addressable equity demand comes from mature enterprises

- Enterprises that have been in operation for more than 10 years and have a history of raising formal external debt tend to have their financial books much more organized as compared to early and growth-stage enterprises. This ensures transparency in financial dealings, which is an important aspect for equity investors. However, growth rates of mature-stage enterprises tend to be lower as compared to early and growth-stage enterprises, which make mature-stage enterprises less attractive to equity investors.

- Research shows that entrepreneurs running established MSMEs, especially ones that are family-run, are less willing to cede control of their business by giving equity stake to financiers.

3.3.2. Breakdown of Equity Demand by Enterprise Size (Micro, Small and Medium)⁴⁷

The MSME universe is usually described according to the definitions laid down in the MSMED Act, 2006. This section aims to provide an understanding of equity demand, segmented according to the MSMED definition. As seen earlier in this chapter, MSMEs that exceed a turnover of USD 40,000 (INR 25 lac) and have an annual growth rate of 25 percent are considered potential enterprises for external equity infusion.

Accordingly, although micro enterprises form about 95 percent of the MSME universe⁴⁸, they account for only about 42 percent of the addressable equity demand (Figure 11). Analysis suggests that the average demand for equity per enterprise from micro enterprises was close to USD 0.05 million (INR 33 lac) in 2017. These ticket sizes are typically perceived as too low by equity investors, as investing such small amounts increases their transaction cost. However, an opportunity exists in this segment for newer models of raising equity such as crowdfunding. Such models can be supported by automated procedures to appraise enterprises for investment suitability by leveraging data from sources such as social media and filings with the Ministry of Corporate Affairs.

⁴⁷ Please refer to Table 3 in Chapter 1 (MSME Landscape) for definitions of enterprise size

⁴⁸ Please refer to Table 4 in Chapter 1 (MSME Landscape) for split of MSME universe by enterprise size

Small enterprises constitute 50 percent of the addressable equity demand, although the MSME universe comprises of only ~5 percent small enterprises

Small enterprises have an average turnover of around USD 1 million (INR 6.5 crore)⁴⁹. The average quantum of demand per enterprise from small enterprises tends to be more than three times that of micro enterprises⁵⁰. The larger quantum of demand makes small enterprises a more attractive segment

for equity investors. Small enterprises constitute 50 percent of the addressable equity demand, although small enterprises comprise only around 5 percent of the MSME universe⁵¹ (Figure 11).

Medium enterprises have an average turnover of around USD 7 million (INR 45.5 crore)⁵². The average demand from medium MSMEs is estimated to be about USD 0.8 million (INR 5.2 crore). Medium enterprises considered addressable are mostly manufacturing enterprises. However, medium enterprises make up only about 0.2 percent of the MSME universe and account for around 8 percent of the equity demand.

Figure 11: Addressable Equity Demand by Enterprise Size, 2017 (USD billion)

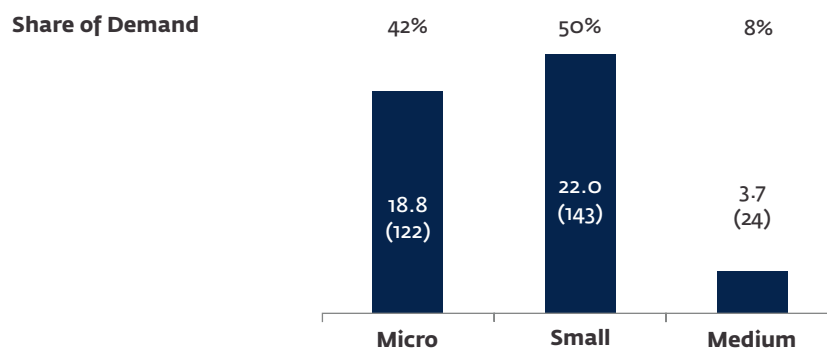


Figure in brackets is in thousand core Indian rupees
Source: MSME Census, WBG - Intelicap Research

3.3.3. Breakdown of Equity Demand by Enterprise Type (Manufacturing and Services)

Although only about 21 percent of MSMEs are manufacturing enterprises⁵³, they account for almost 75 percent of the addressable equity demand⁵⁴. Manufacturing sector enterprises tend to have higher finance requirements than service enterprises owing to the high cost of their fixed assets such as

plant and machinery. On the sales side, these enterprises are heavily dependent on traders who often buy on liberal terms of credit, which increases their working capital cycles. Additionally, informal employment patterns call for short cycles of cash flows as workers are often paid on a weekly or even daily basis. These characteristics of manufacturing enterprises tend to increase their requirement for working capital. The annual average equity

⁴⁹ MSME Census, WBG – Intelicap Analysis

⁵⁰ WBG – Intelicap analysis

⁵¹ Please refer to Table 4 in Chapter 1 (MSME Landscape) for split of MSME universe by enterprise size

⁵² MSME Census, WBG – Intelicap Analysis

⁵³ Annual Reports of Ministry of MSME, GoI

⁵⁴ Enterprises classified as manufacturing/services based on the NIC 2-digit industry classification followed by the MSME Census

demand from manufacturing enterprises is estimated to be USD 0.1 million (INR 65 lac). Around 60 to 70 percent of the equity demand is for capital expenditure while the balance is needed for working capital requirements⁵⁵.

On the other hand, the service sector (which accounts for about 79 percent of the MSME universe) comprises a large number of micro enterprises engaged in activities related to wholesale/retail trade, legal, educational and social services, hotels and restaurants, transport, storage and warehousing⁵⁶. Such enterprises tend to have lower finance requirements as there is almost no recurring capital expenditure. Over 90 percent of such businesses have a turnover of less than INR 25 lac (~USD 40,000).

Thus, although a larger proportion of manufacturing enterprises clear the turnover and growth rate filters used in this study to identify potential enterprises for equity infusion⁵⁷, resulting in manufacturing sector MSMEs accounting for a majority of the equity demand, they are generally less preferred by equity investors because of a perceived lower scalability as compared to service sector MSMEs. Manufacturing enterprises also find it easier to obtain debt from traditional lending institutions owing to their inherent capital-intensive nature. Plants and machinery are tangible assets that traditional lenders accept as collateral. Interactions with commercial banks have revealed that they are more likely to finance manufacturing enterprises, even in their early stages, than service enterprises.

Figure 12: Addressable Equity Demand by Enterprise Type, 2017 (USD billion)

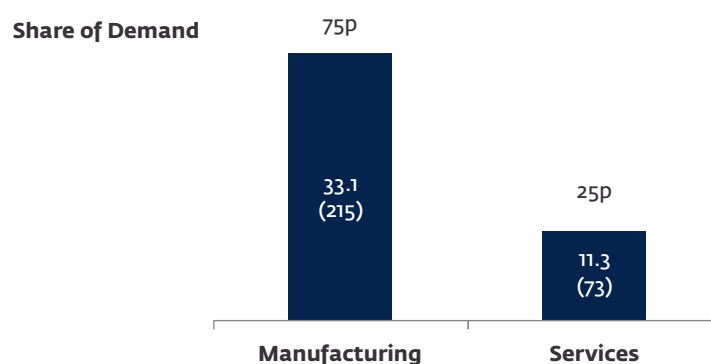


Figure in brackets is in thousand core Indian rupees
Source: MSME Census, WBG - Intelicap Research

⁵⁵ WBG – Intelicap Analysis

⁵⁶ Ministry of MSME, Annual Report, 2014 - 15

⁵⁷ Please refer to Section 3.2 – Addressable equity demand from the MSME sector

Equity Demand by Geography, 2017

Low income states and northeastern states account for roughly 30 percent of the addressable equity demand from the MSME sector in India, although about 42 percent of MSMEs in the country are located in these geographies⁵⁸. As mentioned earlier, less than 1 percent of MSMEs in India account for the addressable equity demand. In the low income and northeastern states, the share of enterprises accounting for addressable equity demand is barely around 0.6 percent. This indicates that fewer enterprises in these geographies exceed the turnover and annual growth rate thresholds considered to estimate addressable demand. It is estimated that the average turnover of enterprises in these states is roughly 80 percent of those in the rest of the country, owing to a number of factors, including a greater lack of infrastructure, lack of access to technology, and talent gap among other things.

Geography	Equity Demand (\$ billion)	Share of Demand
Low income states	12.7 (83)	28.6%
Northeastern states	0.9 (6)	2.1%
Rest of India	30.8 (200)	69.3%
Total	44.4 (289)	100.0%

Figure in brackets is in thousand core Indian rupees
Source: WBG - Intellect Research

3.4. Demand for Other Risk Capital Products

MSMEs often have short-term working capital requirements for which raising equity capital not only often takes too long, but may also not be the most cost-effective mode of financing. At such times, entrepreneurs prefer to access debt that can be availed more quickly and does not lead to dilution of stake. Since access to bank debt, even though it has been growing, is relatively limited, there is a need for alternative forms of debt financing that are more aligned to an MSME's lifecycle stage, specific need, repayment ability and other factors.

In particular, MSMEs are increasingly demanding debt funding that is linked to business prospects, which can adapt to future cash flows and is flexible enough to take into account variations in business models, rather than relying solely on traditional debt that requires tangible assets as collateral and a track

record of profitability. Since such funding mechanisms may carry a higher element of risk, there is a growing need for sources of capital that have a higher risk appetite and that can structure debt according to the risk profile of the enterprise.

Venture debt and unsecured debt (business installment loans) from financial institutions have emerged as products that help meet such needs. Such debt-based risk capital products can potentially meet some of the MSME funding needs for working capital, for which equity has traditionally been sought. It is also estimated that working capital accounts for 30 to 40 percent of the addressable equity demand⁵⁹. A portion of this demand can be potentially addressed by other risk capital products (discussed in detail in Chapter 4).

⁵⁸ Please refer to Table 1 in Chapter 1 – MSME Landscape in India

⁵⁹ WBG – Intellect Analysis

Case Study: Funding lifecycle of an MSME

This box presents the financing journey of an MSME engaged in manufacturing technological solutions for the dairy sector in India. Across the lifecycle stages, the MSME has accessed multiple forms of risk capital from different sources:

Early-stage

In the initial years, the enterprise relied on internal financing through equity contributions from the promoters. This strategy is called bootstrapping. As the scale of operations was small, the MSME did not want to incur any cost of borrowing from external informal sources. "Having our skin in the game at the start gave us the motivation and flexibility to plan operations well," says the promoter of the enterprise.

Growth-stage

As the MSME reached stable cash flows and established a strong brand among local customers, it felt the need for long-term growth funding to make capital investments and replicate its model in other regions. Although dilution of equity was a concern earlier, the promoters believed that bringing in an institutional equity partner would bring financial discipline into the business. Hence, the enterprise raised equity funding a venture capital fund. Besides capital, the enterprise received advice and mentorship from the VC firm, but continued to retain control of strategic and operational decision-making. "VC equity would give us visibility in the market, which is important for future listing in the capital markets," says the founder.

Mature-stage

The VC funding enabled the enterprise to scale up rapidly. To continue the pace of growth and gain further market share, the enterprise raised a private equity funding through a hybrid of convertible also accessed a revolving working capital loan (cash credit) from a public sector bank with equity stocks and promoter's personal property as collateral. This helped the enterprise to build a banking relationship for easier access to secured debt funding in the future.

Lessons learnt by the enterprise

- Equity funding is a long-drawn process and should be planned well in advance. Else, it may be difficult to sustain the business until the closure of the deal.
- Shareholder agreements are complex and may be difficult for entrepreneurs to comprehend fully. Hence, the advice of CAs, lawyers or investment banking advisors should be sought while raising equity.

Chapter 4

Supply of Risk Capital Finance to the MSME Sector

Supply of Risk Capital Finance to the MSME Sector

Key Takeaways

- The overall equity investment in the MSME sector in 2017 was estimated at **USD 1.05 billion** (INR 6.85 thousand crore).
- Almost 70 percent of the amount was invested in early stage enterprises.
- Quality of management team, alignment with investor mindset, industry outlook and market access are the key qualitative factors considered by investors while making investment decisions.
- Venture debt can provide short-term capital to early-stage MSMEs without equity dilution. The supply of venture debt in 2017 was estimated at **USD 140 million** (INR 910 crore).
- Unsecured debt from banks and NBFCs is useful for asset-light MSMEs in raising small ticket size loans. The supply of unsecured debt in 2017 was estimated at **USD 6.5 billion** (INR 42,000 crore).
- Lately, crowdfunding and merchant cash advance have emerged as new risk capital funding models for MSMEs.

4.1. Supply of Risk Capital to MSMEs

There are different forms and sources of risk capital supply in India. The matrix below shows the various sources of risk capital and the corresponding modes of financing that are covered in this chapter.

Figure 13: Sources and modes of risk capital financing

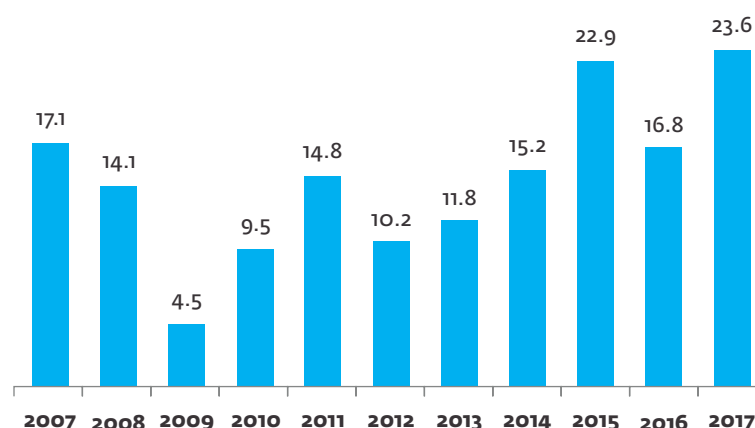
		Sources				
		Bank	NBFCs	SIDBI	Angels	VC/PEs
Modes	Secured debt	✓	✓			
	Unsecured debt	✓	✓			
	Venture debt		✓	✓		
	Equity			✓	✓	✓

Risk Capital

4.1.1. Equity Investments

Equity investments in India peaked at over USD 23 billion (INR 150 thousand crore) in 2017⁶⁰. The global financial crisis substantially reduced private equity investment in India from its earlier peak of roughly 17 billion in 2007 in the subsequent couple of years; however, the investment trend has been upwards since 2012, breaching the USD 20 billion mark for the first time since 2015, with a moderate dip observed over 2015-2016, when total investments went from USD 21 billion to USD 17 billion, to swing back to USD 23.61 billion in 2017 (Figure 14)⁶¹. Although the investments in 2016 are still the second highest since 2010, the dip was largely due to a slowdown in large consumer technology deals⁶². Industry sentiment has been positive in India in the last few years and there has been optimism in the investor community.

Figure 14: Overall Private Equity Investment in India, USD billion



Source: India Private Equity Report, 2017, Bain & Company, Inc., Venture Intelligence, WBG - Intellectap Analysis

4.1.1.1. Equity Investment in MSMEs

The bulk of equity investment goes into large deals in a few sectors and asset light enterprises that have a high potential to scale. New age businesses engaged in IT/ITES, BFSI, healthcare and life sciences have accounted for more than 60 percent of the equity investments made in India since 2012, and over 70% since 2013. In 2017, the three sectors combined contributed 77 percent of the total equity investments in the country⁶³.

MSMEs that require comparatively smaller investments garnered only limited interest from the investor

community. For this study, two filters have been applied to the overall equity investment to estimate the flow of equity capital into MSMEs:

- **Investment filter:** Investments in MSMEs typically have a deal size less than USD 10 million (INR 65 crore)⁶⁴.
- **Investee turnover filter:** Enterprises with a revenue of less than USD 15.4 million (INR 100 crore)⁶⁵.

Applying these two filters reveals that about USD 1.05 billion (INR 6,825 crore) were invested in MSMEs in 2017. This accounts for roughly 4.5 percent of the overall equity investments in 2017 (Figure 15)⁶⁶.

⁶⁰ India Private Equity Report, 2017, Bain & Company, Inc.

⁶¹ Includes PE and VC investments

⁶² India Private Equity Report, 2017, Bain & Company, Inc.

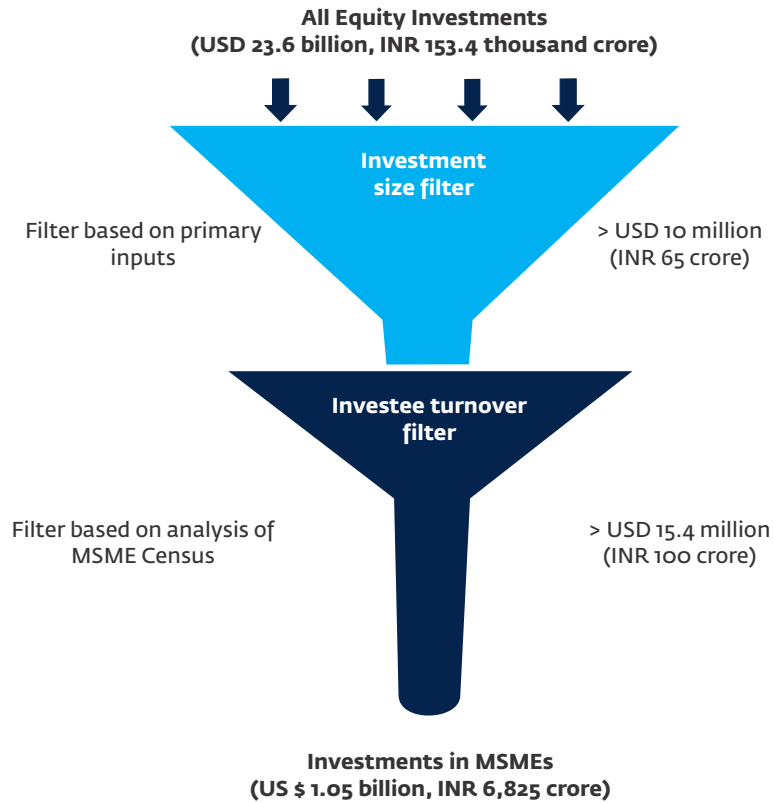
⁶³ Venture Intelligence, WBG - Intellectap Analysis

⁶⁴ Based on primary interactions with multiple investors and sector experts

⁶⁵ Based on primary interactions with multiple investors and sector experts; and analysis of the MSME census corroborates that an overwhelming majority of MSMEs have a turnover of less than this amount. WBG - Intellectap analysis

⁶⁶ WBG - Intellectap analysis

Figure 15: MSMEs' Share of Equity Investment in 2007



Source: Venture Intelligence, WBG - Intelicap Analysis

Among MSMEs, service sector enterprises account for a majority of the equity investments. Analysis shows that as much as 86 percent of the total equity invested in the MSME sector in 2017 went to service sector enterprises. This is partly because of the sector focus of the funds involved. As mentioned earlier, funds typically raise money from investors with a mandate for investing in certain preferred industry sectors.

Apart from traditionally preferred service sectors such as IT/ITES, BFSI and health care, enterprises leveraging mobile based technologies are increasingly finding favor with equity investors, especially with the proliferation of e-commerce⁶⁷. A higher degree of

innovation in the service sector as compared to the manufacturing sector, coupled with success stories of high - value exits, has attracted more equity to service enterprises.

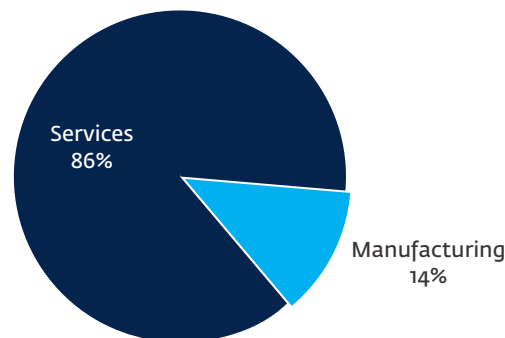
Additionally, manufacturing enterprises tend to be asset heavy and as a result find it relatively easier to raise traditional debt as compared to service enterprises⁶⁸. The median investment size in the manufacturing sector (USD 2.23 million or INR 14.5 crore) – was, however, higher than that in the services sector (USD 1 million or INR 6.5 crore) in 2017⁶⁹.

⁶⁷ Primary Research

⁶⁸ Primary Research indicates that banks are willing to lower margin money requirements for manufacturing enterprises having adequate financial history to as little as 10 percent

⁶⁹ WBG - Intelicap analysis; Investments classified as manufacturing/services based on industry and sector classifications as per Venture Intelligence deal database

**Figure 16: Share of Equity Investment to MSMEs in 2017,
100 percent = USD 1.05 billion**



Source: Venture Intelligence, WBG - Intelicap Analysis

Equity Investments by Geography, 2017

Low income states accounted for roughly 4 percent of the equity invested in MSMEs in India in 2017, whereas northeastern states saw no investments. Within the former group, more than 89 percent of the investment went to enterprises in West Bengal. Primary research indicates that investors often prefer to focus on enterprises near their own physical location – which is often in metros. A lack of adequate enabling infrastructure such as incubators/accelerators in low income states and a lack of awareness of formal external equity as a source of finance also inhibit investment in these geographies. The high concentration of investors near metros is also indicated in the Rest of India figure, with the states having metros – Karnataka, Maharashtra, Delhi NCR and Tamil Nadu — accounting for almost 78 percent of the equity investment.

Geography	Equity Investment (\$ billion)	Share of Investment (as a % of total)
Low Income States	0.04 (261)	4%
Northeastern States	0 (0)	0%
Rest of India	1 (6,590)	96%
Total	1.05 (6,850)	100.0%

Figure in brackets is in thousand core Indian rupees
Source: Venture Intelligence, WBG - Intelicap Analysis.

4.1.1.2. Breakdown of Equity Investment by Lifecycle Stage

As already highlighted, equity investors place greater emphasis on the lifecycle stage of the MSME to guide their investment decisions. Almost 70 percent of the total equity invested in MSMEs in

2017 was in early - stage enterprises (Figure 17). This share is almost 20 percentage points higher than the share in 2012, as the total amount invested increased from USD 0.79 billion in 2012 to USD 1.05 billion in 2017.

Figure 17: Equity Investment by Enterprise Lifecycle Stage, 2017 (USD billion)

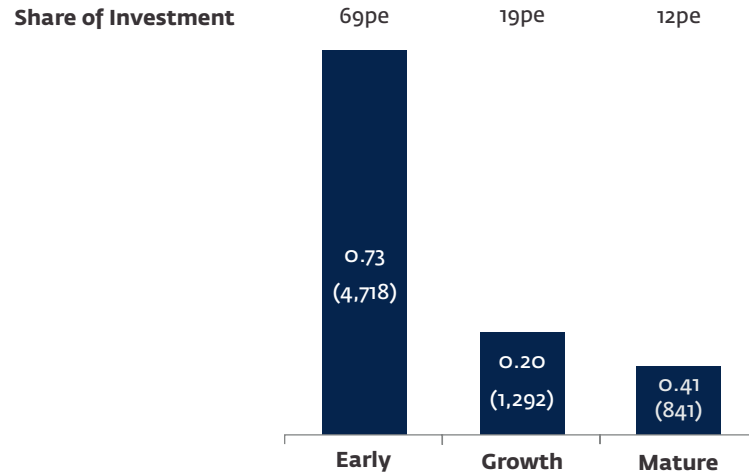


Figure in brackets is in thousand core Indian rupees
Source: Venture Intelligence, WBG - Intellectap Analysis

While there is more risk associated with early-stage investments in MSMEs with relatively less proven business models, the growth prospects, as well as the ability of the equity investor to influence the business model, are much higher. As a result, many equity investors prefer investing in early-stage MSMEs. In the early stages, the amount of finance required also tends to be smaller. The average deal size of investments made in early-stage MSMEs tends to be smaller than those in the growth and mature stages.

MSMEs that progress to the growth stage display greater understanding of the business and have an established financial track record. Investments in growth-stage MSMEs tend to be the third or fourth round of institutional funding and investors draw comfort

from the demonstrated performance of the enterprise in using investments received in earlier rounds over a number of years. These factors lower the perception of risk in investing. Investors are willing to put in larger amounts in such MSMEs. The average deal size of an investment in a growth-stage MSME was more than twice that in an early-stage enterprise in 2017⁷⁰.

Mature-stage MSMEs often need equity to expand their business offerings, enter new geographies or make acquisitions. However, given their longer vintage and business experience, mature-stage MSMEs also tend to have an institutionalized business model and exhibit lower growth prospects. As a result, they attract limited investment.

Table 9: Average Investment in MSMEs, 2017 (USD million)

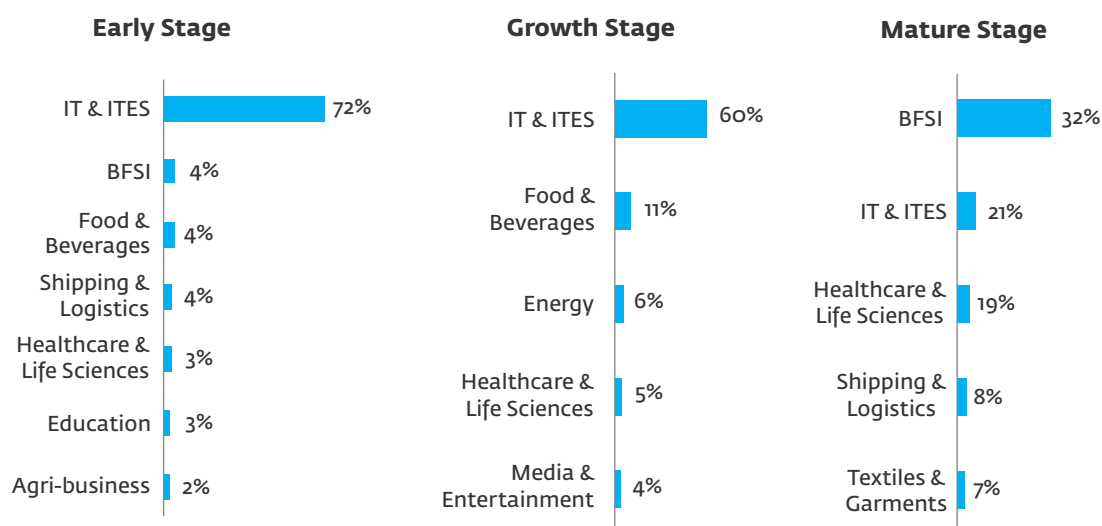
Enterprise Lifecycle Stage	Average Investment, 2017
Early	2.0 (13.0)
Growth	4.1 (26.9)
Mature	4.0 (26.3)

Figure in brackets is in thousand core Indian rupees
Source: Venture Intelligence, WBG - Intellectap Analysis

⁷⁰ WBG - Intellectap analysis

Service sector MSME are preferred by equity investors in all three lifecycle stages – with IT/ITES, healthcare, life sciences and BFSI accounting for the bulk of the equity invested in 2017 (Figure 18).

Figure 18: Share of Equity Investment by Industry Group (2017)



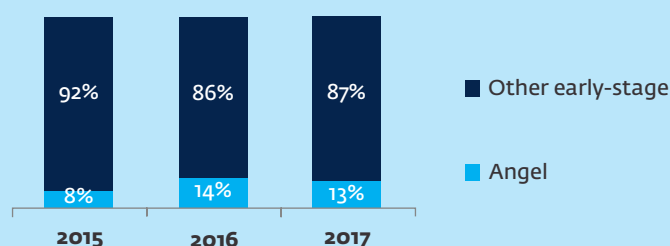
Source: Venture Intelligence, WBG - Intellect Analysis

This is partly because of the wider and stronger supporting infrastructure available to technology based MSMEs in the country. The vast majority of business incubators and accelerators in India focus on sectors such as IT, health

care and life sciences. This has resulted in such MSMEs receiving stronger mentorship and direct exposure to potential investors as compared to other sectors such as manufacturing, engineering and construction.

Angel Investments as a Portion of Early-Stage Investments, 2015-2017

Analysis reveals that there is increasing investor interest in pre-revenue, proof-of-concept stage enterprises. This is partly due to the emergence of a new class of investors — such as HNIs, family offices and successful professionals. Such investors have a larger appetite for risk and are often associated with incubators/accelerators, and provide professional advice and mentorship along with financial support to the investee company. Additionally, with a start-up culture developing rapidly in India, especially in Bangalore and other metro cities, there is a larger breed of young entrepreneurs willing to start a business. Consequently, the capacity of the start-up ecosystem to absorb angel investments has also increased. The share of angel investments, i.e. investments in pre-turnover enterprises, as a portion of investments in early-stage enterprises, has increased at a compound annual growth rate of over 27.2 percent from 2015 to 2017.



Source: Venture Intelligence, WBG - Intellect Analysis

4.1.1.3. Equity Raising Process

Equity investors identify and finance MSMEs either through their own sourcing mechanisms or collaborate with intermediaries such as incubators, accelerators and angel networks. Other intermediaries such as chartered accountants and investment banking advisors also help the process. The typical fund raising process can last a minimum of 18–20⁷¹ weeks once an MSME has been identified for evaluation (Figure 19).

Figure 19: Typical Equity Raising Process



The pitch document is the first introduction of an enterprise seeking equity from a potential investor. In most cases, the investor decides whether to further engage with the enterprise on the basis of the pitch document. Preparation of the pitch is thus the critical first step of the equity raising process. The pitch document clearly defines the business opportunity, describes the MSME and its offering, provides an overview of the industry and the competition, lays out the sales and marketing strategy, defines roles of management and advisers, details risks and indicates a funding plan. The funding plan typically includes detailed allocation of the funds being sought under various heads such as sales, operations, human resources and capital expenditure.

Once the pitch is successful, the equity investor carries out an initial due diligence in which he evaluates the business plan and financial viability of the enterprise. This is followed by negotiations on the deal parameters and the signing of the term sheet. The term sheet establishes the intent of both parties to continue the process.

A detailed due-diligence follows, which includes assessment of not only the financials and legal status of the MSME, but also other soft aspects such as the extent of alignment of the entrepreneurs with the investor's mindset. Investment decisions are made based on several factors:

Figure 20: Key considerations for equity investors



⁷¹ Primary and secondary research

- **Growth prospects of the firm:** It is important to understand the valuation of the company. The return expectation by equity investors typically exceeds 25 percent.

- **Quality of management team:** This is a key consideration. Investors tend to look for entrepreneurs with either substantial experience in the sector they are venturing into or a proven track record of success, backed by strong educational credentials. Additionally, investors prefer enterprises driven by more than one promoter to reduce resource dependency.

- **Robustness of the business model:** For investors, this is essential to ensure financial viability and sustained growth. They insist on a comprehensive business plan and analyze its various components closely, such as value proposition, revenue streams, cost structure, customer segment, competition, partners and distribution channels.

- **Alignment with the investor:** Investors prefer enterprises backed by promoters who are willing to accept investor interventions in management, if and when they occur. Investments are typically made over a period of time in pre-decided tranches and such interventions are subject to mutually agreed upon targets laid out over the investment period. Investors themselves may themselves be sector experts, or may bring in other experts to protect their investments.

- **Industry outlook:** The state of the industry is also considered, both in terms of size of opportunity and regulatory developments. Innovative new age businesses often operate at the fringe of regulatory reach and run

the risk of being disrupted by regulatory changes. Hence investor due diligence includes a detailed assessment of the market and regulatory landscape of the concerned sector, an assessment of market size, intensity of competition and key drivers and restraints that affect or could affect the industry. Such an analysis allows investors to assess the long term viability of the business and potential exit options.

- **Market access:** This is a critical component for an enterprise to establish credibility and demonstrate the viability of the product or service offering. Equity investors encourage enterprises to go-to-market as soon as possible so as to incorporate feedback and tweak the offering if required. Shorter cycles of testing and tweaking the offering in the real marketplace help the enterprise to come up with a truly viable offering. This is especially critical in the pre-revenue stage when an enterprise exists purely as a proof-of-concept and/or is associated with an incubator or angel investor.

However, as seen earlier, MSMEs accounted for only 4.5 percent of the overall equity invested in India in 2017. Some of the key reasons for MSMEs accounting for such a small share are:

- **Lack of awareness** among traditional MSMEs about external equity as a formal source of finance. This limits the number of enterprises actively seeking out investments. MSMEs often rely on informal sources such as friends and family to borrow money to be used as equity in the enterprise⁷². As seen earlier, 87 percent⁷³ of MSMEs either do not have access to finance or self-finance their enterprises. Additionally, there is a lack of adequate

⁷² Ministry of MSME, Annual Report 2016-17

⁷³ Refer to Table 5 in Chapter 1 – MSME Landscape

intermediaries such as financial advisers, investor-entrepreneur platforms and freely available information regarding equity investors.

- **High transaction cost** is a disincentive for equity investors from investing in MSMEs. Ninety five percent of the MSME sector consists of micro enterprises. Equity investors assess enterprises from the point of view of return on investment – which includes both the actual amount invested and the cost of due diligence. This results in investors avoiding micro enterprises, unless their growth prospects are very high – which typically is the case only with e-commerce start-ups and tech-based companies. Not all MSMEs are asset light and thus draw limited interest from equity investors.

- **Inadequate management bandwidth** with MSMEs reduces investor confidence in the enterprises' abilities to adjust to changing market conditions and maintain the growth rate. Reluctance of the management team to cede part control and strategic space to the investor is another barrier. Additionally, MSMEs often do not follow accounting best practices. This reduces transparency and increases the perception of risk, discouraging equity investors.

- **Lack of innovation** in products and services offered by MSMEs result in most enterprises operating in a highly competitive space. This reduces the chances of achieving the scale of growth investors typically look for. Inefficient processes and limited market reach limit the MSMEs' growth prospects further.

Common issues in the equity fund-raising process

MSME perspective

1. **Lenthy and cumbersome funding process:** Equity fundrasing is a long drawn out process. Many MSMEs lack the management bandwidth to engage with investors during that period or sutain their financial needs till the point of time that the deal is closed and capital is received.
2. **High inclination of VCs towards certain sectors:** Most equity investors prefer to invest in assest-light enterprises in the consumer technology, healthcare and BFSI sectors. Hence, it is gettting increasingly difficult for other MSMEs, especially manufacturing ones, to raise equity capital.
3. **Financial savviness of entrepreneur:** The promoters of tradional MSMEs find it difficult to understand complex financial instrument and agreements on the term sheet. They also find it difficult to access trusted intermediaries like CAs and lawyers, Hence, many promoters fail to close an equity deal.

Investor perspective

1. **Reluctance in ceding control:** The misalignment in vision and strategy between the promoter and investor may affect the investment decision. The inability to take investor's inputs and maintain transparency in communication may also lead to a trust deficit between the promoter and investor.
2. **Mismatch in valuation expectations:** Sometimes entrepreneurs are over-confident of the market opportunity in the sector they operate in and discount the competiton, regulatory environment and other circumstances.
3. **Lack of capacity to absorb capital:** Investors prefer enterprises with organizational maturity and proper internal systems and processes. Many MSMEs, especially family businesses, lack the ability to deploy the capital productively. The ability or intent to scale may be absent in the promoter, making it less attractive for investors.

4.1.1.4. SIDBI Venture Capital Ltd.

Besides VCs and PEs, SIDBI Venture Capital Ltd., the venture investment arm of the Small Industries Development Bank of India, provides equity funding support to MSMEs through funds that have specific investment objectives and target sectors. SIDBI has invested in more than 88 venture capital funds, indirectly funding more than USD 873 million (INR 5,675 crores) to more than 472 MSMEs. SVCL, incorporated in 1999, has invested in around 90 MSMEs from diverse sectors. SVCL has generated an internal rate of return of 15 to 17 percent from the funds it has exited.

Figure 21: SIDBI Venture Capital Ltd. Funds

1	2	3	4	5	6	7
Samridhi Fund INR 450 Cr.	India Opportunities Fund INR 450 Cr.	TEX Fund INR 200 Cr.	Maharashtra Fund INR 200 Cr.	West Bengal Fund INR 200 Cr.	SME Growth Fund INR 500 Cr.	National Venture Fund for Software and IT Industry INR 1,000 Cr.

- 1. Samridhi Fund:** This fund invests in social enterprises in Bihar, Uttar Pradesh, Madhya Pradesh, Orissa, Chhattisgarh, Jharkhand, Rajasthan and West Bengal. It is a closed-ended fund with a life of seven years. The focus sectors include water and sanitation, affordable healthcare, agriculture and allied services, clean energy, financial inclusion, education, and skill building. The ticket size is – INR 5-25 crore and the holding period is 3-5 years. The contributors to the fund are the United Kingdom's Department of International Development (85 percent) and SIDBI (15 percent).
The fund has a life of seven years and the average ticket size is INR 1–3 crore.
- 2. India Opportunities Fund:** It funds high-growth MSMEs operating in emerging sectors such as clean-tech, light engineering, agro-based industries, logistics, educational services, and IT/ITES. It is a closed-ended fund with a life of 10 years.
- 3. TEX Fund:** It invests in early and growth-stage MSMEs engaged in textiles, power-loom and allied businesses such as production machinery, weaving and processing.
- 4. Maharashtra State Social Venture Fund (MS Fund):** It identifies and funds early-stage social ventures in Maharashtra that are profitable and have an innovative and inclusive business model. It is registered as a Category-I AIF and has a life of seven years. The holding period is four to five years and the ticket size is up to a maximum of INR 25 crore.
- 5. West Bengal MSME VC Fund:** It invests in enterprises that have innovative business models, and high potential to scale. The fund is a closed-ended one with a life of six years. The West Bengal government contributes 50 percent of the total corpus. The investment in each company is limited to INR 9 crore. The fund is sector-agnostic, but preference is given to women entrepreneurs.

4.1.2. Venture Debt

Need

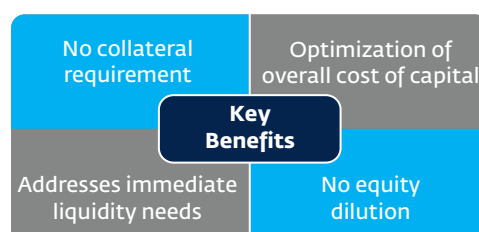
Access to capital is now well-recognized as a key challenge facing MSMEs. However, as the evolution of risk capital in India has shown, there is growing recognition that access to capital has two dimensions: (a) the amount of capital raised and (b) the characteristics (holding time, cost, ease of raising it) associated with the capital. Many MSMEs find it difficult to raise secured debt and, at the same time, are not willing to accept the dilution of control that additional equity raising entails. Venture debt has emerged as an additional source of risk capital supply for such MSMEs.

Venture debt providers typically target venture equity-backed companies which lack the collateral or other criteria required for secured debt financing, or want greater flexibility in repayments⁷⁴. Venture debt is generally structured as a 2-to-3-year loan with a limited equity kicker in the form of warrants of company stock.

While equity financing is essential as long-term growth capital, venture debt may be a better alternative than equity for meeting transitory cash flow mismatches or making small capital investments. Some of the reasons for this include:

1. The process of structuring equity investment is an involved exercise and generally takes a long time to close.
2. Cost of venture debt is generally lower than cost of equity.
3. Venture debt plugs the gap between the investment capability of angel investors and average ticket size of venture capital funds.
4. Equity financing to meet temporary working capital requirements leads to dilution of ownership, which may not be in the best interest of the MSME entrepreneur. Even when venture debt is used to meet growth capital needs, an entrepreneur may benefit by deferring the equity raise to a later date.

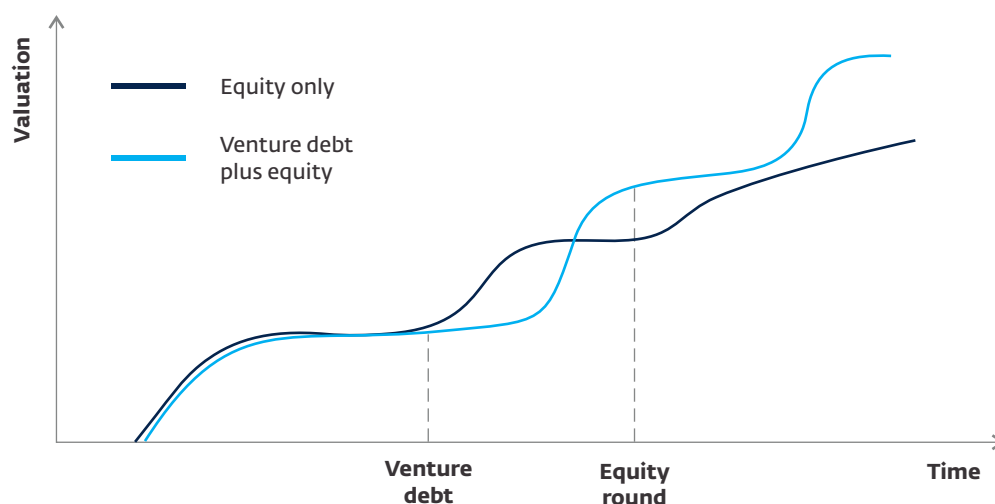
Figure 22: Key benefits of venture debt



⁷⁴ In some cases, venture debt is also provided to early-stage MSMEs that have not raised external equity as well as to MSMEs that are in the growth or mature stages

Research by Kauffman Fellows indicates that enterprises which raise venture debt and deploy it to achieve critical business milestones benefit from increase in valuation in subsequent equity rounds. (Figure 23):

Figure 23: Valuation curves with and without venture debt⁷⁵



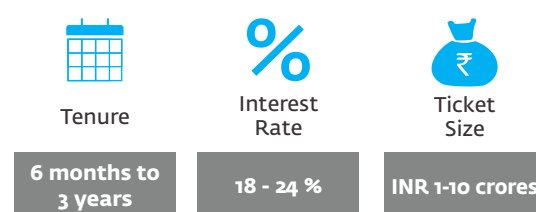
Source: Kauffman Fellows: Venture Debt: A Capital Idea for Startups

Venture debt funding allows MSMEs to accelerate business growth until there is a need for long-term equity infusion. This creates the potential for greater valuation during the next equity round of funding. As shown in Figure 23, enterprises can 'time' their subsequent round of equity financing with venture debt funding. MSMEs can leverage this 'extended runway' that venture debt provides to scout for and select the best-fit equity investors. This is important because compared to a debt provider, an equity investor stays invested for a longer term and requires a higher return on capital invested.

Venture debt is normally structured as a term loan, and both the tenure and repayment schedule are customized to the requirements of the MSME. Most venture debt investments also have a

warrant or an equity kicker that allows the provider to participate in future profits of the MSME by converting a portion of the debt into equity (generally 2 to 5 percent). Repayment may also follow a tranche model wherein debt is repaid as certain business performance metrics are achieved. The following figure shows the common features across venture debt investments in India:

Figure 24: Features of venture debt⁷⁶



⁷⁵ The chart is for indicative purpose only

⁷⁶ WBG - Intelicap research

Venture debt companies prefer to lend to enterprises that are not served by banks or NBFCs – in order to take on the role of senior lender. By doing so, they ensure that they get first preference in recovery in the event of liquidation. Most venture debt providers also differentiate themselves from traditional lenders by having fewer covenants and providing flexible repayment schedules, giving enterprises the room they need to make medium-term strategic investments. For example, enterprises may be given extended moratorium periods at times of large expenses, allowing the enterprise to remain focused on achieving business goals. In case an enterprise is about to go for an equity round of financing immediately after the venture debt tenure, the loan term may be structured such that a majority of interest payments are 'loaded' towards the end.

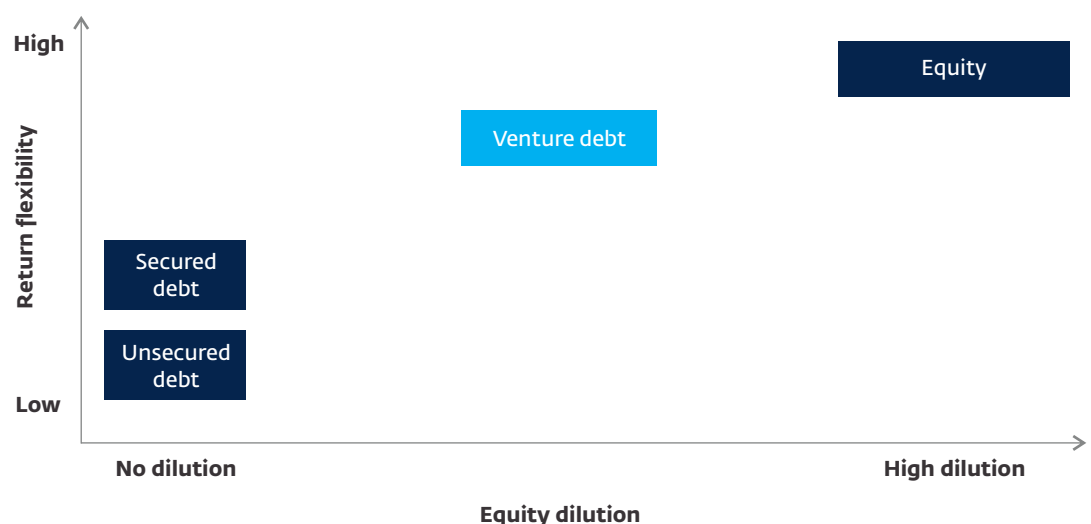
As the chart below indicates, venture debt offers a good balance between return flexibility and equity dilution of stake relative to other types of risk capital.

Due-Diligence

Venture debt companies generally follow a due-diligence process that is more extensive and 'equity-like' as opposed to that generally followed by banks and traditional NBFCs. The average time taken by venture debt providers to assess an enterprise is two months. Generally, a venture debt provider funds 10 to 15 percent of the enterprises it evaluates⁷⁸. During the due-diligence process, venture debt providers prefer the following characteristics in an enterprise:

1. A completed round of equity funding by angels or venture funds
2. Experience, education and delivery capability of promoter(s) and management team
3. An innovative, viable and scalable business model
4. Stabilized drivers of revenues, expenses and cash flows
5. Established path to profitability even if the MSME is not profitable at the time

Figure 25: Return flexibility versus Equity dilution⁷⁷



⁷⁷ The chart is indicative and not drawn to scale

⁷⁸ WBG - Intelicap primary research

Venture debt is best suited for enterprises that are between two rounds of equity investments. There is a need to have more granularity in terms of ticket sizes in order for this type of capital to address demand from enterprises in various growth stages.

Venture Debt in India

Global experience has shown that development of the venture debt market lags the venture equity market by a decade. In the West, venture debt began in the mid-1990s and has now become a mature asset class, comprising around 10 percent of the venture capital ecosystem.

The venture debt supply in 2017 was almost USD 140 million

In India, the venture equity ecosystem has reached maturity level where many innovative enterprises are attracting equity funding at an early-stage. This has created the necessary environment to spur the development of the venture debt market to meet the funding gap between the angel and venture capital rounds. A total of about INR 910 crore, or about USD 140 million was available as venture debt to MSMEs in India over calendar year 2017. It is estimated that the venture debt market in India could grow to USD 1 billion (INR 6,500 crore) by 2022⁷⁹.

Below are a few details of three major venture debt specialists in India – Intellegrow, Innoven (formerly known as Silicon Valley Bank) and Trifecta Capital:

Table 10: Analysis of venture debt specialist companies in India

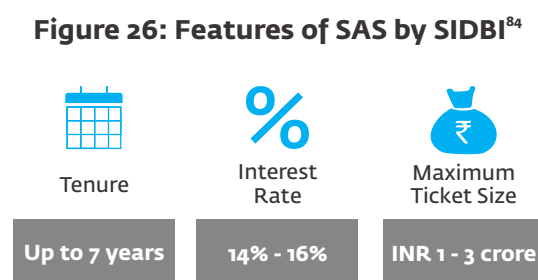
	Intellegrow	InnoVen (SVB India)	Trifecta
Structure	NBFC	NBFC	AIF - Category II
Cumulative loans disbursed (till Feb 2018)	INR 1000 crore	INR 7,290 crore	INR 500 crore
Total No. of disbursements	520	~200	25
Ticket size	INR 0.5-7 crore	INR 5-20 crore	INR 5-30 crore
Average interest rate	19%	18%	16%
Tenure	12-36 months	6-36 months	12-36 months
Target sector / companies	Sector agnostic, Preference is for impact sectors such as financial inclusion, healthcare, sanitation, education and water	Focus areas are education, healthcare, financial services, digital media, clean tech and analytics	VC-backed technology enterprises in healthcare, consumer technology, logistics
Value proposition	Provide working capital loan for early stage, high growth startups	Improve valuation for next round of equity funding	Subscribe to senior secured debentures of investees
Investment timing	Lends independent of VC investment. Independent cash flow analysis based lending	Co-Invests along with equity infusion by VC funds. Lends 15-20% of equity investment	Invests in companies that have raised Series A or B round of funding
Comfort derived from	Projected cash flows, future equity raise and equity kicker of 1.2%	Cash flow generation and warrants of 10% loan value	Warrants, partly-paid shares, equity kicker of 10%-20% of loan value

Source: InnoVen Capital Press Release, Feb 2016, http://articles.economictimes.indiatimes.com/2015-12-01/news/68688492_1_venture-debt-saif-partners-rs-500-crore, http://articles.economictimes.indiatimes.com/2015-12-01/news/68688492_1_venture-debt-saif-partners-rs-500-crore, Intellegrow

⁷⁹ InnoVen Capital Press Release, May 2015

The success of venture debt in India, inferred by the increasing number of startups raising venture debt for issues from working capital requirements to multichannel marketing for primarily ecommerce based companies, has led to a number of new venture debt funds being announced. These include INR 1,000 crore venture debt funds like Alteria Capital, started by ex-InnoVen members, and new venture debt fund announcements by Unicorn Ventures, IvyCap Ventures, Anicut Capital, and Intellegrow⁸⁰. Other organizations offering debt funding to early stage companies in India include Bengaluru-based Capital Float, Chennai's IFMR Capital, and Lendingkart from Ahmedabad⁸¹.

Besides these private sector players, SIDBI too offers venture debt through its Start-up Assistance Scheme (SAS)⁸² for early-stage enterprises. SAS aims at providing venture debt to early-stage MSMEs, between one and five years old. Financing can be structured in a way that it has an 'equity kicker' component of 1 to 2 percent equity on paid-up capital at par⁸³. The financing is aimed at enabling the MSMEs to scale up and reach operational stability. Such MSMEs can then comfortably attract mainstream debt or equity finance. The following figure shows the features of SAS:



Under this plan, SIDBI funds MSMEs that have started generating revenues and have a clear profitability roadmap, even though they may not be generating profits right then. SIDBI also prefers enterprises that have market-accepted products, and conduct business with large enterprises. It targets asset-light sectors like web/mobile based solutions, biotechnology, and social ventures. SIDBI has also partnered with the IT industry body, the National Association of Software and Services Companies and TiE for conducting due diligence and help investee enterprises with technical know-how, business mentorship and other handholding support.

4.1.3. Unsecured debt

Need

As noted earlier, many MSMEs find it difficult to access regular secured debt funding from banks due to lack of collateral, strict financial covenants, and the requirement of detailed documentation of their financial track record. The risk-evaluation process adopted in secured debt funding disqualifies many MSMEs which may

Unsecured debt is useful for asset - light MSMEs in raising small ticket size loan

have the cash flow to service the debt but do not fulfill the other criteria. While most banks have a cash - credit/ overdraft facility, accessing it generally requires collateral (property or inventory) and an existing relationship with the bank. Also, the debt tenure is generally very short and the amount allowed is restricted by the deposit that the enterprise has with the bank.

⁸⁰ http://www.business-standard.com/article/specials/from-capital-to-good-demand-here-s-what-is-driving-venture-debt-in-india-118020800065_1.html

⁸¹ <https://www.vccircle.com/venture-debt-firm-trifecta-capital-backs-agri-marketing-startup-ninjacart/>

⁸² The interest rate is approximately 14 to 16 percent; it may vary depending on the internal rating and due - diligence

⁸³ https://www.sidbi.in/sites/default/files/SIDBI_Ebrochure_start_up_assistance.pdf

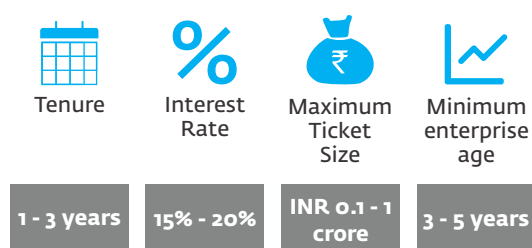
⁸⁴ Ibid.

However, a few banks and NBFCs have also started offering unsecured debt funding as an alternative collateral-free credit facility that is suited to the needs of MSMEs. Unsecured debt provides short-to-medium term funding to MSMEs for working capital needs, purchase of equipment, and business expansion. It is popularly known as business installment loan or small business loan.

Features

Unsecured debt funding has certain advantages over secured debt funding, such as no collateral, faster approval process and less documentation of financial history. The following figure shows the typical features of unsecured debt products by banks and NBFCs in India:

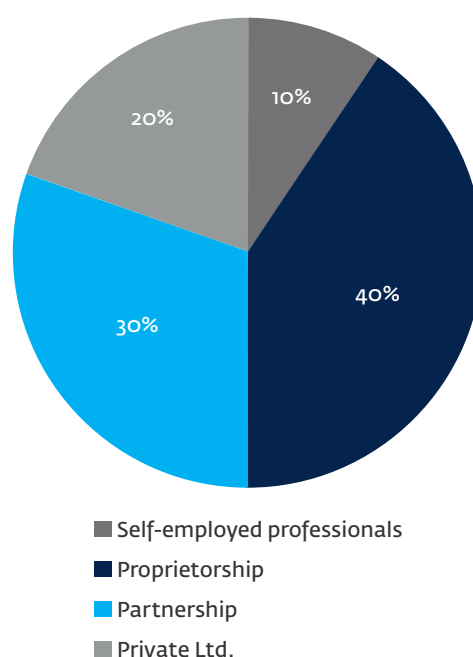
Figure 27: Features of unsecured debt⁸⁵



Banks have the option of covering a part of their unsecured lending portfolio under the Credit Guarantee Fund Trust for Micro and Small Industries⁸⁶ plan. This facility enables them to manage their portfolio risk and also to reduce the risk premium for lending. NBFCs are not covered under CGTMSE and generally have an interest rate that is 2 to 3 percent higher than that of banks. NBFCs, however, offer quicker turnaround time – around 4 to 10 days – to sanction loans as compared to banks, which take 2 to 4 weeks.

The chart below shows the split of unsecured debt customers by their ownership structure:

Figure 28: Ownership structure of MSMEs that access unsecured debt funding⁸⁷



As can be seen, enterprises structured as proprietorships or partnerships, which are not amenable to external equity infusion, are the major customers of unsecured debt. These include traditional businesses such as retail traders, distributors, small manufacturers, restaurants and different service providers.

Due-Diligence

Most financial institutions providing unsecured debt have a standardized underwriting process as shown as follows:

⁸⁵ WBG - Intellect research

⁸⁶ Please refer to the chapter on enabling environment for details on CGTMSE

⁸⁷ The chart is prepared based on primary interviews of a total of 14 banks and NBFCs and may not be representative of the entire sector. Note that venture debt is included as a subset of unsecured debt.

Figure 29: Due-diligence process followed in unsecured debt funding



The eligibility criteria include review of the borrower's tax records, credit bureau rating and business plan, with a focus on profitability track record and stability of cash flows. In some cases, the business performance metrics are also evaluated against industry benchmarks. Financial institutions place a significant emphasis on the debt service coverage ratio⁸⁸ of MSMEs to assess the ability of the MSME to adhere to the repayment schedule. The acceptable industry norm is a DSCR of 1.5 to 2.

Unsecured debt in India

More than 20 financial institutions (banks and NBFCs) provide unsecured debt to MSMEs in India. It is estimated that unsecured debt amounting to USD 6.5 billion (INR 42,000 crore)⁸⁹ was provided to enterprises in 2017.

The supply of unsecured debt in 2017 was roughly USD 6.5 billion

The following table shows some of the major banks and NBFCs in India that provide unsecured debt:

Table 11: Major financial institutions that provide unsecured debt⁹⁰

Financial Institution	Type	Ticket size (INR)h	Tenure (Years)	Interest rate	Minimum turnover (INR)	Minimum enterprise age	Profitability track record
HDFC Bank	Bank	Up to 15 lac	1-3	16.25%-19.75%	40 lac	3 years	2 years
RBL	Bank	10-35 lac	1-3	NA	1 crore	3 years	3 years
Standard Chartered	Bank	Up to 30 lac	1-4	17.5% onward	NA	NA	NA
Deutsche Bank	Bank	10-50 lac	1-3	Base rate + margin	NA	3 years	NA
MAGMA Fincorp	NBFC	3 lac - 2 crore	1-4	15%-20%	Manufacturing: 40 lac; Services: 15 lac	5 years	2 years
Bajaj FinServe	NBFC	5-30 lac	1-3	15%-20%	NA	2 years	NA
Tata Capital	NBFC	3-50 lac	1-3	NA	40 lac	NA	3 years

⁸⁸ DSCR = Net operating income/ (Principal + Interest + Lease payments)

⁸⁹ WBG - Intellect primary research

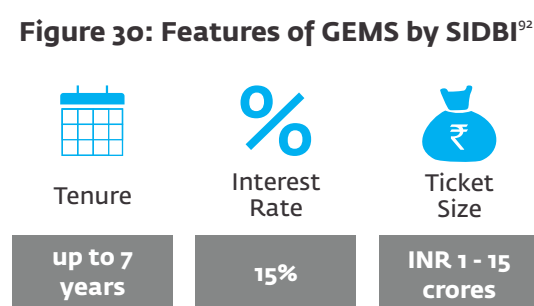
⁹⁰ The data has been sourced from the websites of the financial institutions listed in the table

⁹¹ Cure period refers to a penalty-free timeframe offered in the event of default to the borrower to defer the payment of arrears and avoid legal recovery procedures

Besides banks and NBFCs, SIDBI also offers unsecured debt through its Growth Capital and Equity Assistance Scheme (GEMS) for MSMEs. The debt is quasi-equity in nature (subordinated to bank debt and with an equity component). It offers flexibility in debt repayment by providing a principal moratorium period up to three years and a one-time cure period⁹¹ of six months. The structures by which the funding is provided under this scheme include:

1. **Subordinated debt:** A debt instrument that ranks lower than bank debt (senior debt) with regard to claim on assets or earnings of the enterprise in the event of bankruptcy.
2. **Participatory debt:** Royalty on sales or convertible structures and equity warrants that enable participation in future payoff.
3. **Convertible preference equity:** Preference shares that earn regular dividends and have the option to be converted into common equity whenever a pre-determined event is triggered.

The objective of this scheme is to provide long-term funding to growth-stage MSMEs which are looking to expand, modernize their plant and machinery, or diversify into a new business line. The plan also aims to finance non-asset generating investments such as product development, marketing, R&D and quality control. The funding is in the form of structured debt. The following figure shows the features of GEMS:



Under this plan, SIDBI funds MSMEs with at least three years of profitability and two years of satisfactory bank records. Although SIDBI engages a third-party for due-diligence, it prefers funding MSMEs which have had a previous round of equity funding by a venture capital firm. The credit evaluation is done on the basis

of cash flow predictability instead of asset cover. The first lien on the assets purchased from the funding belongs to SIDBI.

4.2. Emerging Models of Risk Capital Financing

There are other forms of risk capital that are emerging to meet specific demands of MSMEs. Two such products are discussed here:

4.2.1. Merchant Cash Advance (MCA)

Need

Working capital forms the major financing need of MSMEs operating as retail merchants. However, such MSMEs find it difficult to access traditional banking products for working capital – cash credit and overdraft – due to collateral requirement, need for strong financial track record keeping and unpredictable nature of its cash flows. The need for operational liquidity is often at relatively short notice (matter of days) and cannot be met by banks within the required timeframe. Hence, there is need for an alternative form of risk capital characterized by relatively small ticket size, short duration and quick turnaround to help retailers meet liquidity shortfalls.

Over the past few years, Merchant Cash Advance has emerged as an innovative solution for meeting the working capital needs of retail merchants. MCA providers are NBFCs that offer merchants a short-term unsecured loan without a fixed repayment schedule. The repayments are linked to future sale receipts that are generated when customers transact using their debit/credit cards at the

⁹² SIDBI Growth capital and Equity Assistance Scheme brochure

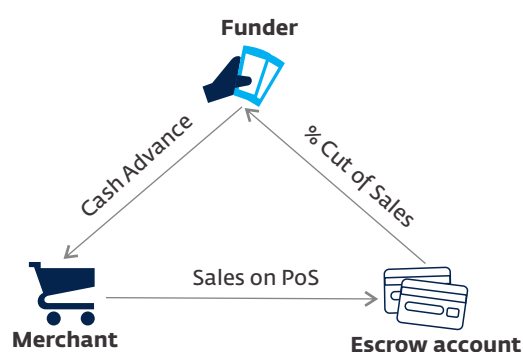
merchant location. This mechanism has the following advantages:

1. A dynamic tenure, tailored to align with business cash flows. This provides a cushion to the merchant during periods of low sales.
2. Merchants are able to build credit history to access larger size debt from banks in the future.
3. Risk to the MCA provider is reduced because of the relatively high frequency of repayment (daily/weekly/fortnightly) and availability of real-time sales data.
4. The electronic collection mechanism lowers the cost of cash management for the MCA provider.

Funding Model

Repayment amount is defined as a pre-agreed share of transaction receipts generated at a merchant's Point-of-Sale machine. As and when a customer transacts at the merchant's PoS, the funds from the customer's bank are automatically credited to an escrow account managed by the issuer of the merchant's PoS machine. Before these funds are credited to the merchant's bank account, the pre-agreed percentage share (typically 5 to 10 percent) is credited to the MCA lender. The basic model is illustrated below:

Figure 31: Merchant Cash Advance funding model






Due-Diligence

MCA funders carry out a credit assessment of retailers based on their PoS based transaction history over the past 6 to 12 months, analysis of their bank account statements and tax records. These inputs are used to predict future sales and determine both the quantum of loan and its pricing.

Merchant Cash Advance in India

The major MCA providers in India are NeoGrowth, Intellecash and Capital Float. The estimated supply of merchant cash advance in 2017 was nearly INR 2,000 crore (USD 308 million), having grown almost 100% over 2 years. Apart from brick-and-mortar merchants, online merchants have also started accessing loans from MCA providers.

Figure 32: Features of merchant cash advance in India⁹³

		
Tenure	Interest Rate	Ticket Size
6 months - 1 year	1% - 2% per month	INR 50 lac

4.2.2. Crowdfunding

Need

Very early-stage enterprises, which have not yet started generating revenues, may need a small amount of risk capital to develop a product prototype or pilot for the business idea. Such enterprises often find venture capital or even angel funding unsuitable, because of difficulties in access and the long time taken for deal closure. The funding requirements of these start-up enterprises may also be below the radar of these investors. Moreover, the

⁹³ WBG - Intellectap research

enterprise is less likely to receive bank debt following lack of a tangible asset base and relatively short existence.

An alternative funding mechanism, popularly known as crowdfunding, has emerged to address this funding opportunity in early-stage enterprises. These platforms enable enterprises to solicit funds from multiple investors through a virtual platform.

Crowdfunding provides a new investment avenue and portfolio diversification for investors. Crowdfunding is an innovative way to provide low-value funding to budding entrepreneurs who need seed capital or rapid-growth enterprises in their early stages.






















Models

The following figure shows the different crowdfunding models being used globally. Among the three models, peer-to-peer lending, also called P2P lending, and equity crowdfunding, fall under the domain of risk capital funding.

1. **P2P Lending:** Online P2P lending companies work as marketplaces that bring individual borrowers and lenders together for loan transactions

without the intervention of traditional financial institutions such as banks and NBFCs. There are around 30 P2P lending platforms in India⁹⁵. Some are involved in the microfinance business with the stated primary goal of social impact and providing easier access to credit to small entrepreneurs. They provide a web-based platform to bring lenders and borrowers together. One of the main advantages of P2P lending for borrowers has been lower rates than those offered by moneylenders and the unorganized sector in general. The advantages for lenders are higher returns than those offered by conventional investment opportunities. Interest rates and the methodology for calculating those rates vary among P2P lending platforms. They range from a flat interest rate fixed by the platform to dynamic interest rates as agreed upon by borrowers and lenders to the cost plus model (operational costs plus margin for platform and returns for lender). The interest rates vary from 16 to 24 percent, while ticket size varies from 10,000 to INR 25 lac⁹⁶.

Figure 33: Various models of crowdfunding⁹⁴

	1 Donation-based crowdfunding	2 P2P Lending	3 Equity-based crowdfunding
Objective	To raise fund in exchange for tax exemptions or intangible rewards	To raise fund as a debt instrument from individuals	To raise fund in exchange for ownership in the project/ organization
Global examples	  	   	  
India examples	    	  	  

⁹⁴ IOSCO Staff Working Paper- Crowd-funding: An Infant Industry Growing Fast, 2014, WBG-Intellect research

⁹⁵ http://articles.economictimes.indiatimes.com/2016-01-28/news/70150353_1_peer-to-peer-lending-moneylenders-borrowers

⁹⁶ Ibid

It is estimated that around 20 crore Indian rupees of risk capital have been provided through P2P platforms in India⁹⁷. There is a growing demand for raising funds through P2P platforms in India because of its ability to provide small ticket size debt funding at the seed stage in a cost-effective manner by leveraging technology.

2. **Equity crowdfunding:** This is a relatively new concept in India and has very few market players so far. It refers to fund-raising by an enterprise, particularly early-stage funding, by offering equity interest in the business to investors through an online platform. Enterprises that seek to raise capital through this mode typically advertise online on a crowdfunding platform website, which serves as an intermediary between registered investors and the early-stage enterprises. The process of raising capital on equity crowdfunding platforms takes around three to four weeks; the average number of investors on each platform is 60 to 100. Crowdfunding platforms charge listing fees, fund raising commission (2 to 6 percent) and sometimes equity participation in the range of 0.5 to 1 percent. It is estimated that around 200 enterprises have raised around USD 53 - 70 million (INR 350-450 crore)⁹⁸ on equity crowdfunding platforms in India, with ticket sizes ranging from USD 38,400 to USD 0.9 million (INR 25 lac to 6 crore)⁹⁹.

Regulatory Framework for Crowdfunding in India

Crowdfunding is at a nascent stage in India, though it is fast gaining traction.

P2P Lending platforms in India are classified as NBFCs and need to be registered as such. In most of the cases, crowdfunding is sought online on the basis of future projections rather than a viable business model in operation, which increases the risk for investors. This exposes investors on crowdfunding platforms to risks from default, fraud and information asymmetry. Some mechanisms have been put in place to reduce such exposure to risk – such as a cap on the amount that can be lent by one lender (across platforms), and a cap on the amount that can be borrowed (across platforms). This is further to consultation papers^{100,101}, put out by the SEBI and RBI to understand the existing systemic risks, elicit views of various stakeholders, and assess various business models in crowdfunding that have emerged globally. Some of the guidelines for regulating P2P lending include¹⁰²:

1. **Registration:** Lending platforms to be classified as NBFCs and shall be allowed to operate only after procuring the Certificate of Registration. Every company seeking registration as an NBFC - P2P shall have a net owned fund of at least INR 2 crore (USD 300,000).
2. **Permitted activity:** The platform shall act as an intermediary providing an online marketplace or platform to the participants involved in P2P Lending. It cannot raise deposits nor lend on its own.
3. **Prudential requirement:** NBFC-P2P shall maintain a Leverage Ratio not exceeding 2. A lender can only lend up to INR 50,000 to the same borrower (aggregated across multiple platforms). An upper cap has been

⁹⁷ Ibid

⁹⁸ <http://economictimes.indiatimes.com/small-biz/money/crowd-control-sebi-warning-turns-off-crowdfunding-tap-for-startups/articleshow/54202702.cms>

⁹⁹ http://articles.economic-times.indiatimes.com/2016-01-14/news/69765628_1_crowdfunding-angellist-investors

¹⁰⁰ http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf

¹⁰¹ <https://rbidocs.rbi.org.in/rdocs/Content/PDFs/CPERR280420162D5F13C3A2204F4FB6A2BEA7363D0031.PDF>

¹⁰² <https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=11137&Mode=0>

placed on the aggregated investment by a single lender across all P2P platforms at INR 10 lac. Similarly, a borrower can borrow up to an aggregate INR 10 lac across platforms.

- 4. Operational guidelines:** The company will put in place a Board of Directors for setting out the eligibility criteria, determine the pricing and formulating non-discriminatory rules. The outsourcing of any activity by NBFC-P2P does not diminish its obligations and it shall be responsible for the actions of its service providers including recovery agents and the confidentiality of information pertaining to the participant that is available with the service providers.
- 5. Fund transfer mechanism:** Fund transfer between the participants on

the platform shall be through escrow account mechanisms which will be operated by a trustee. At least two escrow accounts, one for funds received from lenders and pending disbursement, and the other for collections from borrowers, shall be maintained.

- 6. Submission of data to CICs:** An NBFC-P2P shall become member of all CICs and submit data (including historical data) to them.
- 7. Fair practices:** an NBFC-P2P shall put in place a Fair Practices Code, adhere to transparency and disclosure requirements and put in place a grievance redressal mechanism. It shall also protect data privacy of the participants and report to the RBI as and when directed.

Regulation of Crowdfunding — Global experience

P2P lending is approached differently by different regulators in different regulatory jurisdictions. In countries such as Brazil, China, Egypt and South Korea, P2P lending does not have a separate regulation or legislation. In countries such as Australia, Argentina and New Zealand, P2P platforms are regulated as financial intermediaries and subject to related legislations. In countries such as France, Germany and Italy, P2P platforms are regulated as banks, while in Israel and Japan, both P2P lending is prohibited.

In case of Equity Crowdfunding, most countries have enabled it as an exemption to general requirement regarding public solicitation through prospectus/offering memorandum. While in some jurisdictions such exemption is given only to offer made to 'accredited/informed/wealthiest' investors, others specifically exempt solicitation made through 'crowdfunding platform,' capping the amount that can be raised or the amount that can be invested by each investor.

Many countries have adopted 'regulatory sandboxes' to deal with existing grey areas in regulators, particularly the FCA in the United Kingdom, the Monetary Authority of Singapore and Bank Negara Malaysia, have proposed and are currently in the process of implementing a regulatory sandbox. This is a novel approach through which regulators allow experimentation with the fintech ecosystem to test financial products within a very restricted and limited framework. The sandbox allows participant fintech enterprises to offer their products, testing their outcomes and allowing regulators to understand and monitor first-hand how a particular their outcomes and allowing regulators to understand and monitor first-hand how a particular product or service works. This approach has three benefits: (i) lower costs in time-to-market for innovation, (ii) faster and better access to investment in innovative enterprises taking part in the sandbox, and (iii) increased encouragement for innovation.

In India too, the concept of regulatory sandbox could be implemented by RBI in consultation with SEBI and the Government to address lack of clarity in regulations related to crowdfunding and encouraging innovative ideas to pilot their offerings.

The following table presents the broad advantages and disadvantages of the various modes of risk capital discussed.

Risk Capital Modes – Comparative Advantages and Disadvantages

Risk capital mode	Advantages	Disadvantages
Equity	<ul style="list-style-type: none"> • High repayment flexibility • Access to mentorship and other support from investors' network 	<ul style="list-style-type: none"> • Protracted processing time for raising equity (18–20 weeks) • High cost of capital (>25%) • Partial relinquishing of ownership-equity dilution required
Venture debt	<ul style="list-style-type: none"> • Customized repayment schedule • Lower cost of capital as compared to equity (18 to 25 percent) • Limited equity dilution • Suitable for working or short-term capital 	<ul style="list-style-type: none"> • Protracted processing time (4–8 weeks) • Fixed repayment schedule at rates higher than bank rates may lead to cash burn
Unsecured debt (Business installment loan)	<ul style="list-style-type: none"> • Lower cost of capital as compared to equity and venture debt (15–20 percent) • Shorter and simpler process as compared to equity and venture debt (1–3 weeks) 	<ul style="list-style-type: none"> • Fixed repayment schedule, irrespective of business cycle. Growth trajectory allows for little flexibility
Merchant cash advance	<ul style="list-style-type: none"> • Very short process time (< 1 week) • Repayment schedule synched to business cycle 	<ul style="list-style-type: none"> • Very high cost of capital (>30 percent)
Crowdfunding	<ul style="list-style-type: none"> • Short process time (2–4 weeks) • Indirect validation of product/service at the idea stage 	<ul style="list-style-type: none"> • High cost of capital (16–25 percent)

Chapter 5

Assessment of the Demand - Supply Gap

Assessment of the Demand - Supply Gap

Key Takeaways

- **Less than 2.5 percent** of the equity demand from the MSME sector was fulfilled by formal external investors in 2017.
- The demand-supply gap is most pronounced in mature stage enterprises.
- The sheer size of the MSME sector, the limited sectoral and geographical focus of investors, and information asymmetry regarding extent of opportunity are the key reasons for the large demand - supply gap.

5.1. Demand - Supply Gap by Enterprise Lifecycle Stage¹⁰³

Although organized VC/PE funds have been investing in India for over 20 years, the MSME sector continues to be underserved by formal external equity. The sector is heavily dependent on informal sources for equity financing. Not only do informal arrangements constrain the ability of the sector to raise adequate funds for its growth, they often expose entrepreneurs to unscrupulous lenders.

At an overall level, equity invested in MSMEs was only around 2.3 percent of the addressable demand from the MSME sector in 2017. The total investment was

USD 1.05 billion (INR 6,851 crore) against an estimated addressable demand of USD 44.4 billion (INR 289 thousand crore). Since investors' focus was primarily on early-stage enterprises, the demand supply gap was marginally lower in the early-stage enterprise segment as compared to growth-stage and mature-stage segments. The investment was roughly 6.6 percent of the addressable equity demand from early-stage enterprises, whereas for growth-stage enterprises it was about 1.8 percent and as low as 0.5 percent for enterprises in the mature-stage (Figure 34).

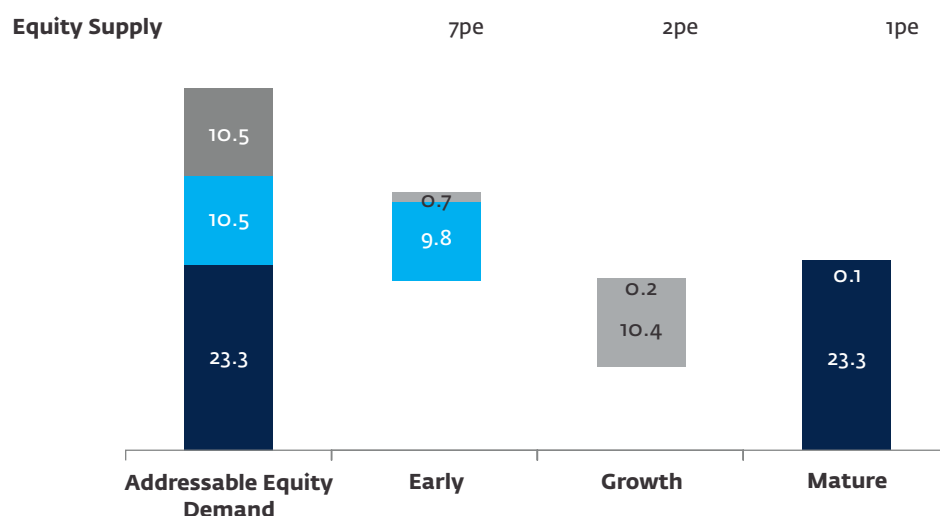
Figure 34: Gap in Equity Investment by Enterprise Lifecycle Stage, 2014 (USD billion)

Enterprise Lifecycle Stage	Addressable Equity Demand ¹⁰⁴	Equity Investment ¹⁰⁵	Gap
Early	10.5	0.7	9.8
Growth	10.5	0.2	10.4
Mature	23.4	0.1	23.3

¹⁰³ Early-stage enterprises have been defined as enterprises having a tenure of 0–5 years, Growth-stage as 6–10 years and Mature-stage as >10 years. Please refer to Table 7 in Chapter 2

¹⁰⁴ Please refer to Figure 10 in Chapter 3

¹⁰⁵ Please refer to Figure 17 in Chapter 4



Source: MSME Census, WBG - Intelicap Research

5.1.1. Early-stage Enterprise Segment

Equity investment in early-stage enterprises in 2017 was around USD 0.7 billion (INR 4,477 crore), which was 6.6 percent of the estimated demand of USD 10.5 billion (INR 68 thousand crore). Although the equity invested in early stage enterprises accounted for almost 70 percent of the total equity invested in MSMEs¹⁰⁶ in 2017, it is evident that a large demand-supply gap still exists in this segment. The gap comprises both unfunded and underfunded enterprises.

The typical quantum of demand per enterprise from MSMEs tends to be much lower than the average ticket sizes that are being invested currently.

Investments are often made based on valuation and future prospects of the enterprise, rather than with the express purpose of fulfilling the equity demand of the enterprise. From a purely operational perspective, a typical early-stage MSME demands an investment of roughly USD 93,000 (INR 60 lac)¹⁰⁷, whereas the average investment size of early-stage investments was around USD 2 million (INR 13 crore) in 2017.

This suggests that early-stage investors are providing ticket sizes that are much more than what a typical early-stage MSME demands.

As a result, numerous early-stage MSMEs that do not easily lend themselves to high valuations – owing to either their location or industry – get neglected by investors¹⁰⁸.

Investments in early stage enterprises are made both by VC funds and individuals. While organized investors such as VC funds often have dedicated sourcing mechanisms, individual investors such as HNIs depend on word of mouth and angel networks to identify companies for potential investments. While there has been a burgeoning of enabling infrastructure for start-ups and early-stage enterprises in the country, the penetration of information regarding availability, utility and procedural requirements of availing external equity is still limited. This results in numerous enterprises seeking equity investments being unprepared to meet the terms set by the investor – both procedurally and in terms of business growth prospects.

Investors typically look for enterprises that have the potential to disrupt the

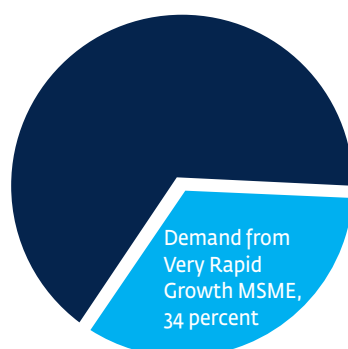
¹⁰⁶ Please refer to Figure 9 in Chapter 2

¹⁰⁷ WBG – Intelicap Analysis

¹⁰⁸ Report on the Expert Committee on Innovation and Entrepreneurship, NITI Aayog, August 2015

market with a scalable business model. Since equity investors take the risk of investing at an early stage, they tend to prefer enterprises that hold the potential for very rapid growth. The rapid growth rates sought by early-stage investors can often be multiple times the benchmark growth rate of 25 percent considered by this study for demand estimation¹⁰⁹. It is not uncommon for early-stage investors to expect a growth rate of almost 100 percent in the initial period of the lifecycle of an enterprise. It is estimated that enterprises growing at such high rates account for roughly one-third of the addressable demand at this stage¹¹⁰. This indicates that there exists a demand of USD 3.5 billion (INR 23 thousand crore) from early-stage enterprises that equity investors will find especially appealing.

Figure 35: Share of Demand from Very Rapid Growth MSMEs, Early-Stage (100% = USD 10.5 billion)



Source: WBG - Intelicap Analysis

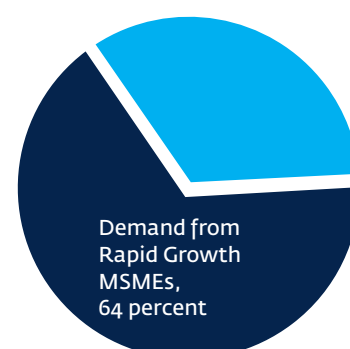
A wider reach of intermediaries such as incubators and accelerators and increased awareness among business enablers such as CAs about external equity as a source of financing will help to improve visibility of such MSMEs for investors.

5.1.2. Growth-stage Enterprise Segment

Equity investment in growth-stage enterprises in 2017 was about USD 0.2 billion (INR 1,225 crore) – 1.8 percent of the estimated addressable demand of around USD 10.5 billion (INR 68.5 thousand crore). Although demand for equity from the growth-stage enterprise segment was roughly equal to that from the early-stage enterprise segment, the demand-supply gap was larger in the former. Lower equity investments in growth-stage MSMEs is due to various reasons, such as lower willingness of entrepreneurs to cede control, a mismatch regarding valuation of the enterprise from the demand and supply sides, and an investor perception of lower growth prospects for the enterprise as compared to the early stage.

However, it is estimated that enterprises that are able to maintain a rapid year-on-year growth rate of 50 percent or more¹¹¹ in this stage of their lifecycle account for over 60 percent of the addressable demand from this segment – amounting to about USD 6.7 billion (INR 44 thousand crore).

Figure 36: Share of Demand from Rapid Growth MSMEs, Growth Stage (100 percent = US 10.5 billion)



Source: WBG - Intelicap Analysis

¹⁰⁹ Please refer to section 3.2 – Addressable equity demand

¹¹⁰ WBG – Intelicap Analysis

¹¹¹ Taken to be ~50percent for enterprises in the growth stage, based on WBG - Intelicap research

There is thus a demand of about USD 10.3 billion (INR 67 thousand crore) from early and growth stage MSMEs that can be considered an especially attractive subset of the addressable demand. This presents a promising opportunity for equity investors to widen and deepen their sourcing mechanisms and tap into this demand.

5.1.3. Mature-stage Enterprise Segment

Equity investment in mature-stage enterprises in 2017 was around USD 0.1 billion (INR 798 crore) – which was roughly 1 percent of the estimated demand of about USD 23.4 billion (INR 152 thousand crore). Although a typical mature-stage enterprise demands less external equity infusion than a typical growth-stage enterprise, at an aggregate level, most of the addressable equity demand came from the mature-stage enterprise¹¹² segment, thanks to its sheer size in the MSME sector¹¹³. Lower supply of equity to this segment has resulted in the largest demand-supply gap. The gap is driven by the perception among equity investors that mature-stage enterprises have comparatively lower growth prospects and are unable to provide the expected return on investment.

Additionally, it is estimated that more than 50 percent of the mature-stage enterprises that account for the addressable demand have been in operation for more than 20 years¹¹⁴. This suggests that they have a long history of using traditional methods of financing. Such enterprises might be unwilling to avail formal external equity as a source of financing, or to cede stake in their long-held enterprises.

Creating awareness among mature stage enterprises via business intermediaries such as CAs, audit firms and advisory firms will help introduce formal external equity as a viable source of financing. Additionally, building advisory expertise among equity investors in one or more business segments such as HR, sales and marketing or supply chain management, will help them collaborate with MSMEs on a wider level, apart from providing equity financing.

5.2. Demand-supply Gap by Nature of Enterprise (Manufacturing and Services)

Investors often focus on a few preferred industry sectors because of various reasons such as fund-raising mandate, industry growth rate and prospective high valuations. This practice often excludes enterprises in other sectors. Investor preference for certain sectors is rarely in sync with the demand from that sector. The skew in investor perception of the opportunity as compared to actual demand is very apparent from the larger gap in demand and supply of equity in the manufacturing sector as compared to the services sector.

Equity investment in manufacturing sector enterprises in 2017 was USD 0.15 billion (INR 950 crore) – which was close to 0.4 percent of the estimated addressable equity demand of about USD 33.1 billion (INR 215 thousand crore). In contrast, investment in the services sector was about 8 percent of the addressable demand. The supply to services sector enterprises in 2017 was USD 0.91 billion (INR 5,901 crore), the estimated demand being about USD 11.3 billion (INR 51 thousand crore).

¹¹² Please see Section 3.3.1.3

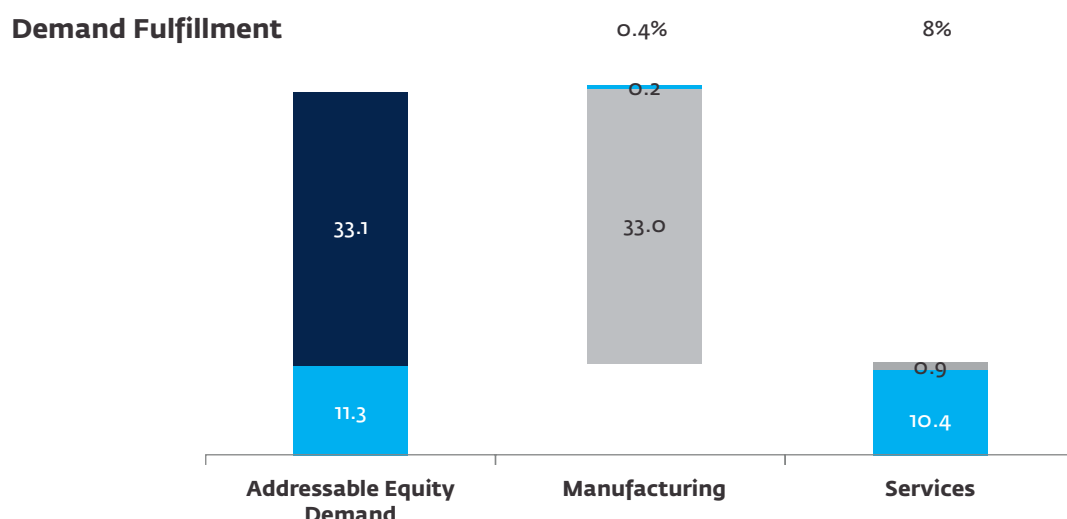
¹¹³ Almost 50 percent enterprises in the MSME sector are mature enterprises. Please see Table 8.

¹¹⁴ MSME Census, WBG-Intellicap Analysis

(Figure 37) Widening the target sectors considered for equity investments will help traditional MSMEs with high

growth rates to be considered for equity investments.

Figure 37: Gap in Equity Supply by Enterprise Type, 2017 (USD billion)



Demand-Supply Gap of Geography, 2017

The low income and northeastern states accounted for around 31 percent of addressable equity demand; however, less than 5 percent of the equity invested in 2017 went to these geographies. This is indicative of both the lack of awareness among entrepreneurs in these states about formal external equity as a mode of financing, as well as the limited reach of equity investors outside of metro areas and large cities. Although there has been a mushrooming of enabling infrastructure for start-ups in India, it has been limited to metros such as Mumbai, Bangalore, Delhi and Hyderabad. Equity investors often lack the wherewithal and the mandate to explore geographies outside their physical locations for identifying MSMEs for investment.

Geography	Equity Demand (\$ billion)	Equity Investment (\$ billion)	Fulfillment
Low Income States	12.7 (83)	0.04 (0.261)	0.3%
Northeastern States	0.9 (6)	0.0 (0.0)	0%
Rest of India	30.8 (200)	1 (6.59)	3.2%
Total	44.4 (289)	1.05 (6.85)	2.4%

Figure in brackets is in thousand core Indian rupees
Source: MSME Census, Venture Intelligence, WBG - Intelicap Analysis

5.3. Factors Influencing Demand-supply Gap

It is noteworthy that a demand-supply gap of close to 98 percent exists across early, growth and mature-stage enterprises. This stems from various factors:

- **Sheer size of the MSME sector:** Although the turnover and growth rate filters used in this study to identify potential enterprises for equity infusion disqualify more than 99 percent of enterprises in the MSME sector¹¹⁵, the sheer number of enterprises still remaining makes the equity demand very high.
- **Limited sector and geography focus of equity investors:** Investors typically raise money with a mandate of investing in certain industry segments – which tend to be limited to service sector industries such as IT/ITES, BFSI and healthcare. However over 75 percent of the addressable demand comes from manufacturing enterprises. Primary research has revealed that the manufacturing sector as a whole receives less attention from investors, and this contributes to the large demand-supply gap. Additionally, equity investors tend to be located in a few large metropolitan areas such as Bangalore, Mumbai and Delhi NCR. As a result, demand from Tier II and Tier III cities and non-urban areas often remains unaddressed.
- **Lack of information regarding extent of opportunity:** Investors are often unaware of the large amount of addressable demand from the sector – especially from mature-stage enterprises. As a result, investors often struggle to identify enterprises for

investment despite having funds to invest.

- **Low degree of financial literacy among MSMEs:** Entrepreneurs are often unaware of formal external equity as a source of finance. As a result, they do not seek such equity investment and their demand remains 'unaddressed'. Additionally, MSMEs often lack proper guidance and links with investors for them to avail of equity financing – especially in Tier II and Tier III cities and rural areas. The lack of effective intermediaries contributes to the demand–supply gap.
- **High prevalence of informal finance:** MSMEs are often reluctant to approach formal equity investors owing to complicated documentation procedures. Informal finance has become the norm for a large number of MSMEs owing to their chronic dependence on it and the ease of access and more timely nature of this type of finance. Thus a large portion of addressable demand remains outside the reach of formal equity investors.
- **Non-transparent accounting practices of MSMEs:** MSMEs often do not follow accounting best practices. Primary interviews with equity investors suggest that this increases the perception of risk and such demand remains unfulfilled.

Although the gap described above refers to the gap in demand and supply of equity, it presents an opportunity for alternative structures and sources of finance, especially in fulfilling the portion of demand that is used to fund working capital requirements. Alternative structures may include patient capital,

¹¹⁵ Please refer to Section 3.2 – Addressable equity demand from the MSME sector

blended finance and returnable capital¹¹⁶, all of which are growing in popularity in global markets. Additionally, the gap presents an opportunity for traditional lenders such as banks and NBFCs to develop innovative products and methods of credit assessment to enable them to cater to this specific niche demand. These may include unsecured lending of smaller loans and credit assessment based on transactional data

of enterprises. Other interventions such as developing the skills and outlook to lend without collateral and strengthening the enabling environment for MSMEs can also be initiated, by both private lenders and the government. Please refer to Chapter 7 for further details.

¹¹⁶ Please refer to Chapter 7

Chapter 6

Enabling Environment for Risk Capital Finance to MSMEs

Enabling Environment for Risk Capital Finance to MSMEs

Key Takeaways

- The enabling environment for risk capital financing to MSMEs has three key pillars: 1) Regulatory framework and taxation, 2) Government schemes, 3) Supporting infrastructure.
- SEBI AIF Regulations, 2012 govern on-shore funding, and SEBI FVCI Regulations 2000 and FDI (TISPRO) Regulations govern off-shore funding to enterprises in India.
- CGTMSE and MUDRA are two flagship government schemes to support financial institutions such as banks, NBFCs and MFIs that lend to MSMEs.
- Recent government initiatives to boost risk capital supply to MSMEs include a fund-of-funds called India Aspiration Fund and the SIDBI Make in India Loan for Enterprises (SMILE).
- Various intermediaries such as incubators, accelerators, angel networks and SME exchanges support risk capital providers and MSMEs seeking capital. These intermediaries enable MSMEs to access finance and help ease the funding process.

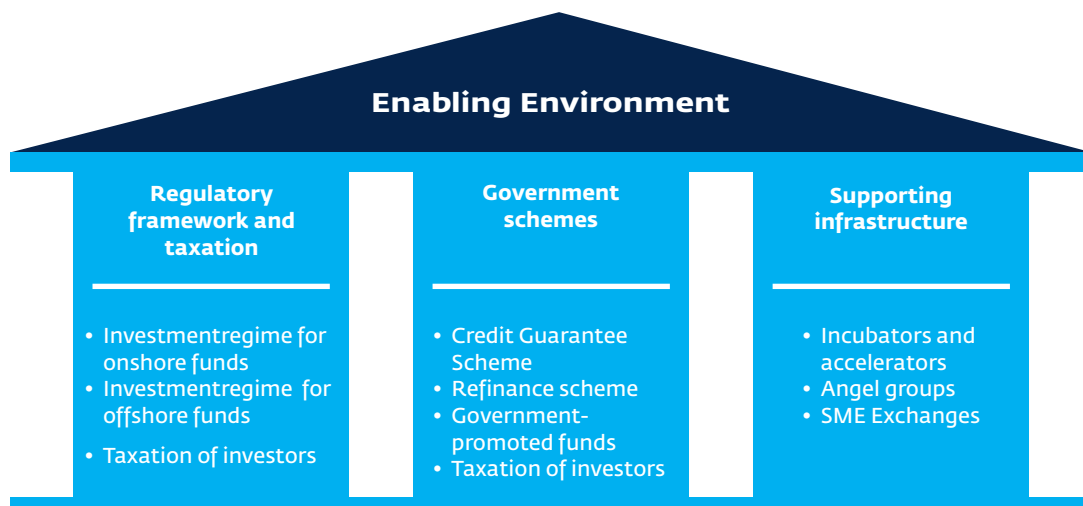
6.1. Overview of the Enabling Environment

Access to suitable and timely financing options is critical to promote growth, innovation and commercialization of ideas in the MSME sector. Apart from the internal readiness of an enterprise, its ease of access to risk capital is governed by external factors such as MSME-focused investors, government policies, regulatory and tax regimes, and various

financial intermediaries such as incubators and angel networks. Designing a favorable enabling policy framework and creating adequate infrastructural support have a positive impact on both the supply of risk capital and the ease of access to such capital for MSMEs.

The different elements of the enabling environment are shown below:

Figure 38: Enabling Environment for the supply of risk capital



These elements of the enabling environment can impact either the supply-side or the demand-side or both. The matrix below provides a classification according to the direct impact of each element:

Figure 39: Impact of the elements of enabling environment on supply-side and demand-side players

	Key elements of the Enabling Environment	Supply-side enabler	Demand-side enabler
Regulatory framework and taxation	Investment regime for onshore funds		
	Investment regime for onshore funds		
	Taxation of investors		
Government schemes	Credit Guarantee Scheme		
	Refinance of non-bank MSME lenders		
	Government-promoted funds		
Supporting infrastructure	Incubators and Accelerators		
	Angel groups		
	SME Exchanges		

6.2. Regulatory Framework and Taxation¹⁷⁷

The equity investment process is complex and time consuming, involves significant capital commitment and lacks liquidity due to limited exit options. A stable and consistent regulatory and tax regime enhances investors' confidence and reduces risk aversion¹⁷⁸.

The equity investments in Indian enterprises by privately pooled capital, both onshore and offshore, are regulated by SEBI and RBI. The following sections discuss the regulatory framework and taxation norms governing equity investments in India.

6.2.1. Investment Regime for Onshore Funds

In 1996, SEBI announced the SEBI Venture Capital Funds Regulations to regulate investments carried out through onshore pooled vehicles in early-stage ventures. In due course, however, pooled vehicles with different investment themes and objectives, such as private equity funds, hedge funds, and infrastructure funds, all started using VCF as an omnibus investment vehicle. Hence, to align rules, concessions and restrictions with the different types of emerging funds, it was necessary to make clear regulatory distinctions among the different investment vehicles¹⁷⁹. Thus, in 2012,

¹⁷⁷ Only for equity investments by funds

¹⁷⁸ SEBI Alternative Investment Policy Advisory Committee (AIPAC) Report, 2015

¹⁷⁹ SEBI Concept paper on AIF Regulations

the SEBI VCF Regulations were replaced by the SEBI Alternative Investment Funds Regulations that lay down a comprehensive regulatory framework for the different categories of investment funds.

Onshore funding is regulated by SEBI AIF Regulations, 2012

AIF refers to any fund established in India (onshore fund) in the form of a trust, company or limited liability partnership, which is a privately pooled investment vehicle and is not covered by SEBI's Mutual Funds Regulations or Collective Investment Schemes Regulations. AIFs have been divided into the three categories based on their investment objectives and strategies as shown below:

Table 12: Categories of Alternate Investment Funds¹²⁰

Category	Description	Types of funds
Category I	Funds that invest in early-stage enterprises and are perceived to have positive spillover effects on the economy	Infrastructure Fund, SME Fund, Social Venture Fund, Venture Capital Fund
Category II	Funds that are categorized as neither Category AIF nor Category III AIFs	Debt Fund, Private Equity Fund
Category III	Funds that employ complex or diverse trading strategies and high amount of leverage	Hedge Fund

SEBI's AIF Regulations, 2012, have helped bring all types of investment funds domiciled in India under a single umbrella, thus recognizing AIFs as a distinct asset class. Most of the AIFs in India are structured as trusts because the regulatory framework governing trust structures is stable and taxation rules are favorable¹²¹. While the AIF Regulations permit a Limited Liability Partnership as a fund structure, the Registrar of Companies overseeing the registration of LLPs does not permit LLPs to be used simply as 'investment vehicles'. In view of this, both SEBI and the Registrar of Companies discourage the LLP structure for AIFs¹²².

6.2.2. Investment Regime for Offshore Funds

Investment by offshore funds in private enterprises in India is governed by the Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India, or TISPRO) Regulations, 2000 issued by RBI (in keeping with the Consolidated FDI Policy of the Department of Industrial Policy and Promotion). The regulations allow an offshore fund to invest in India through the following two routes:

- 1. Foreign Direct Investment route:** Investment through the FDI scheme (Schedule 1 of the Foreign Exchange Management TISPRO Regulations)
- 2. Foreign Venture Capital Investor route:** Investment through SEBI Foreign Venture Capital Investor Regulations, 2000 (Schedule 6 of Foreign Exchange Management TISPRO Regulations)

Offshore funding is regulated by SEBI FVCI Regulations 2000 and FDI regulations

¹²⁰ SEBI AIF Regulations, 2012 notification

¹²¹ Fund Structures & Operations, Nishith Desai Associates, 2015

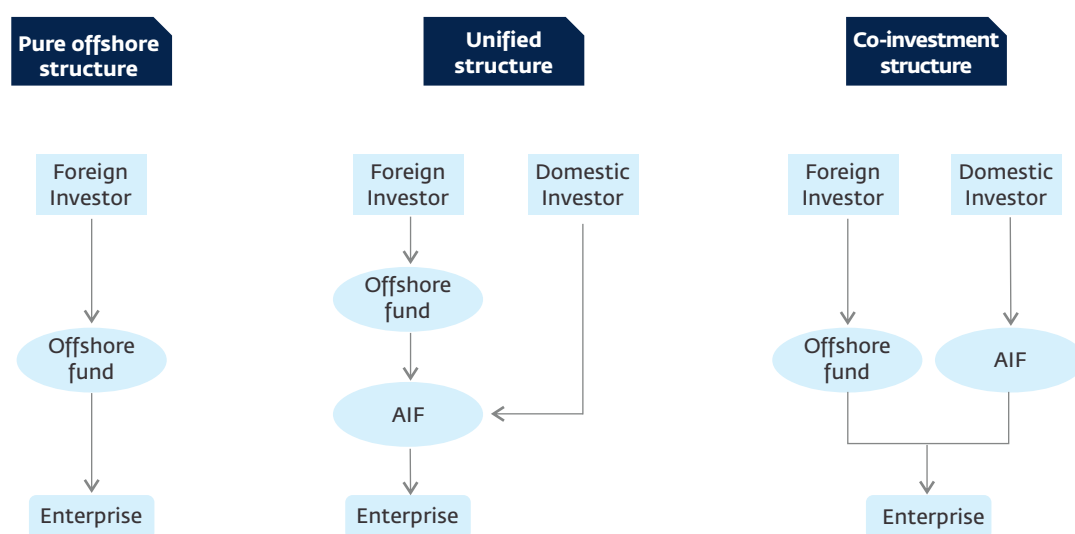
¹²² There seem to be no restriction on the legal structure of investee in terms of LLP or private limited company, although most enterprises receiving investments are the latter. Interactions with investors seem to suggest that if all other details can be agreed upon, legal remedies exist to amend the status of an investee.

To invest via the FVCI route, an offshore fund has to register with SEBI and receive approval from RBI. The FVCI route has relaxed some requirements of the FDI route, such as entry/exit pricing norms imposed by RBI, the lock-in requirement following an initial public offering, and the need for approval from the Foreign Investment Promotion Board¹²³ among others. But it also restricts the scope of investments (for example, FVCIs can invest in only nine sectors specified by RBI¹²⁴) and mandates reporting of investments and disclosure of strategy. As on March 2018, there were 240 FVCIs registered with SEBI with a cumulative investment of over INR 46,000 crore (USD 7.1 billion)¹²⁵.

Offshore funds can invest in Indian private enterprises either directly or through onshore funds (AIFs). The following figure shows the different structures that a foreign investor may adopt:

1. **Pure offshore structure:** In a pure offshore structure, the pooling vehicle is domiciled outside India and the foreign investor makes investment directly to an enterprise in India.
2. **Unified structure:** In a unified structure, the offshore fund vehicle invests in an onshore fund (AIF) that draws funds from domestic investors as well.
3. **Co-investment structure:** In a co-investment structure, funding into a private enterprise flows from foreign and domestic investors through an offshore fund and an onshore fund respectively. Although these funds are independent, they typically maintain a ratio while investing and have management teams that closely interact with each other.

Figure 40: Modes of Investment by FVCIs in Enterprises in India¹²⁶



¹²³ Despite the introduction of the AIF Regulations, the corresponding RBI regulations governing foreign investment have not been amended to specifically allow investments in AIFs by FVCIs under the automatic route, and hence FVCI route requires Government approval too.

¹²⁴ The nine sectors are: nano-technology, information technology of certain qualifying forms, seed research and development, biotechnology, pharmaceutical research, production of bio-fuels, construction and operation of certain hotel/convention centers having more than 3,000 seating capacity, dairy and poultry industries.

¹²⁵ SEBI Consultative Paper on Amendments to FVCI Regulations

¹²⁶ Fund Structures & Operations, Nishith Desai Associates, 2015

6.2.3. Taxation of Investors

The taxation system in India is set by the Ministry of Finance, Department of Revenue, and income is taxed as per India's Income Tax Act, 1961. The tax on FVCI investments is determined by the ITA alongside the Double Tax Avoidance Agreement that India has signed with a number of countries – whichever is more beneficial to the investor. Prior to the AIF Regulations, 2012, venture capital funds) were granted tax pass-through¹²⁷ status under the provisions of Section 115U of the Income Tax Act. To rationalize the taxation of other forms of AIFs, the Finance Act, 2015 extended the pass-through status to Category I and Category II AIFs as well¹²⁸.

6.3. Government schemes

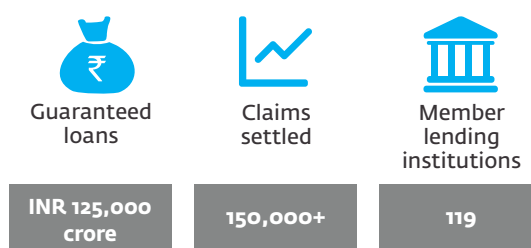
The government has taken several initiatives to promote the supply of risk capital to MSMEs and collaborate with risk capital providers to reduce their risk. It has two flagship programs – the Credit Guarantee Scheme and the Micro Units Development and Refinance Agency – to promote the supply of unsecured debt to MSMEs. In the case of equity, the government promotes several funds at the center and state levels.

6.3.1. Credit Guarantee scheme¹²⁹

Non-availability of debt funding from banks due to inadequate collateral has been a major obstacle to the growth of MSMEs. To address this challenge, in July 2000, the government established the Credit Guarantee Fund Trust for Micro and Small Enterprises, in partnership with SIDBI. CGS provides a guarantee cover under which member banks can give unsecured debt funding to micro

and small enterprises. The extent of guarantee cover is capped at 75 percent of the loan value, and the maximum loan size that can be guaranteed is INR 1 crore¹³⁰.

Figure 41: Achievements of CGS¹³¹



6.3.2. Refinance scheme

A large part of the MSME sector, especially sole proprietorship firms, has limited access to the banking system due to limited geographical penetration of banks, and perception of higher credit risk of the enterprises. Many small manufacturing units, traders, vendors and artisans are unregistered and belong to the informal sector, but are critical for employment generation and local economic development. They often struggle to access institutional micro-loans due to low interest-bearing capacity, and difficulty in meeting the collateral requirement and other eligibility criteria of financial institutions. MUDRA¹³² has been constituted by the government to refinance last-mile financial institutions that provide unsecured debt funding to MSMEs. MUDRA Bank will help address capital constraints of such MSMEs as face difficulty in accessing external equity funding from VCs. Most sole proprietorship firms, especially traders, are not amenable to receiving equity financing, and have to borrow from private moneylenders at interest rates as

¹²⁷ Tax pass-through implies that income from investments is taxable only in the hands of unit holders i.e. investors (after distribution) and the fund vehicle is exempted from income tax

¹²⁸ The Finance Act 2015 calls the Category I and Category II funds as 'Investment Funds'

¹²⁹ For further analysis of CGS, please refer to Section 7.1.3

¹³⁰ CGTMSE Website; As per Budget 2017-18 announcement, the loan limit is expected to increase to INR 2 crore

¹³¹ CGTMSE Website

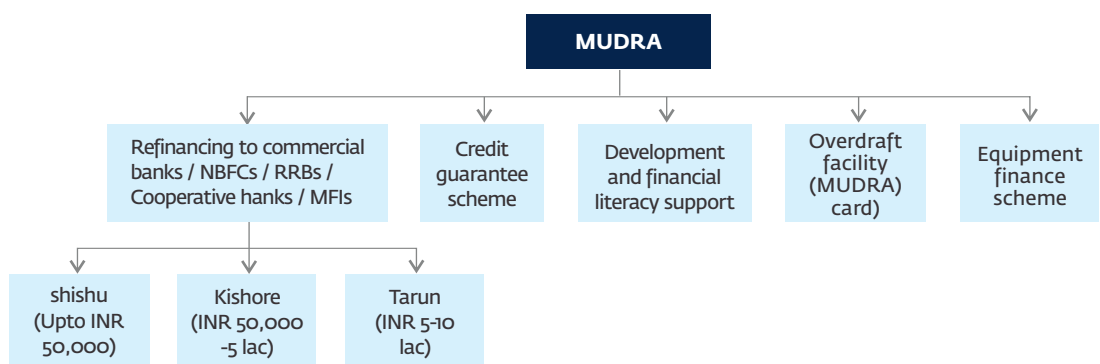
¹³² <http://www.mudra.org.in/>

high as 25 to 40 percent. MUDRA refinancing scheme can incentivize banks and NBFCs to increase their portfolio allocation to such micro entrepreneurs.

MUDRA will also lay down policy guidelines for lending to micro businesses to minimize the risk of lending. Under the refinancing scheme, financial institutions can extend loans up to INR 1 million to micro enterprises. These loans have been categorized in three buckets – Shishu, Kishore and Tarun, corresponding to early, growth and mature stage respectively – and are disbursed according to the lifecycle stage and funding needs of the micro-entrepreneurs. MUDRA is also in the process of rolling out a Credit Guarantee Scheme to reduce the credit risk for member lending institutions of the MUDRA scheme.

The following figure captures the major offerings of MUDRA:

Figure 42: MUDRA offerings



6.3.3. Government Promoted Funds

In August 2015, the Government launched two funds called **India Aspiration Fund** and **SIDBI Make in India Loan for Enterprises (SMILE)** through SIDBI¹³³.

1. **India Aspiration Fund:** Launched in August 2015, this is a fund of funds with an initial corpus of INR 2,000 crore. This fund has a total corpus of USD 610 million. Launched with an initial corpus of USD 305 million, the fund received another USD 140 million in December 2015, and USD 150 million in April 2016. The last investment was intended for 30 venture funds channeling investment through the India Aspiration Fund, to invest in

early stage startups. In April, the state owned insurance group and investment company Life Insurance Corporation (LIC) signed an MoU promising a contribution of 10% of the fund size as co-investor. IAF aims to support VCs to channel investments towards a larger number of early-stage start-ups. It will help increase the pool of equity supply for technology start-ups that find it difficult to raise debt due to lack of collateral, by providing a cushion to domestic VCs which invest in seed-stage start-ups and carry an element of high risk. Sectoral allocations may be built in to channel funds to emerging areas with a high potential for impact and job-creation.

¹³³ <http://www.livemint.com/Politics/gFaxOhSxGDqbjXLRvMrZcl/Arun-Jaitley-launches-funds-for-startups-small-firm.html>

2. SMILE: The government has also launched a new loan program called the SMILE plan under SIDBI with an initial corpus of INR 10,000 crore. SMILE aims at providing soft loans¹³⁴ to MSMEs in 25 manufacturing sectors identified under the Make in India program. The loans can also be utilized to establish new MSMEs, or for projects related to expansion, modernization, or upgrading technology at existing MSMEs. As part of SMILE, SIDBI can collaborate with banks to co-finance projects for MSMEs so that banks are comfortable with the leverage and terms of the project's financing. SIDBI will also work with other MSME-focused programs such as the Micro and Small Enterprises Cluster Development Programme (MSE - CDP) and the Prime Minister's Employment Generation Programme (PMEGP) to provide funding to MSMEs participating in these interventions. This fund has allocations for startups 25 priority sectors for startups under PM Modi's 'Make in India' vision. It provides quasi-equity and term based short term loans, to MSMEs to enable them to continue meeting adequate debt-to-equity requirements as they grow. Minimum loan size if INR 25 lac. The loan financing is available through an affirmative action oriented policy. A total of 10 percent of the project cost (maximum of INR 20 lac) as the loan amount for general category, 15% for enterprises promoted by Schedule Caste, Scheduled Tribes or Persons with Disabilities (PwD) representatives (maximum of INR 30 lac). Payback period is up to 7 years, inclusive of a 1-1.5 years and up to 2 years' moratorium applicable on term loans

and soft loans respectively. It is structured in a way that on expiration of 3 years from the date of first disbursement, the outstanding debt amount with any dues thereon will be converted into a secured term loan, with the entire loan carrying an interest rate as per internal rating of the borrowers¹³⁵.

3. SAARC Development Fund: In April 2016, SAARC Development Fund (SDF) and SIDBI signed an MoU envisaging a co-funding partnership in MSMEs on a risk sharing basis in shortlisted sectors for MSMEs in India as well as other SAARC countries.

4. ASPIRE Fund: Established in October 2016, this fund aims to promote entrepreneurship in rural India with a total corpus of USD 9 million (INR 58.5 crore). Funds are administered by SIDBI with a focus on technology inclusive interventions, especially in agriculture, livestock, social impact, healthcare and life sciences through setting up various Technology Business Incubators (TBIs). A total of INR 34.92 crore has been sanctioned, while another INR 15.3 crore has been disbursed to nine TBIs. A total of 30 TBIs are in various stages of set up. Eligibility to access norms focus on MSMEs with Entrepreneurs Memorandum (EM) registration. Average ticket size is INR 10 crore¹³⁶.

5. Fund of Funds for Startups: Approved by the Centre in 2016, the FFS is a USD 1.5 million (INR 10,000 crores) which was aimed to boost the Startup India initiative. Under it, INR 500 crore was already released to the corpus in financial year 2016, and another INR 600 crore was earmarked for financial year 2017¹³⁷.

¹³⁴ Concessional interest rate of around 10 percent

¹³⁵ https://www.sidbi.in/files/SIDBI_Ebrochure_SMILE_new.pdf

¹³⁶ <http://msme.gov.in/sites/default/files/MSME-ASPIRE-FINALBOOK.pdf>

and <https://inc42.com/startup-101/startup-scheme-indian-government-startups/>

¹³⁷ <https://economictimes.indiatimes.com/small-biz/sme-sector/fund-of-funds-for-startups-sidbi-ramps-up-its-startup-funding-operations/articleshow/52896311.cms>

Recent initiatives by the Government

1. ATAL Innovation Mission:

The Government has proposed setting up an organization under NITI Aayog to promote innovation and entrepreneurship, called the ATAL Innovation Mission (AIM). The following are the goals of AIM:

Short-term goal

- Incentivize early-stage startups through competitions and incubation facilities

Medium-term goal

- Address inadequacies in education, skilling and infrastructure

Long-term goal

- Inculcate entrepreneurial spirit and change cultural attitudes towards self-employment.

AIM would have four working groups to undertake different activities: 1) Idea and Networks, 2) Angel fund of funds, 3) Governance innovation, 4) Special Initiatives.

AIM can help support entrepreneurship cells within institutes and help establish incubators in semi-urban and rural areas. AIM can also play the role of linking early-stage institutional investors with incubators and accelerators to source startups for funding.

2. Startup India Standup India Scheme

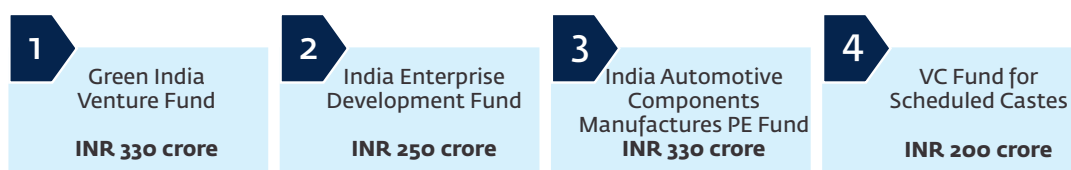
Startup India is an initiative by the Government to nurture innovation and strengthen the startup ecosystem in India. As a part of the action plan, the scheme aims to provide various types of funding support and incentives to eligible startups (as defined). Some of the items include:

- Startups having annual turnover less than INR 25 crore (~USD 3.8 million) and incorporated after April 1, 2016 eligible for getting 100% tax rebate on profit for a period of 3 years.
- Startups will be exempt from long-term capital gains tax if the long-term capital gain is invested in a fund notified by Central Government within a period of six months from the date of transfer of the asset.
- Carry forward losses to be allowed if certain conditions with respect to shareholding are met.

Besides the various funds under SIDBI Venture Capital discussed earlier, there are some funds managed by other venture capital firms promoted by the Central and state governments. The prominent ones include:

1. IFCI Venture Capital Funds Ltd: IFCI was established around four decades ago as a risk capital foundation to provide equity-based financing. IVCFL is a subsidiary of IFCI and provides equity finance to manufacturing, health care, IT solutions and companies setting up new projects from scratch in India. IVCFL has the following funds operating at present:

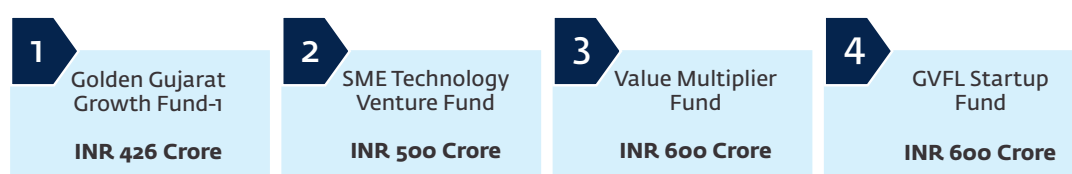
Figure 43 : IVCFL Funds



Under these funds, IVCFL has invested in 29 enterprises so far¹³⁸. It also rolled out two new funds called Green India Venture Fund–II and Small and Medium Enterprises Advantage Fund. GIVF-II will focus on enterprises in clean-tech and renewable energy, while SMEAF will nurture MSMEs in auto components, chemicals and fertilizers, food processing, fast moving consumer goods, leather, healthcare, pharmaceuticals and textiles.

2. Gujarat Venture Finance Ltd. (GVFL): GVFL is one of the first venture capital firms in India, jointly owned by the Gujarat state government and private sector companies. It was established in 1990 with the help of the World Bank to provide financial assistance to innovative tech-driven enterprises. So far, GVFL has invested in more than 90 tech-based MSMEs¹³⁹. GVFL has the following funds under its management, of which Golden Gujarat Growth Fund closed in February 2015:

Figure 44: GVFL Funds



Please refer to Appendix E for details on other government schemes for MSME financing.

6.4. Supporting Infrastructure

Various intermediaries such as incubators, accelerators, angel networks and SME exchanges support risk capital providers and MSMEs seeking capital. These intermediaries enable MSMEs to access finance and help ease their funding process.

6.4.1. Incubators and Accelerators

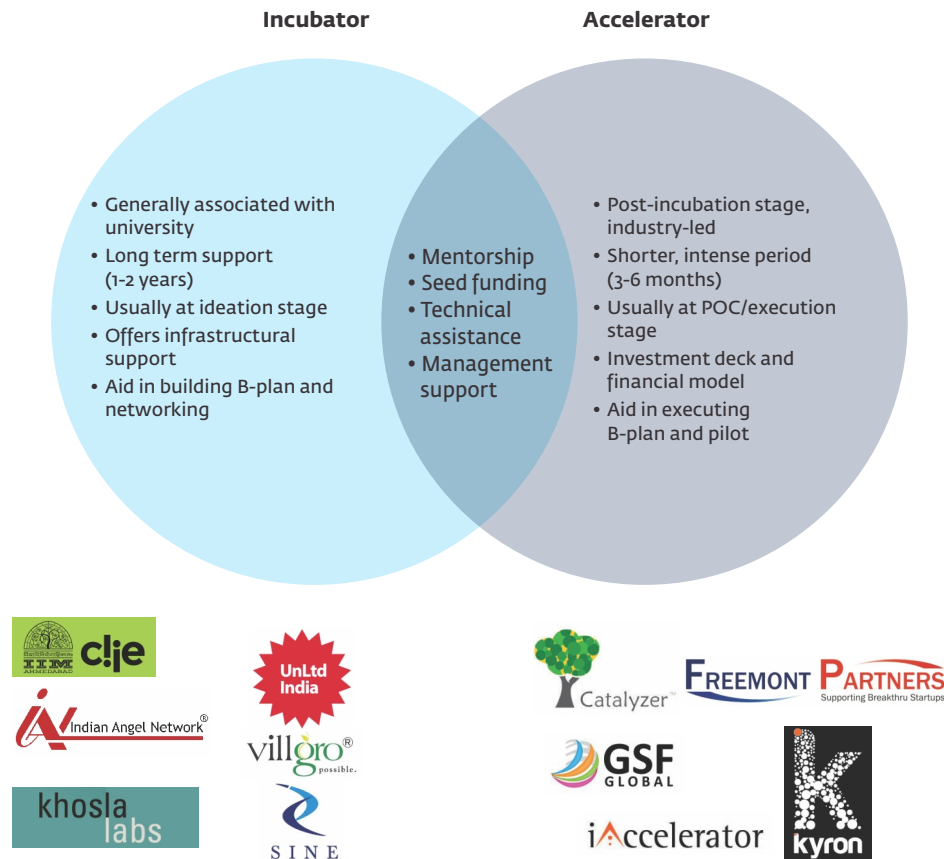
Incubators and accelerators provide handholding support to entrepreneurs to help them transition from concept to implementation. They provide a structured environment and basic business resources and infrastructural

facilities that improve a start-up's chances of commercial success. While incubators provide support in the business model development phase of the ventures they serve, accelerators generally provide support at the business model execution phase. The key difference, though, is that the gestation period in an incubator (1 to 2 years) is longer than in an accelerator (3 to 6 months).

¹³⁸ Source: <https://www.ifcilt.com/?q=content/ifci-venture-capital-fund-ltd>

¹³⁹ <http://www.gvfl.com/funds.html>, WBG-Intellectap Analysis

Figure 45: Incubators and Accelerators



Incubators: Incubators provide a test bed for entrepreneurs to refine their business models and build a market-fit product or service. They are generally set up in universities or backed by the government, and offer shared working space, mentorship, networking opportunities, and basic services such as IT, research labs and administrative support. At the end of the incubation phase, the ventures ideally graduate with a clear business model and some traction in terms of revenue, user adoption, reach and partnerships.

Accelerators: Accelerators have a standardized approach and offer a more structured program for start-ups to expedite the process of product/service deployment. They only support start-ups with a sound business model and a

market-validated product or service. Entrepreneurs get access to a network of mentors, business advisers and investors in exchange for 5-8 percent equity. Accelerators may also help connect the start-ups with service providers for product development and design, marketing, inventory management and recruitment of personnel. Generally, accelerators cater to technology start-ups and other asset – light ones that can scale fast.

Start-up Chile

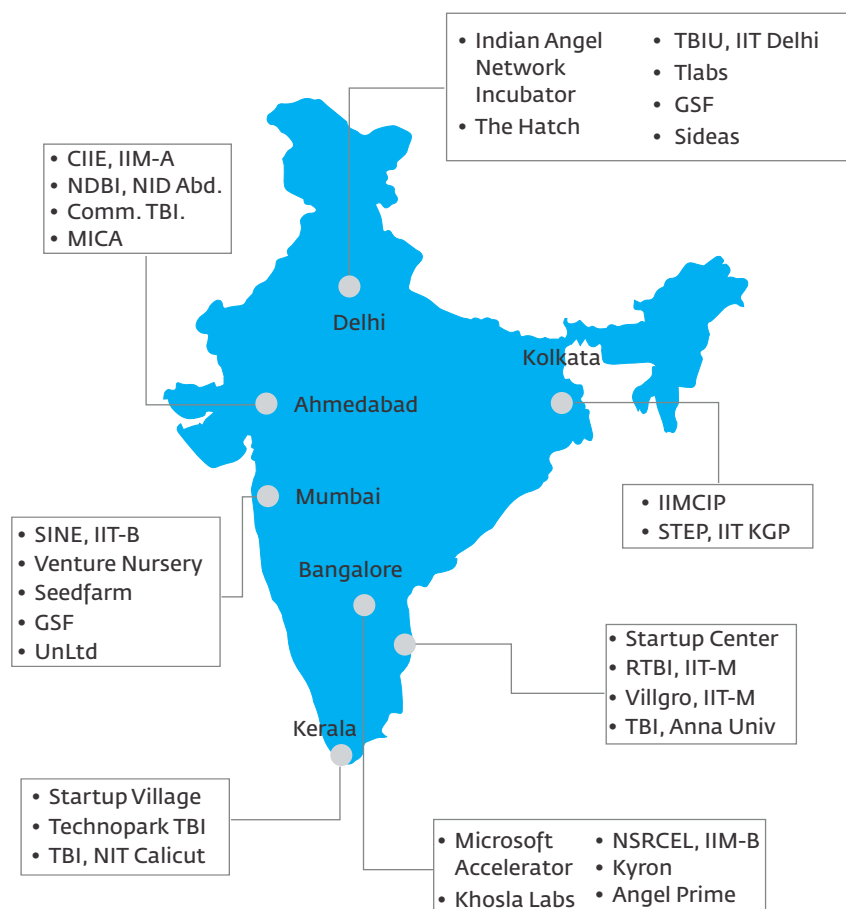
Startup Chile is an accelerator program directly funded by the Chilean Government to provide impetus to the local entrepreneurial ecosystem. It aims to attract entrepreneurs from all over the world to participate in the program and create job opportunities for the local population. The 6-month Startup Chile program provides entrepreneurs with office space, a temporary visa, mentorship opportunities and USD 40,000 of grant money. In return, the startups engage the local population through workshops, hackathons and other community outreach initiatives, thus promoting a startup culture in Chile.

The Chilean Government has also created a follow-on fund called SCALE under the Startup Chile program. The fund is raised through a co-financed grant in which Startup Chile puts 70% and the investees put the remaining 30% themselves. Graduates from the accelerator program that have gained significant traction in the market and that are willing to stay in Chile for one more year are eligible to receive funding.

In India, there are over 250 incubators and accelerators, of almost 100 provide financial support as well, through their own fund or their network of investors.

The following figure shows the major incubators and accelerators across the country:

Figure 46 : Major Incubators and Accelerators in India



6.4.2. Angel Networks

Angel networks play a vital role in the early-stage financing ecosystem. They help organize angel investors on to a common platform, connect them with entrepreneurs seeking seed capital, and facilitate the entire investment transaction. This helps address the information asymmetry and reduce the search and transaction costs of both investors as well as early-stage enterprises.

Angel networks carry out an initial screening and due-diligence before enterprises get to pitch their business idea to potential investors. The common platform enables entrepreneurs to access a larger pool of investors to meet their funding requirement in a single round and helps angel investors diversify their portfolio with a large deal flow. Angel networks have well-defined processes for deal-sourcing that make discovery of enterprises easier for them.

Angel groups also assist entrepreneurs in preparing their business plans, refining their projections and rearticulating their pitches. They provide administrative support (documentation and legal support) so that angel investors can focus on imparting mentorship. Evaluation of start-ups by different angel investors results in a more robust valuation, thus reducing the risk of adverse selection. Often, angel networks leverage their relationships with early-stage VC funds to co-invest with angel investors. Angel groups can also help start-up enterprises join an accelerator program on the advice of angel investors.

Angel networks facilitate equity investment by HNIs into MSMEs

Some of the major angel groups in India include India Angel Network, Mumbai Angels, Calcutta Angels, Chennai Angels, Hyderabad Angels, Intelicap Impact Investment Network and Spark Angels. According to industry sources, there are more than 1,000 angel investors in India¹⁴⁰.

6.4.3. SME Exchanges

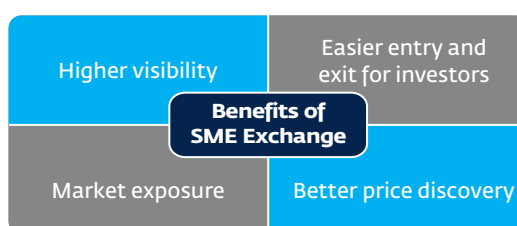
MSMEs in the growth and mature stages often find raising equity capital a better option than raising debt capital due to an over-leveraged balance sheet or inability to bear interest expenses. However, raising capital from VC/PEs may not be always possible due to mismatch between investors and enterprises in valuation. Many such enterprises wish to access funding from multiple investors in the capital markets. As public listing on the main exchanges is difficult due to stringent regulatory norms and various compliance issues, the concept of a dedicated SME trading platform has emerged. SME exchanges create a credible and efficient market place to bring about convergence of sophisticated investors and high-growth enterprises. The opportunity to trade securities with other institutional investors also provides an easy exit option to existing VC/PE investors of an enterprise.

Globally, there are several examples of such exchanges such as Alternate Investment Market in the

¹⁴⁰ WBG - Intelicap Analysis, <http://www.livemint.com/Companies/tbJoT8oH7nlRoXtO9tasAL/Domestic-VC-funds-proliferate-as-HNI-interest-in-startups-g.html>

United Kingdom, TSX Ventures in Canada, Growth Enterprise Market in Hong Kong, MOTHERS in Japan, Catalist in Singapore and Chinext in China. Along these lines, SEBI has also allowed MSMEs that fulfill certain criteria to list separately on the two major bourses in India – the Bombay Stock Exchange and the National Stock Exchange.

Figure 47: Benefits of SME Exchange



The listing norms are designed specifically to suit MSMEs and are less stringent than those for an IPO. The following table shows a comparison of key listing requirements in the main exchanges and the SME exchanges:

Table13: Key Listing Requirements

	SME Exchange	Main Exchange
Post-issue paid-up capital	INR 10 - 250 million	Minimum INR 100 million
Lock-in period for promoter capital	1 year	3 years
Net tangible assets and net worth	BSE: Minimum INR 10 million NSE Emerge: Positive networth	Net tangible assets: Minimum INR 30 Million for 3 years Net worth: Minimum INR 10 million in 3 years
Time-to-market	3 months	6 months
Reporting requirement	Half yearly	Quarterly
Underwriting	100% (with merchant banker underwriting 15% from own account)	Not mandatory

The MSMEs that list on the SME exchange, with a paid-up capital between 10 crore and INR 25 crore also have the advantage of easier migration to the main exchanges after two years of listing. Some additional requirements for listing on SME exchanges include a minimum application size of INR 1 lac and a minimum of 50 shareholders. The SME exchanges also provide tax benefits such as zero long-term capital gains tax and 15 percent short-term capital gains tax, as compared to 20 percent and 30 percent respectively, for unlisted shares.

In 2013, SEBI also introduced the Institutional Trading Platform (ITP) to facilitate capital-raising for early-stage enterprises in high-growth sectors such as e-commerce, biotechnology and analytics. This offers opportunities to institutional investors and HNIs to explore and invest in innovative businesses models. The incentives for an enterprise to list on the ITP are relaxation in disclosures, eligibility and other compliance rules. The following are the eligibility norms for listing on the ITP:

Figure 48 : Eligibility norms for listing on ITP

Minimum 1 year audited financial statements
Vintage< 10 years
Turnover< INR 1 billion
Paid-up capital< INR 250 million

The following table shows the growth of SME exchanges on the two bourses as of March 2017¹⁴¹:

Table 14: SME Exchanges in India

	BSE SME Exchange	NSE Emerge
SMEs that have listed (excluding ITP)	231	7
SMEs migrated to main exchange	182	1
SMEs listed through ITP	21	21

The interplay of MSMEs and risk capital providers with the different elements of the enabling environment impacts the access and supply of capital. A clear and consistent regulatory regime, effective formulation and implementation of fiscal policies, and a well-integrated financial infrastructure are vital for MSME finance. The next chapter explores actionable ideas and suggestions to develop and implement multiple support mechanisms for both investors and MSMEs.

¹⁴¹ NSE, BSE websites

Chapter 7

Recommendations and Potential Interventions

Recommendations and Potential Interventions

Key Takeaways

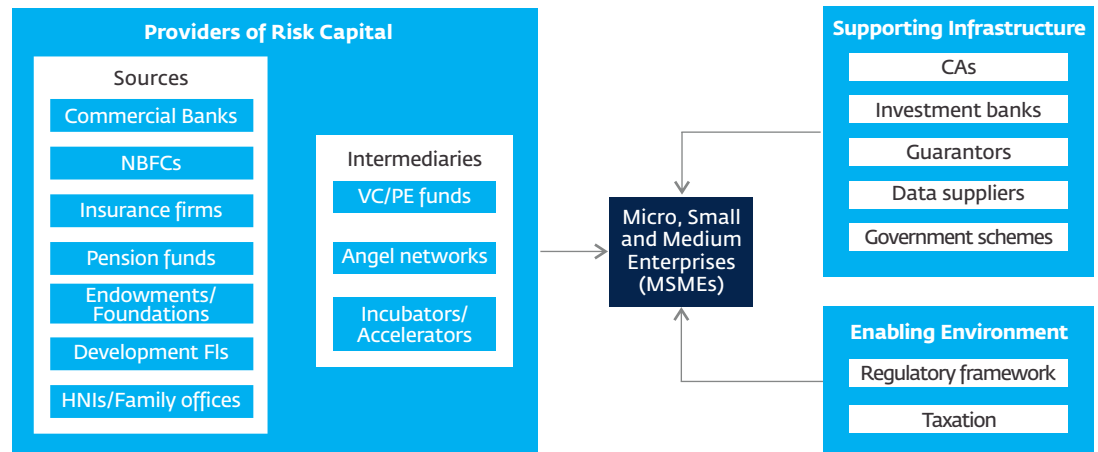
- Investment through onshore funds could be promoted to unlock domestic pools of capital from institutional investors and HNIs.
- New funding models such as patient capital, returnable capital and blended finance could be explored to fund MSMEs.
- Co-investment by government-promoted funds can help mobilize funds from private investors for financing high-impact MSMEs.
- The use of technology and alternative data, coupled with stronger government schemes, can enable financial institutions to increase the supply of unsecured debt to MSMEs.
- The supporting infrastructure of financial intermediaries such as incubators could be strengthened to cater to the growing entrepreneurial ecosystem.
- Greater parity between onshore funds and offshore funds with respect to regulatory compliance, investment scope, operational flexibility and taxation could be beneficial for equity investors.
- Harmonization and consistency in the investment regime for offshore funds can boost investor confidence.
- Tax incentives and compliance relaxations for risk capital providers can stimulate early-stage investing.
- Policies and infrastructure to enable easier investment exits can decrease the liquidity risk for investors.

As discussed in the earlier chapters of this report, there exists a significant gap in the demand and supply of risk capital to the MSME sector in India. This gap presents an opportunity for risk capital investors to help spur the latent growth potential of the sector. At the same time MSMEs need to be better equipped to absorb more risk capital. Favorable policy and effective supporting infrastructure can help catalyze the

process of bridging the demand-supply gap. It is thus critical that interventions be made across the ecosystem to make the supply of risk capital to the MSME sector in India more efficient and effective.

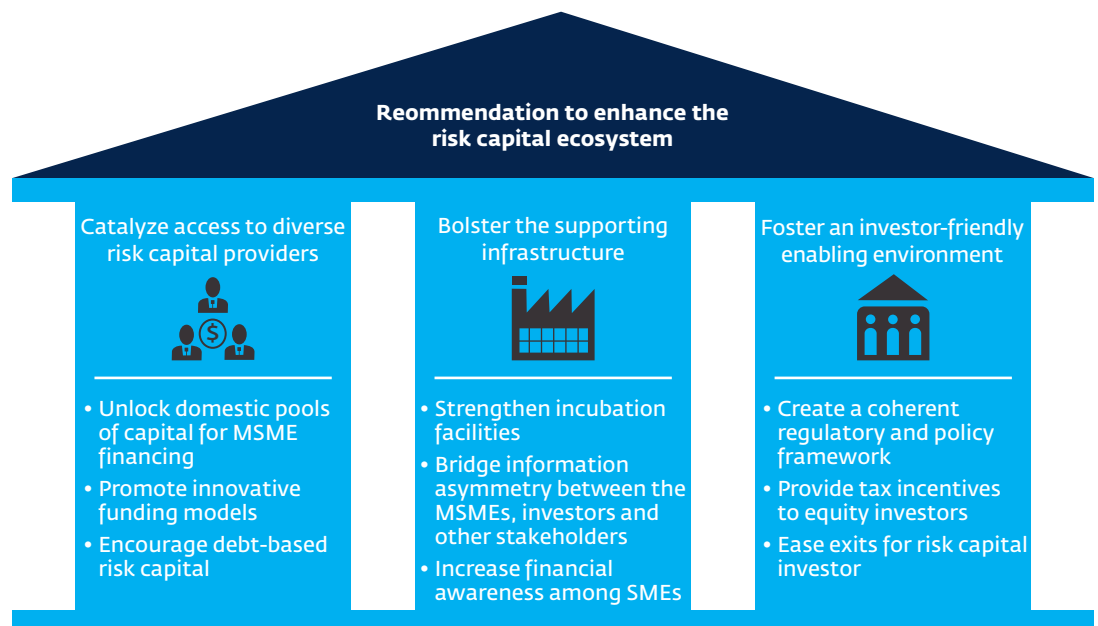
The risk capital ecosystem in India can be considered to comprise of providers of risk capital, supporting infrastructure, and the enabling environment.

Figure 49: Risk Capital Ecosystem



Interventions across the ecosystem can boost the risk capital provided to the MSME sector. Some potential interventions to strengthen these elements are outlined below:

Figure 50: Recommendations to enhance the risk capital ecosystem



Broadly, the implementation of the above recommendations requires interventions by stakeholders such as the government, risk capital investors, VC/PE funds, supporting intermediaries

and regulators. The following matrix shows the ecosystem stakeholders that have a role to play in each of the potential interventions:

Figure 51: Recommendations Matrix

	Recommendations/ Potential interventions	Government	Risk capitals investors	VC/PE funds	Regulators	Supporting intermediaries	Financial institutions
Catalyze access to diverse risk capital providers	Unlock domestic pools of capital for MSME financing						
	Promote innovative funding models						
	Encourage debt-based risk capital						
Bolster the supporting infrastructure	Strengthen incubation facilities for entrepreneurs						
	Bridge information asymmetry between MSMEs and investors						
	Increase financial awareness among MSMEs						
Foster an environment -friendly enabling environment	Create a coherent regulatory and policy framework						
	Provide tax incentives to equity investors						
	Ease exits for risk capital providers						

Interventions across stage, size and type of MSME:

		Enterprise Stage			Enterprise Size		Enterprise Type	
	Recommendations/ Potential interventions	Early Stage Enterprises	Growth Stage Enterprises	Mature Stage Enterprises	Micro & Small Enterprises	Medium Enterprises	Manuf. Enterprises	Service Enterprises
Catalyze access to diverse risk capital providers	Unlock domestic pools of capital for MSME financing							
	Promote innovative funding models							
	Encourage debt-based risk capital							
Bolster the supporting infrastructure	Strengthen incubation facilities for entrepreneurs							
	Bridge information asymmetry between MSMEs and investors							
	Increase financial awareness among MSMEs							
Foster an environment -friendly enabling environment	Create a coherent regulatory and policy framework							
	Provide tax incentives to equity investors							
	Ease exits for risk capital providers							

These interventions are further detailed in the following sections.

7.1. Catalyze Access to Diverse Risk Capital Providers

The investor base for MSME financing can be widened by tapping diverse pools of capital available with domestic institutions and sophisticated investors. Access to large pools of risk capital can also be increased by devising innovative

funding structures that align the risk and return characteristics of MSMEs to the risk appetite and return expectations of investors.

7.1.1. Unlock Domestic Pools of Capital for MSME Financing

In 2015, SEBI established the Alternative Investment Policy Advisory Committee to recommend reforms in the regulatory and taxation framework of alternative investments in India. According to the committee, only 10 to 15 percent of equity capital flowing to enterprises is sourced domestically. Due to more stringent regulatory restrictions on domestic institutional investors, most VC/PE funds draw their capital from foreign investors. The foreign investors benefit from the Double Taxation Avoidance Agreement between India and their countries. However, foreign capital is exposed to currency risk, country risk and other global economic factors¹⁴². In contrast, domestically sourced capital is less volatile in nature. Domestic investors can better deploy capital towards the MSME sector due to strong local networks and better understanding of the domestic regulatory context and entrepreneurship ecosystem. In turn, the domestic pools of capital can benefit from the higher returns and diversification effects associated with 'alternative investments' in MSMEs through VC/PE funds. Also, domestic investors largely tend to reinvest in India, making a sustained pool of capital available for investment in the MSME sector¹⁴³.

**There is a need to
unlock domestic pools
of capital**

Additionally, as opposed to foreign investors, domestic investors have historically shown a higher preference for investing in VC funds than in PE funds¹⁴⁴. Since VC funds invest mostly in

smaller enterprises, increased availability of domestic capital augurs well for the MSME sector. A wider pool of domestic capital would encourage more VC investment in early-stage MSMEs.

7.1.1.1. Commercial Banks

In India, public sector banks have allocated more towards VC/PE funds than private banks¹⁴⁵. Many large banks have created their own subsidiary VC/PE funds, and contribute to the fund pool among other institutional investors. However, the allocation by banks to VC/PE funds is low due to tight regulations and prudential norms. Indian banks have to assign a very high risk weightage towards investment in VC/PE funds as an asset class while staying within capital adequacy limits.

To boost the supply of risk capital from banks, investments in certain AIFs, such as VCFs and social venture funds, could perhaps be excluded from capital market exposure ceilings¹⁴⁶. The government's fund of funds could also commit a higher amount to the VC/PE funds created by banks to lower risk and incentivize larger commitments from the bank. At present, banks can invest only 10 percent of their paid-up capital in AIFs or 10 percent of the total corpus of an AIF. These limits could be raised suitably.

Additionally, commercial banks can devise newer products such as venture debt on the lines of SIDBI's Start-up Assistance Scheme which targets early-stage MSMEs less than five years old¹⁴⁷. Since a lack of sufficient enterprise data restricts the ability of commercial banks to lend to MSMEs, alternative data sources such as customer ratings, utility payments, and projected cash flows could potentially be used to evaluate creditworthiness.

¹⁴² Concept note prepared by TVS Capital Funds Limited, 2014

¹⁴³ India Venture Capital and Private Equity Report 2014

¹⁴⁴ Ibid

¹⁴⁵ Ibid

¹⁴⁶ SEBI Alternative Investment Policy Advisory Committee (AIPAC) Report, 2015

¹⁴⁷ Please refer to Section 4.2.1

7.1.1.2. Pension Funds

Globally, over 40 percent of the aggregate investments in VC/PE funds flow from pension funds¹⁴⁸. Pension funds in developed countries have been increasing their percentage allocation in equity and VC/PE funds since 1995¹⁴⁹. However, in India, pension funds have traditionally preferred investing in fixed income debt instruments. The liberalization of the investment pattern of pension funds in India can unlock a huge amount of equity capital for private enterprises¹⁵⁰.

In India, until recently, pension funds were not allowed to invest in alternative asset categories. In February 2016, the pension regulator of India, the Pension Fund Regulatory and Development Authority, allowed 2 percent of the private sector National Pension System corpus to flow into Category I and II AIFs¹⁵¹. This move is likely to make INR 800–1,000 crore (USD 120–150 million) available for investment in AIFs annually. This regulatory amendment is expected to enhance the domestic fund-raising environment, given the huge corpus of pension funds under the NPS¹⁵². Pension funds could be a significant source of long-term and steady capital for onshore funds in India.

Since alternative equity investment is a new domain for pension fund managers, they can be provided initial handholding in terms of what strategies to adopt and exit options available¹⁵³. AIFs that raise domestic capital can potentially build collaborations with pension funds to understand the investment preferences, risk appetite, liquidity needs, taxation and other issues of pension fund managers. Investment from the government sector pension fund corpus could also be opened up to AIFs, since government pension comprises the majority (almost 90 percent) of the total corpus¹⁵⁴.

Since 2015, a small but growing number of overseas pension funds and endowments have been looking to invest in the Indian consumer internet sector¹⁵⁵. Pension funds such as Ontario Teachers' Pension Plan, Canada Pension Plan and global aerospace and defense major Lockheed Martin's pension fund, are among those that have invested or are currently scouting for avenues. Endowments of major US universities, including Harvard University and Columbia University, have also expressed interest in investing in consumer internet enterprises.

Investment by pension Funds in VC/PEs – Global Experience

Globally, pension funds are one of the largest investors in the VC/PE asset class due to their long term liabilities and low need for liquidity. Pension funds account for the greatest proportion of capital billion to VC funds in 2015 (PitchBook Data). Generally, pension funds invest in mature-stage enterprises that have achieved scale, are profitable, carry lower risk of investment and require a large amount of capital. Pension funds globally have long-term horizon (holding periods of around 8-12 years) and add a lot of credibility for future investments.

¹⁴⁸ TVS Capital

¹⁴⁹ PFRDA Annual Report, 2013-14

¹⁵⁰ Report of the Committee on Investment Pattern for Insurance and Pension Sector, G.N. Bajpai, 2013

¹⁵¹ PFRDA Chairman, IVCA Annual Conclave, March 2016

¹⁵² The total corpus as of 2015 was INR 1.1 lac crore (USD 17 billion) out of which private sector portion is INR 12,000 crore (USD 1.8 billion) according to PFRDA data

¹⁵³ PFRDA Chairman at an ASSOCHAM conference on 'Budget Proposals and Role of Private Equity: The Road Ahead,' April 2015

¹⁵⁴ <http://www.livemint.com/Industry/vZvDQhmmGyqvvXfOFHPyAK/PEVC-fund-managers-cheer-move-to-allow-pension-funds-to-inv.html>

¹⁵⁵ http://articles.economic-times.indiatimes.com/2015-11-06/news/68071750_1_pension-plan-debt-funds-venture-capital

7.1.1.3. Endowment Funds

Most endowment funds in India are structured as charitable trusts set up for different purposes, such as construction of hospitals, of educational institutes, religious establishments, and the promotion of social causes. These charitable trusts have an investible corpus of more than INR 5 lac crore¹⁵⁶ (USD 77 billion) and expect relatively low risk-adjusted returns. There is potential for capital from such endowment funds to flow towards angel funds or early-stage focused funds that carry a high element of risk.

In the US, investment in VC/PE funds represents a significant portion of the investment portfolios of endowments (funds generated from donations)¹⁵⁷. For example, the endowment fund of Yale University has an equity-oriented portfolio and an allocation of USD 3.6 billion in venture capital funds¹⁵⁸. Capital from endowment funds is well-aligned for investment in VC/PE funds due to their long-term horizon and low need for liquidity.

The Ministry of Finance could put in place enabling regulations to channel capital from these trusts into the entrepreneurial financing ecosystem and allow professional deployment of the corpus. For example, the regulatory framework could be amended to permit these trusts to invest a portion of their assets in AIFs.

7.1.1.4. Insurance Companies

Globally, insurance companies serve as large pools of capital for VC/PE funds. In India, however, the allocations made by life insurance and general insurance companies to VC/PE funds are far below the regulatory limits specified by the

insurance regulator, the Insurance Regulatory and Development Authority¹⁵⁹. Some of the reasons for this include lower risk appetite of insurance companies, limited ability to commit to VC/PE funds, the illiquid nature of VC/PE investments, and a relatively weak domestic VC/PE industry¹⁶⁰.

Regulatory changes allowing insurance companies to invest in both Category-I and Category-II AIFs provide a huge opportunity for domestic VC/PE funds to raise funds from insurance companies. A stable domestic regulatory environment and greater impetus to investment through onshore funds (AIFs) can help attract capital from domestic insurance companies, especially life insurance companies which have a long-term investment horizon.

Investment limits in AIFs for insurance companies could be increased from 10 to 20 percent of the total corpus of an AIF. Also, investments in AIFs could be included in the list of approved investments by amending the Insurance Investment Regulations, 2000¹⁶¹.

7.1.1.5. High Net-worth Individuals

High net-worth Individuals are wealthy individuals with significant investible capital, which is often managed through family offices in case of inheritance across generations. In India, there has been a steady growth of HNIs over the last decade. Less than 1 percent of the HNI wealth in India has been invested in alternative assets¹⁶², out of which only about 15 percent allocation is towards VC/PE funds. A stronger collaboration between the VC/PE fund industry and HNIs or their family offices, could be beneficial to both stakeholders.

¹⁵⁶ India Venture Capital and Private Equity Report 2014

¹⁵⁷ Preqin Special Report: North American Endowments as Investors in Private Equity Funds: June 2012

¹⁵⁸ Yale University Website, September 2015

¹⁵⁹ Overall exposure limits to AIFs are 3 percent and 5 percent of total investment for life insurance companies and general insurance companies, respectively

¹⁶⁰ India Venture Capital and Private Equity Report 2014

¹⁶¹ SEBI Alternative Investment Policy Advisory Committee (AIPAC) Report, 2015

¹⁶² India Wealth Report, Karvy Wealth

Increasingly, many successful entrepreneurs in India have begun to invest through their own venture capital funds (family offices) in early-stage enterprises. The expertise and experience that such entrepreneurs bring can be leveraged by VC/PE funds in deal generation and validation of investment opportunities. Such entrepreneurs can provide access to their networks and give sector-specific advice to the funds. In several cases, HNIs source enterprises and co-invest with the funds they have invested in. This can add greater value to the fund than the more traditional passive funding by institutional investors.

Many HNIs invest as angels on their own or through angel groups. SEBI guidelines for angel investors state that individual investors should have early-stage investment experience, or experience as serial entrepreneurs, or should have been senior management professionals with at least 10 years of experience. Additionally, the investor is required to have tangible net assets of at least INR 2 crore (USD 0.3 million) excluding the value of investor's primary residence¹⁶³. Although these regulations are made to ensure that investments are made by only such individuals who are able to absorb the risk associated with VC/PE investments, they are substantially restrictive for participation of retail investors¹⁶⁴. In 2016, SEBI relaxed

guidelines for angel investors: minimum investment requirements were changed from INR 1 crore to INR 25 lac for AIFs registered with SEBI, while lower regulatory fee and lower fund size norms were instated. SEBI also relaxed the regulation for minimum investment requirement by an angel fund in a venture capital undertaking from INR 50 lac to INR 25 lac. The lock-in period of these investments was also reduced to one year from three years, besides the legitimization of angel schemes (funds) to invest 25 percent of their investible corpus in startups overseas.

Accreditation could also be an effective tool to recognize and incentivize such early-stage investors. Qualified investors including HNIs, corporate houses and others could be given incentives such as tax credits, exemption or rollover of capital gains tax and reinvestment benefit to invest in VC/PE funds. Wealth management companies and family offices can form stronger relationships with the VC/PE industry and channel a higher proportion of personal capital across VC/PE funds with different stage and sector focus. This will help achieve diversification and better risk-adjusted returns for the HNIs.

¹⁶³ SEBI Memorandum to the Board – Amendments to SEBI (AIF) Regulations, 2012

¹⁶⁴ India Venture Capital and Private Equity Report 2017

Growth in investment by HNIs

According to the Asia-Pacific 2016 Wealth Report, India has around 2,36,000 HNIs. HNIs have traditionally invested in asset classes as real estate, gold, commodities and capital markets. However, post the 2008 global financial crisis, as foreign investors started scouting for new opportunities in emerging markets. As more capital started to flow in India, it had a catalytic effect on the growing entrepreneurial ecosystem, attracting higher investment from domestic HNIs. The 50–60 percent returns realized in this space has made MSMEs an attractive investment avenue for HNIs.

MSMEs that bring technological innovation have seen rapid traction and exponential financial growth in India. Higher risk-adjusted returns, combined with favorable Government policies, have encouraged domestic HNIs to increase their allocations to this asset class. Many of the ultra HNIs have established family offices that work with MSMEs closely to understand their business models and co-fund with VC/PE investors. Majority of HNIs go via the angel network route or collaborate with incubators/accelerators to make their investments.

7.1.2. Promote Innovative Funding Models

Apart from increasing the availability of investible capital, it is critical that funding models other than traditional equity be devised to address the gap in the demand and supply of risk capital to the MSME sector. These models may include what are often termed 'mezzanine' structures – with elements of both debt and equity – or pure-equity-like investments, albeit with different expectations of returns.

7.1.2.1. Patient capital

Equity investors typically expect a return of more than 25 percent, while the average holding period of investments by VC/PE funds is roughly five years. This translates into fund managers looking for quicker returns and investing in new age enterprises that present a high potential to scale. Traditional MSMEs are often unable to scale at such high rates. VC/PE funds source capital from investors on the basis of assurances

of investment in new-age businesses that exhibit very high growth rates. This results in most investments going to only a few sectors. Bridging the mismatch between return expectations of the current breed of equity investors and the typical growth rates experienced by MSMEs is a challenge that needs to be addressed.

Patient capital refers to capital that has been raised specifically to be invested for the long term – with the recognition that certain businesses need time to scale. Such capital has evolved out of philanthropic giving and as such has a high tolerance for risk. Creation of such funds that will pool philanthropic capital from institutional and individual donors could be encouraged. Such funds could be given explicit recognition within the existing AIF norms, and target sectors/geographies can be identified to direct such capital.

Evergreen funds

Typically, VC/PE funds have a life of 5-10 years, after which investors draw all the returns and the funds have to initiate the process of capital raise again. Evergreen funds are funds with indefinite life and wherein the realized investment returns are recycled back into the investment strategies focused on longer-term hold periods, often with a greater emphasis on yield generation, are the key drivers for evergreen funds.

When investors find enterprises with a high future potential but long gestation periods, they would prefer to remain invested. However, due to the traditional closed-ended structure of funds, investors have to sell their stakes and restructure their portfolio. Alternatively, the lifespan of enterprises in capital-intensive industries (eg. manufacturing, infrastructure) is simply too long to fit in the traditional fund model. The evergreen fund structure allows investors to take a very long-term view on companies in a way that can't be done with regular funds. The open-ended structure also gives the fund the liberty of investing in enterprises at various stages without the pressure of exits. Because evergreen structures have no specific time frames, enterprises can also set the growth rate and business strategy that is best for their business, not necessarily a strategy imposed by fund level restrictions.

Pension funds, insurance companies, university endowments and foundations have a long-term horizon and are ideal investors into an evergreen fund. Category-I and Category-II AIFs, that are required to be closed-ended, could find innovative ways to create longer life funds that have liquidity intervals for investors and lowers their reinvestment risk.

7.1.2.2. Returnable Capital

Returnable capital refers to money raised to be invested with low or no expectation of returns, beyond the investment amount itself. Such capital expects to create impact in terms of poverty alleviation, skill development and employment generation. Constituting such funds can be considered to augment the supply of capital to MSMEs located in remote regions of the country. Such capital can also be used to support enterprises in politically unstable or disaster-prone geographies. Returnable capital can be especially useful for enterprises engaged in capital intensive sectors such as manufacturing – where high upfront costs and long gestation periods dissuade equity investors from venturing.

Development finance institutions are increasingly using returnable capital as a method of channeling their official development assistance – accounting

for about 20 percent of the total ODA provided¹⁶⁵. DFIs typically invest such capital to achieve 'pro-poor' development impact – which includes MSME finance, apart from other sectors such as health and education. Such overseas capital can be supplemented with domestic sources to specifically target the MSME sector.

7.1.2.3. Blended Finance

The term blended finance refers to 'the deliberate use of public funds to attract private capital towards investments delivering development impact in emerging and frontier markets.' Typically, in such arrangements, public investors primarily bear the risk while enhancing returns for private investors. Although this concept was originally floated to create development impact, it can be used as a guiding philosophy for deploying capital from guarantee funds and MSME-focused corporates set up by the government.

¹⁶⁵ Social Sector Applications of Returnable Capital by Development Financial Institutions, Evans School Policy Analysis and Research (EPAR), University of Washington

Blended finance can be used to pool capital from traditional investors, impact investors and public funds to create credit guarantee funds and/or to provide concessional debt at interest rates lower than market rates¹⁶⁶. Such pools can be raised with the specific purpose of creating an impact in a particular geography, MSME cluster or sector that has been traditionally underserved by financial institutions.

Financing through Masala Bonds

Masala bond is a term used to refer to a financial instrument through which Indian corporates, especially financial institutions, can raise capital from overseas markets in rupee denomination. These are Indian rupee denominated bonds issued in offshore capital markets. The rupee denominated bond is an attempt to shield issuers from currency risk and instead transfer the risk to investors buying these bonds.

Issue of Masala Bonds can ease access to capital for financial institutions as they would widen the investor pool. Such a structure can be used by FIs to raise finance specifically for lending to MSMEs in India. A masala bond has the advantage of diversifying funding sources and hedging the currency risk, which may result in a lower cost of borrowing for FIs. This benefit could be passed on to MSMEs as lower interest rate or relaxation of collateral requirement. RBI has allowed FIs to raise Tier-1 and Tier-2 capital by issuing Masala bonds for financing infrastructure and affordable housing. This move could potentially also be extended to MSME sector financing so that the proceeds from the bond serve as unsecured debt capital for MSMEs, increasing the total pool of finance available to the MSME sector.

7.1.2.4. Government–Private Sector Co-investment

The government, through its various ministries, already plays a key role as a provider of funds through grants, seed funds and other schemes to MSMEs. Increasing the scope and scale of direct funding by the government in MSMEs may 'crowd out' the potential for innovation by private risk capital providers. In addition, private fund managers have the ability to bring in-depth sectoral knowledge, a systematic due-diligence process and operational know-how to the MSME sector for more efficient capital deployment.

International experience shows that government intervention in the financing of early-stage MSMEs in low income states and high impact sectors can mobilize greater private investment for such MSMEs. The government could thus consider pursuing co-investment strategies that involve participation of

private investors. For example, a 'fund of funds' set up by the government could invest in a portfolio of VC/PE funds, with the requirement that such funds invest in MSMEs that typically do not attract venture capital funding. Funds like the TEX Fund, Samridhi Fund and National Venture Fund for Software and IT Industry operated by SIDBI could be encouraged to target specific sectors or geographies¹⁶⁷.

Globally, there are also examples of co-investment plans wherein government matches the capital provided by private investors by either grant or equity, to provide either upside leverage or downside protection to the private investors (see box on the following page). Such a model is an effective way to leverage private capital and can also drive the building and professionalizing of the seed and early-stage investment market by providing a more structured investment process.

¹⁶⁶ Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders, OECD, World Economic Forum, September 2015

¹⁶⁷ Please see section 4.2.2

An 'asymmetric' model of funding could also be adopted whereby the fund allocates a higher proportion of the returns to private sector investors or bears a greater part of the losses. Schemes can also be formulated to provide safety nets for investors in MSMEs that are engaged in non-traditional businesses which have a high inherent risk of failing. For example, guarantee schemes can be introduced for certain sectors to cover risk of failing partially. This provides a premium to private sector investors to compensate for the risk and long-term nature of seed and early-stage investments.

Global experience – Co-investment between Government and private funds



United States: Under the Small Business Investment Company (SBIC) program, the SBA supplements the capital that the VC funds raise from private investors with low-cost, government-guaranteed debt. SBIC operates as a fund of funds, investing up to 75 percent in a VC fund's capital.



Israel: The government has set up a fund, YOZMA, to invest directly and also to operate as a fund of funds. Its objective is to promote private venture capital in the technological sector. It can invest up to 40 percent of the total fund size and has invested around USD 200 million. It has led to 164 start-ups receiving funding, more than 50 percent successful exits and breakeven in 5 years.



New Zealand: The New Zealand Venture Investment Fund (NZVIF) invests with VC funds and angel investors to support technology companies with start-up growth capital. It invests through 2 vehicles: 1) A USD 260 million VC fund of funds, 2) A USD 40 million Seed Co-investment fund.



Singapore: SPRING SPEEDS Capital, a Singaporean government agency, co-invests in Singapore-based innovative startups along with independent angel/VCs, matching dollar-to-dollar, and taking an equity stake proportionate with the investment.



Turkey: The Treasury of Turkish Government has started a system for accrediting angels. There is a joint mutual funds system, which is run by the government, which can match investments made by business angels.

The Department of Industrial Policy and Promotion (DIPP) is in the process of setting up a Credit Guarantee Fund of INR 2,000 crore. The fund will provide partial risk cover for collateral-free credit by banks to start-up enterprises¹⁶⁸.

7.1.3. Encourage Debt-based Risk Capital

Apart from equity capital, a venture also needs debt for working capital. Due to limited formal sources of debt, the entrepreneur is often compelled to use equity capital as working capital, which limits the ability of the

entrepreneur to scale the business. At present, banks provide unsecured debt funding based on factors such as revenue, profit, business vintage, credit rating and audited financial statements. Often, banks also demand personal guarantees from promoters for these loans. MSMEs find it difficult and costly to meet these requirements and furnish the paperwork for small ticket size loans. More banks could have pure cash-flow based lending products for MSMEs by analyzing transactional data to assess risk and pricing the loan accordingly. This will especially enable service sector

¹⁶⁸ <https://www.vccircle.com/dipp-to-move-cabinet-note-on-credit-guarantee-fund-for-startups/>

enterprises with low tangible asset bases to access debt funding more easily.

Based on their risk appetite, banks can fund early-stage enterprises through a dedicated 'start-up cell.' Besides financing, this cell could also provide advisory services to entrepreneurs on taxation, investment planning, legal consultation, maintaining proper financial statements, details of CGTMSE, determinants of credit rating and other issues.

There is a dearth of short-duration and small ticket size unsecured debt funding to MSMEs in India for their working capital requirements. The potential demand-supply gap is over USD 10 billion¹⁶⁹. MSMEs often need such finance on an immediate basis, while the current credit assessment process can take up to two weeks. Globally, many NBFCs are beginning to mine alternative data sources such as customer ratings on ecommerce platforms, social networks, daily sales and bill payments for quicker credit scoring and disbursal. As the online presence of MSMEs in India increases, financial institutions could leverage technology and use such proxies to screen MSMEs faster and widen the pool of potential borrowers, simplifying the application and underwriting process. Tapping alternative sources of data will allow lenders to advance venture debt or alternative products based on projected cash flows.

The existing government schemes – CGTMSE and MUDRA – can also be strengthened to encourage the banks to increase the supply of unsecured debt to the MSME sector.

Credit Guarantee Scheme

Over 2017-18, only about 17.4 percent of total credit disbursed by banks went to MSMEs, while 82.6 percent of credit was disbursed to large enterprises¹⁷⁰. As of March 2017, CGTMSE guaranteed loans formed approximately 10 percent of the total outstanding debt to MSMEs by banks¹⁷¹. While there has been significant increase in recent years, there is potential for further increases. Some ways of doing so are set forth below:

1. Expanding the CGTMSE corpus¹⁷²:

A significant rise in claims in the past three years has resulted in over-extension of the CGS corpus. The ratio of guarantees approved to overall corpus is as high as 36 times. Increasing the CGTMSE corpus would help in widening the coverage of the plan. Keeping in view the existing over-extension of guarantees by the CGS, niche guarantee agencies can be established that can provide credit guarantees for specific sectors.

2. Reducing procedural delays in case of default^{173,174}:

Right now, the realization process for claims under CGTMSE is slower than desirable. A mechanism for quicker settlement of the guaranteed sum would be beneficial. A step towards achieving this has already been taken by the Ministry of MSME as part of the recent policy changes in the scheme. The Ministry announced that it will be enhancing the IT infrastructure of the Trust to improve operational efficiencies and reduce turnaround time for claim settlement¹⁷⁵.

3. Introducing risk-based pricing: CGS caps the downside risks for lenders by offering guarantees. However, some

¹⁶⁹ Please refer to Chapter 3 for details

¹⁷⁰ <https://economictimes.indiatimes.com/small-biz/sme-sector/economic-survey-large-businesses-corner-82-6-of-credit-msmes-get-a-paltry-17-4-/articleshow/62693254.cms>

¹⁷¹ MSME Committee Report, 2015

¹⁷² According to CGTMSE Annual Report 2014-15, the corpus as of March 2015 was INR 2,400 crore

¹⁷³ IFC - Intelicap Primary research, MSME Committee Report, 2015

¹⁷⁴ According to a research titled 'Innovative Credit Products for MSME sector and to evaluate the Credit Guarantee Mechanism under CGTMSE and compare with Credit Guarantee Mechanism of Japan' undertaken as part of the IIBF Diamond Jubilee and C H Bhabha Banking Overseas Research Fellowship project, an assessment of the CGTME against Principle 13 (relating to the efficiency and transparency of the claim management process) reveals that the biggest concern faced by banks [sic] is slow realization of claims. Faster settlement of claims under the CGTMSE scheme would help foster confidence amongst the member lending institutions (MLIs). Given the legal issues and procedural delays involved, the number of cases for which full settlement of eligible claims (2nd instalment) gets completed is negligible. Source: <http://www.iibf.org.in/documents/IIBF-report-Final-12.06.2018.pdf>

¹⁷⁵ https://www.cgtmse.in/news_and_features.aspx?article=301.

private banks consciously enter the high-risk zone of unsecured loans for higher returns. To encourage private banks to lend to MSMEs under the plan, a high-risk-high-reward approach must be adopted and interest rate caps should be made flexible according to the risk of the borrower.

4. Implementing better risk

mitigation practices: The scheme should adopt better risk mitigation measures such as a fee-based, robust, independent and periodic credit health assessment of both the MSMEs and of the lender portfolios.

Some plan changes are already underway, such as increasing risk-sharing among member banks to 50 percent of the loans exceeding INR 50 lac, and differential pricing of loans based on historical non-performing assets as recorded by banks. These changes are expected to significantly

increase the use of the plan by member lending institutions¹⁷⁶.

Refinance scheme (MUDRA)

The target customers for MUDRA Bank belong to the informal sector. Thus, the member lending institutions may face higher NPAs if proper risk management systems are not in place. There is an opportunity for MUDRA to periodically rate NBFCs and microfinance institutions on the basis of recovery performance and promote responsible lending practices. This could be extremely beneficial in reducing the risk of adverse selection on the part of NBFCs and MFIs.

There is an opportunity for banks too to introduce venture debt as a risk capital product. DBS Bank in Singapore, for example, was one of the first banks to provide venture debt to growth-stage technology-based enterprises to complement venture capital, as an alternative source of finance.

Venture debt by banks

Venture debt is an instrument that is increasingly being promoted by banks too. In Singapore, for example, there is a popular venture debt loan offered by commercial bank OCBC (and other Singapore banks) that enjoys backing of SPRING Singapore, a government body established to promote financing to technology startups for meeting working capital needs, buying fixed assets and project financing. DBS has partnered with a few venture capital firms and funds only those enterprises that have raised funding from one of these VC firms.

Similarly, in India, Dena Bank is one of the few banks that has stepped into Venture Debt funding by launching a specialized branch called 'smallB' to offer term loans to early-stage MSMEs that have innovative and asset-light business models. Although the loans are collateral-free and guaranteed under the CGTMSE scheme, they require a personal guarantee from the promoter. SmallB finances only those MSMEs that have raised an equity round of funding from an angel network or a SEBI-registered venture capital fund. An advantage for the MSMEs that raise venture debt from smallB is the access to the parent bank for larger loans at a later stage.

Total size: INR 50 lac to INR 1 crore | **Tenure:** 5-7 years | **Interest rate:** 12.5% p.a.

Federal Bank, too, has introduced a dedicated startup fund worth INR 25 crore. This fund is housed within specialized lounges called Lanchpad in the bank branch premises. These lounges act as incubators and provide financial and advisory support to entrepreneurs.

By acquiring startups as a client at the beginning of their business development journey, banks are able to build relations with growing enterprises.

¹⁷⁶ As of Financial Budget 2017-18, other changes such as increasing the corpus by an additional INR 5,000 crore to a total of INR 7,500 crore, increasing the loan limit from INR 1 crore to INR 2 crore, and including NBFCs in the member lending institutions are also underway.

7.2. Bolster the Supporting Infrastructure

The extent and efficiency of supporting infrastructure plays a critical role in ensuring investment in the MSME sector. 'Supporting infrastructure' here refers to various enabling intermediaries that assist both demand side and supply side entities in facilitating investments – ranging from incubation support to MSMEs, to data suppliers and insurance providers, to investors. This section looks at such ecosystem players and suggests interventions to strengthen them.

7.2.1. Strengthen Incubation Facilities for Entrepreneurs

There has been a burgeoning of incubators and accelerators in the country following increased interest in investing in start-up enterprises. However, incubators are mostly located in a few metro cities and are relatively inaccessible to new entrepreneurs from Tier-II and Tier-III cities. Additionally, incubators are often unable to provide end-to-end hand-holding to entrepreneurs. Incubators can facilitate value creation for new enterprises by addressing the critical support needs of entrepreneurs throughout various junctures in the early stages of the enterprises' existence.

On-boarding of business experts: Incubators and accelerators can bring business and market experts on board, apart from subject experts, to provide mentorship to new enterprises. Primary research with incubators and angel investors has revealed that most new enterprises fail at the go-to-market phase of their business despite having a technically sound and subject-expert-vetted offering. Early intervention in

building market readiness can substantially increase the probability of success for a new venture. A platform for successful entrepreneurs to interact and mentor the youth about different financing options can help increase awareness and streamline the flow of finance.

Increasing ecosystem support from the government: The Ministry of MSME could explore building outcome-based financial support mechanisms for incubators. One of the ways to achieve this could be by holding competitions and theme-wise challenges with prizes to provide incentives to entrepreneurs who develop innovative products and solutions with a high potential for social impact. The ministry could support impact investors who invest in early-stage ventures and establish a standardized system of impact assessment. A common platform could be created to register various angel networks and individual angels to share best practices. The ministry could also link early-stage institutional investors with incubators and accelerators to source start-ups for funding.

Government could augment private sector in providing incubation support to MSMEs

Self Employment and Talent Utilization (SETU) Scheme

The government has announced the Self Employment and Talent Utilization (SETU) scheme, especially for technical, financial and other important aspects of self-employment activities, especially for technology-intensive startups. Presently, various startup ecosystem actors such as investors, incubators, universities and service providers operate in silos. SETU scheme aims at strengthening the network among these players to accelerate the growth of MSMEs. The funds allocated to the SETU scheme could be used to build capacity of incubators and accelerators that focus on supporting startups that require a high initial capital outlay. For example, in the healthcare products space, entrepreneurs often do not have adequate infrastructural facilities for building and testing prototypes.

SETU scheme can encourage incubators to induct such startups by way of cost-sharing or allocation of earmarked funds. SETU scheme may also connect local government departments and civic bodies with incubators in universities to involve the youth in developing solutions to local issues. To this end, 'Tinkering labs' could be set up in engineering institutes and polytechnics for providing students with hands-on experience in creating innovative products and prototypes. Corporates can also be looped in to partner with universities and fund such labs.

Developing sectoral expertise:

Incubators could build expertise in particular sectors by creating relevant mentorship teams with industry connections. Incubators need to look beyond popular sectors such as IT/ITES, BFSI and healthcare. Additionally, a database of incubators and their sector focus would help entrepreneurs find the right incubator.

Launching innovation labs: Innovation labs could act as intermediaries that liaise between industry experts and new enterprises to design and execute pilots that validate market feasibility of the product/service in question. Incubators could partner with such innovation labs to shorten the failure cycles of new entrepreneurs and ensure that they are developing a scalable product or service.

Expanding geographical reach: Rural enterprises typically find it difficult to access institutional finance and incubation facilities because of their small size and localized operations. They also lack the management

capability, infrastructural support and market network required to compete in the national market. Incubators too are usually located in large metro cities or within academic institutions. As a result, new enterprises in non-metro locations are often unable to access the mentorship they need. Thus there is a need to nurture talent, especially in the rural areas, where over 45 percent of MSMEs are located¹⁷⁷. Incubators should expand their sourcing mechanisms to non-metro geographies to be able to support such enterprises. The concept of virtual incubation has emerged as an effective mechanism to enable entrepreneurs from non-metro areas to access incubation support. StartupWave is one such virtual incubator that allows entrepreneurs to connect with mentors online and receive incubation support remotely.

StartupWave: A virtual incubation platform

StartupWave is a virtual incubation platform developed by Intellect in partnership with DFID and GIZ. It caters to entrepreneurs and early-stage enterprises with sector-specific support. It works in collaboration with existing incubators, accelerators and investors, and complements their efforts. In partnership with incubators and accelerators, business support service providers (legal, marketing, technology support) and a vast network of investors (angels and VCs). StartupWave provides personal mentoring and access to content on building a business model around their startup idea. Incubation-ready startups are taken through a customized journey involving sector and theme-based mentoring, pitch preparatory support, and connections to corporates / startups based on synergies. For startups that are at a sufficiently advanced stage. StartupWave also conducts periodic 'demo days' (virtual and physical).

Getting incubators and industry

stakeholders to collaborate: Engaging with industry stakeholders such as large corporate houses, regulators and market research agencies to identify market gaps can help incubators provide specific inputs to entrepreneurs. This will help in any course correction required for the enterprise and/or to expand the enterprise's offering to address related opportunities. Moreover, relationships built with industry stakeholders can be beneficial to the enterprise in the long run. Currently awareness among corporate houses about MSMEs and

start-ups is low. Contributions of corporate houses to this sector as part of their Community Social Responsibility commitment, is low as well. Incubators approved by the Department of Science and Technology can put in place robust outreach mechanisms, better governance structures and reporting frameworks to encourage corporate houses to fund incubators. Initiatives such as SIDBI's StartupMitra could be useful platforms for entrepreneurs to connect with mentors and apply to suitable investors¹⁷⁸.

SIDBI StartupMitra platform

SIDBI has recently launched an online platform to enable entrepreneurs in the start-up community to get connected with various stakeholders, namely incubators, angel investors, and venture capital funds. The launch of the platform is in line with the objective of the government in forging innovation-led entrepreneurial growth through various measures. The portal also shares other information such as government schemes and allows entrepreneurs to apply to different investors and schemes. The one-stop shop platform has already on-boarded 2254 enterprises, 79 investors, 80 incubators and 88 venture funds.

¹⁷⁸ <https://www.sidbistartupmitra.in/>

Global experience- Government driven initiatives focused on incubation



Singapore: There are various business incubation schemes as well where government bodies such as the Media Development Authority, SPRING and National Research Foundation partner with incubators and provide them grant support based on the condition that the incubators take equity stake of 10-25% in the startups they support.



Israel: The government has entered into public-private partnerships with incubators to focus on domestic capacity building for products manufactured in Israel. The program has created 1,600 companies in a decade with the government funding leveraged six fold by funding from private sources.



New Zealand: Incubators are supported under the Incubator Support Program (ISP), launched in 2001. The government has launched a Repayable Grants Programme wherein it contributes a certain portion of repayable grants to technology-focused incubators that incubate startups commercializing complex intellectual property in these incubators.



Brazil: The Brazilian innovation agency called FINEP sponsors a program called PRIME to fund business incubators that incubate innovative startups.



South Korea: Korea's National IT Industry Promotion Agency (NIPA) provides training and support for startups as well as provides policy research. NIPA sponsored the K-Global Startup Engine which was designed to help place 40 Korean startups into global accelerators. The government has launched the Tech Incubator Program for Startups (TIPS) to identify promising startups for funding and expansion.



Germany: The Federal Ministry of Economic Affairs and Energy runs startup funding programs called EXIST. The INVEST programme provides subsidy up to 20% of investment to private investors to acquire shares of 'Innovative' companies and hold them for three years. The 'EXIST business start-up' grant supports the preparation of innovative start-up projects at universities and research institutions. 'The EXIST transfer of research' complement the 'EXIST business start-up' by promoting technology-based start-up projects in the pre-start-up and start-up stage. BMWI also promotes various Business Membership Organizations (BMOs) to provide consultancy service to MSMEs.

7.2.2. Bridge Information Asymmetry between MSMEs and Investors

Most MSMEs in India are structured as sole proprietorships or partnerships. Such enterprises are required to file minimal financial records with the government and often lack proper documentation. This makes the availability of credible data on such MSMEs a challenge for risk capital providers. While equity investors generally perform an independent and thorough due-diligence before funding, debt providers generally require

enterprise data and financial records according to standard criteria. In the absence of information required by traditional methods of credit analysis, financial institutions are often hesitant to provide unsecured debt to MSMEs. Financing constraints tend to be more acute for early-stage enterprises because they have limited internal funds and lack a track record to give confidence to investors. When information asymmetries are large, a 'missing-market' problem may emerge, implying that many of the innovations associated

with early-stage firms may never be commercialized¹⁷⁹. In addition, early-stage financing often involves long-term investments, which carry a premium. The information asymmetry increases the transaction cost, posing difficulties for investors in devising the appropriate contract. There is a need, therefore, to establish a stronger database of relevant data for a wider pool of MSMEs – either by credit information companies or by a separate body set up with the express purpose of collating data for MSMEs. Globally, many models have emerged where alternative data points are used to underwrite and provide MSMEs with easier access to funding. Utility bill payments by MSMEs, demographic and social network data and cluster-level information are all being used as proxies

to assess creditworthiness in the absence of historical financial and business records. Banks and other financial intermediaries, credit rating agencies and credit bureaus, could be encouraged to develop and use new tools for risk assessment using such alternative sources of data. Analytics and algorithms can be applied to such data to arrive at an aggregate credit score. Psychometric evaluation has also been experimented with as a means of credit assessment. Such non-traditional and innovative frameworks for credit rating would facilitate a greater flow of risk capital to MSMEs. Increased digitization of government processes in different sectors can increase access to information and expedite approvals.

eBiz G2B Portal

For an entrepreneur, setting up a new business currently requires several compliances to be met and clearances to be obtained from multiple government departments. The information about these government services is scattered across different acts and platforms. An entrepreneur has to apply and pay for each service individually before receiving the statutory clearances. Such a fragmented service delivery is one of the major causes for India's low ranking in the ease of doing business.

To provide a one-stop shop solution for various regulatory sanction and licenses required while starting up a business, DIPPP has launched the 'e-Biz Portal'. e-Biz web portal aims to provide a single-window clearance of various G2B services from the Central, State and local governments. The centralization of services under the e-Biz umbrella would be done in a phased manner. As of 2015, fifteen pan-India services are available in the e-Biz portal. The Government is planning to centralize services from specific state departments under the e-Biz portal too. Services from Andhra Pradesh and Delhi have already been integrated in the portal. It is envisaged that over the next 10 years, around 200 services for investors and businesses will be rolled out. The e-Biz portal will enable businesses to submit a consolidated application for several licenses and clearances. This concept of a universal gateway for e-governance application would help in reducing delays due to numerous approvals required from different departments at the time of incorporation. The online payment mechanism for the delivery of services through e-Biz would enhance security, increase transparency, and facilitate a fast, convenient and secure way of obtaining information and accessing services related to licenses, permits and clearances.

While setting up the e-Biz portal is a step in the right direction, its usefulness could potentially be enhanced if it can be linked with the DCMSME portal which presently facilitates online registration for MSMEs on national-level.

¹⁷⁹ Policy lessons from financing young innovative firms, OECD

Credit reporting and rating agencies can play a key role in enhancing MSME data availability and quality since banks and NBFCs rely on credit reports and registries to make lending decisions. The robustness of the data becomes even more important in the case of unsecured debt funding, to evaluate the willingness and capacity of the MSMEs to repay. An effective commercial credit reporting system could reduce reliability on 'soft' information and encourage financiers to better engage with MSMEs for lending.

It can also enable the financiers to design new financial products by customizing the tenure, repayment schedules, interest rate and other relevant elements.

Credit insurers, which typically cover short-term accounts receivables, can be a rich source of trade data for credit bureaus. Financiers could also increase transparency of their credit policies, create awareness about proper book-keeping practices, and provide actionable feedback to MSME borrowers so as to enable the MSMEs to take corrective measures and increase their credit-worthiness. Collaboration and data-exchange (as legally permissible) among the different credit bureaus could also strengthen the depth of enterprise data for financiers.

Additionally, in order to reduce dependence on immovable collateral such as land, property and plant, a framework for using movable assets as collateral can be devised. Movable assets such as machinery, stock, receivables or livestock often account for most of the capital stock of MSMEs. Such movable assets can be more easily pledged as collateral to obtain debt. A sound legal and regulatory framework is essential to allow movable assets to be used as collateral. Without a well-functioning registry for movable assets, even the best secured transactions laws could be ineffective¹⁸⁰. Recognizing this, the Ministry of Finance and RBI are in advanced stages of setting up a 'movable asset registry' in association with IFC and Central Registry of Securitization Asset Reconstruction and Security Interest of India, which provides a facility for registering charge on immovable property. The registry will enable MSMEs to borrow from banks, especially for working capital requirements.

¹⁸⁰ <https://blogs.worldbank.org/allaboutfinance/does-introduction-movable-collateral-registries-increase-firms-access-finance>

Global experience – Movable asset registry



China: After the enactment of the Property Law in October 2007, the People's Bank of China Credit Information Center has created a national online registry for security interests in receivables. The percentage of moveable asset-based lending in China went up from 12% pre-reform to around 20% post-reform. Of the USD 3.5 trillion in new financing facilitated that year, approximately USD 1.1 trillion corresponded to SME financing.



Ghana: In 2008, Ghana embarked upon a reform of its movable collateral legal framework and registry. Before the reform took place, the use of movable collateral in Ghana was a key constraint for SME financing. Upon enactment of the 'Borrowers and Lender Act' 2008, the Bank of Ghana established a collateral registry. With IFC support, the Bank of Ghana updated the Borrowers and Lenders Act and redesigned the Registry system to align more with international best practice. Over 20,000 loans were reported to have been registered since March 2010. The total financing secured with movable used the registry in Ghana that year. The new secured transactions system led to the development of productive supply chain financing schemes in the mining and oil industry, benefiting more than 100 local SMEs and creating hundreds of new jobs.

7.2.3. Increase Financial Awareness among MSMEs

Apart from devising new methods of credit assessment, there is a need to concurrently create awareness among MSMEs about the importance of adhering to accounting best practices and regarding institutional risk capital as a source of finance. Networks of industry bodies and MSME associations such as ASSOCHAM, FICCI, CII and FISME can be used to reach out to MSMEs. Awareness can also be created through various advisory services that MSMEs access. The equity raising process is complex and many MSMEs lack in-house capability to manage it. This is true especially of family-owned proprietorships and partnership enterprises. Such enterprises seek external support from business advisers such as CAs, banks, consultants and investment banks. These advisers assist the MSME to maintain financial statements, prepare a detailed business plan, assess the tax implications of various financing

activities, adhere to regulatory compliance, and execute a term sheet. The Ministry of Finance can engage CAs, banks, consultants and investment banks to provide advisory services to both MSMEs and financiers under a national scheme. This can ensure a smooth investment process and decrease transactional costs for MSMEs. Adherence to accounting best practices will ensure transparency and help bring enterprises under the ambit of institutional finance. Access to institutional risk capital can help protect entrepreneurs from unscrupulous informal lenders in the short term.

A system of professional credit advisers could also help MSMEs with weak credit histories and inadequate expertise in preparing financial statements, as well as assist banks in making better credit decisions. A proposal to accord accreditation to a few credit counselors who would act as facilitators for small entrepreneurs to access the formal financial system has been floated¹⁸¹.

¹⁸¹ <http://indianexpress.com/article/business/business-others/collateral-for-msme-loans-monetising-non-land-assets-2781436/>

7.3. Foster an Investor-friendly Enabling Environment

A well-functioning entrepreneurial and financial ecosystem is likely to have positive spillover effects on the economy in terms of job growth, self-sustenance and wealth creation. Policy intervention can play a catalytic role both in facilitating the functioning of the ecosystem and targeting actions to trigger its further development.

A framework of policies and procedures that makes it easy for entrepreneurs to create and operate new ventures, take risks, and raise financing at different stages should be encouraged. While the government is already taking several initiatives in this regard, some more are suggested below:

7.3.1. Ease Exits for Risk Capital Providers

Extensive procedures and compliance requirements for mergers and acquisitions, and strict criteria for IPOs, are key deterrents to exits for venture capital investors. A well-integrated financial services market allows investors to realize returns on investments with a lower transaction cost, reducing their exit risk. An efficient secondary market for VC/PE investors enables higher liquidity and incentivizes them to reinvest in the MSME sector.

Efficient SME platforms can prove a vital source of capital for MSMEs. However, despite the presence of two SME exchanges in India, many enterprises get listed in Singapore or the United States because of the less stringent domestic regulatory regime and lower compliance requirements in those countries. SEBI has recently proposed a modified version of the Institutional Trading Platform,

especially for knowledge-based enterprises in the technology sector, such as e-commerce and software product development. The modified ITP, called Alternate Capital Raising Platform, is similar in concept to London's AIM exchange or New York's Nasdaq, and is aimed at providing relaxations on eligibility criteria to enable high-growth start-up companies to list on Indian bourses. Compared to the present ITP, this proposed platform further relaxes the criteria on restriction of fund-raising, promoter shareholding lock-in period, profit history and more. Such a platform could ease liquidity concerns of early-stage investors in technology start-ups, and thereby increase their risk appetite.

Often, an enterprise may also fail and go bankrupt, forcing it to shut down. Capital providers recover their investments by liquidating the assets of the enterprise. However, shutting down a business is a time-consuming process in India. At present, it takes an average of 4.3 years to resolve insolvency in India and the recovery rate of debt is very low compared with other countries, according to a report by Nomura. Even asset-light enterprises take about six months on average to shut down. There are multiple laws dealing with bankruptcy (SICA, SARFAESI and the Companies Act). As a result, four different agencies – the high courts, the Company Law Board, the Board for Industrial and Financial Reconstruction, and the Debt Recovery Tribunals have overlapping jurisdiction, giving rise to ambiguities and complexities. Due to the number and expense of procedures, many entrepreneurs choose to keep their defunct businesses alive 'on paper', which proves costly in the long-run.

Slow recovery proceedings also impact the ability of the investors of that enterprise to free up funds and feed them into other enterprises.

To expedite the process of winding up businesses and subsequent sale of assets, the recently implemented Insolvency and Bankruptcy Code, 2016 proposes an institutional mechanism to deal with asset recovery and creates a time-bound process for insolvency resolution. The enforcement of this new legislation could potentially have a positive impact in promoting investments in the MSME sector¹⁸².

Insolvency and Bankruptcy Code, 2016

The Insolvency and Bankruptcy Code, 2016 is a law aimed at speedy winding up of insolvent companies, lowering NPAs, and redeploying capital productively. It consolidates and amends the existing framework and create a new institutional structure. The Code creates time-bound processes for insolvency resolution of companies and individuals. These processes will be completed within 180 days. If insolvency cannot be resolved, the assets of the borrowers may be sold to repay creditors. Some of the key features of this Code include:

- The new law creates a new class of insolvency professionals who will help sick companies and banks with a smooth takeover of the insolvent company and manage the liquidation process.
- It sets up a new entity, the Insolvency and Bankruptcy Board of India, which will regulate insolvency professionals and information companies – those which will store all the credit information of corporates.
- The National Company Law Tribunal will adjudicate cases for companies and limited liability partnerships, while the Debt Recovery Tribunal will do the same for individual partnership firms.

7.3.2. Create a Coherent Regulatory and Policy Framework

A transparent, clear and consistent regulatory regime can incentivize risk capital providers to create a steady pipeline of long-term investments in MSMEs. Multiple regulatory jurisdictions and agencies create grey areas that may discourage investors and hamper the flow of funding to MSMEs. Regulations that are implemented must be coherently coordinated with the government policy on the subject. This will reduce administrative and compliance hassles for the investors and fund managers.

Greater compatibility between rules for domestic investors and foreign investors in terms of taxation, investment and compliance could facilitate greater onshore pooling of foreign investment. At present, investment through onshore funds constitutes only around 10 percent of the total funds flowing into private enterprises in India annually¹⁸³. The pure offshore investment structure has historically been the preferred investment route of foreign investors. Greater parity in investment matters between offshore funds and onshore funds could be beneficial in encouraging onshore pooling.

A clear and consistent regulatory framework enhances investors' confidence

Regulatory parity between domestic and foreign investors could provide significant benefits

¹⁸² <http://blogs.wsj.com/briefly/2016/05/12/what-indias-new-bankruptcy-law-means-the-short-answer/>

¹⁸³ SEBI Alternative Investment Policy Advisory Committee Report, 2015

Similarly, as suggested by the SEBI Alternative Investment Policy Advisory Committee Report, 2015, there is a need to liberalize investment structures through the FVCI investment route and reduce sector restrictions. The report suggests that greater flexibility of investment via the FVCI route can also incentivize foreign investors to direct funds through an AIF. Onshore pooling can potentially help SEBI and other regulatory bodies to exercise better control and monitor systemic risks. Greater flow of investments from foreign investors through AIFs could also encourage domestic investors to co-invest in the AIF, and hence increase the total available risk capital to MSMEs. A localized ecosystem of onshore funds can catalyze growth in the MSME sector by providing finance and mentorship to MSMEs.

7.3.3. Provide Tax Incentives to Equity Investors

Taxation is an important factor that shapes investment decisions and inconsistencies in taxation may pose a barrier to entrepreneurial funding activity. SEBI's Alternative Investment Policy Advisory Committee (AIPAC) Report, 2015 has made the following recommendations to iron out some inconsistencies in the taxation rules for equity investors:

1. **Withholding tax:** Even though Category I and Category II AIFs have tax pass-through status, a withholding tax of 10 percent is levied on dividends and long-term capital gains payable to investors. Although this tax is refundable in case of investors who may have lesser tax liability or may benefit from the Double Taxation Avoidance Agreement, the withholding tax

may well be deterring foreign investors from investing through AIFs. This tax is applicable only to offshore funds using the FVCI route. Elimination of this withholding tax for exempt income flowing through AIFs can ease capital repatriation for foreign investors¹⁸⁴.

2. **Pass-through of net losses:** Net losses at the AIF level are not allowed to pass through for investors to be able to offset the losses against their income. Consequently, in case of a net unabsorbed loss at the end of fund life¹⁸⁵, investors are unable to derive a tax credit from the net loss. As a result, investors are taxed on an amount that is greater than the 'real' taxable income derived by them from their investment¹⁸⁶. A provision to allow pass-through at the end of the tenure of the fund could further incentivize investors to invest through AIFs.

3. **Section 56(2) (vii b) of ITA:** In cases where the shares of a private limited enterprise are purchased at a premium to the fair market value (FMV), the difference is treated as taxable income for the enterprise under the Section 56(2) (vii b) of the Income Tax Act. Only investments made by the VCF subcategory of Category I AIF are exempt from this section. However, many MSMEs also raise capital from private equity funds and angel investors. The funding generally depends on future prospects of the enterprise more than the present underlying tangible assets. Consequently, the fair market value of such enterprises may be very low compared to the perceived enterprise value. Exemption under this section could possibly be extended to angel investors and other sub-categories and categories of AIFs.

¹⁸⁴ India Tax Insights, January – March 2015, EY India

¹⁸⁵ Category I and Category II funds are closed-ended i.e. they have a limited tenure

¹⁸⁶ SEBI Alternative Investment Policy Advisory Committee (AIPAC) Report, 2015

Tax incentives may be difficult to target effectively, so careful design, monitoring and evaluation are necessary to ensure the intended results are achieved. Some countries provide tax incentives at the regional level for a more geographically relevant policy. These include the United States where tax incentives are implemented at the state level and Canada, where tax incentives are at the provincial level, as well as some other countries.

**Tax incentives can
boost early-stage
investing**

In India, the Start-up India has exempted tax being levied on investments above the fair market value in eligible startups – investments made by angel investors, incubators, family or funds which are not registered as venture capital funds. This will help augment funds available to Category - I AIFs, many of which invest in MSMEs. Also, the exemption from tax on long-term capital gains on the sale of a residential property if such gains are invested in MSMEs is now also extended to eligible startups. These incentives, along with the ones described earlier, could significantly decrease the tax burden on entrepreneurs and investors.

Global experience – Tax incentives



United Kingdom: UK has 2 major tax relief schemes for startups:

- **Seed Enterprise Investment Scheme (SEIS):** Caters to early stage companies which are usually funded by angel investors. 50% income tax relief with maximum investment of GBP1lac p.a.
- **Enterprise Investment Scheme (EIS):** Caters to slightly mature companies which are funded by VCs. 30% relief with maximum investment of GBP1mn p.a.

Startups incur no capital gains tax on sale after 3 years of lock-in. For sale within the lock-in period, no capital gains tax is applicable in case the money is re-invested in an EIS/SEIS eligible company.



United States: Many states give tax write-offs for angel investments up to USD 500,000 to startups.



China: SMEs with revenue less than RMB 30,000 are given tax waiver of 50% and a tax grace period of 3 months.



Turkey: Angels are allowed to deduct 75% of their investments from income tax.



Israel: The government levies lower company tax of 10% for MSMEs operating in certain priority sectors compared to 15% for other sectors.

Focus on Low Income States and Northeastern States

Roughly 45% of the MSMEs in the country are located in the Low Income States and the Northeastern States. However, less than 5% of equity investments in 2017 have been made in these geographies. Within these geographies too, there is a high concentration of investments in a few states, whereas most states have witnessed no equity investments.

There is an urgent need for targeted efforts to bolster the supporting infrastructure in the LIS and NES to encourage more flow of capital to MSMEs in these geographies. Sufficient support for entrepreneurs is not available in these geographies, with less than 25% of all incubators and accelerators in the country located in these geographies¹⁸⁷. A start has already been made in the direction of correcting this imbalance – with multiple Atal Incubation Centers coming up in these geographies as part of the Atal Innovation Mission. It is critical to keep the momentum going and ensuring that support is available to MSMEs in a sustained manner.

While most of the recommendations listed in this Chapter would be relevant across the states/geography, some specific recommendations for Low Income States and the Northeastern States:

- Sectoral expertise pertaining to the trades dominant in specific regions of the LIS and NES can be nurtured and augmented with appropriate business expertise, provided through regular programs executed by the incubators and accelerators.
- A cluster-based approach can also be taken to support multiple MSMEs at the same time; and pooled structures can be explored.
- Industry stakeholders and large retail businesses can be encouraged to collaborate with the Government in this effort and supporting MSMEs in these regions by prioritize sourcing from these regions.
- Investors can be incentivized to invest in these geographies by providing them tax breaks.
- Targeted programs for improving the financial awareness of MSMEs (on Risk Capital and more broadly) in the region can also be undertaken – with financial advisers, CA firms, retired bankers etc. being empaneled to provide support to MSMEs in the region.

The Government's push towards digitization is expected to address the issue lack of availability of credible information about MSMEs, in the long run. It is hoped that increased digital transactions will enable alternate credit assessments all over the country, and especially in the LIS and NES where the level of formalization is low.

¹⁸⁷ Source: WBG - Intelicap analysis, Inc42

Appendices

Appendices

Appendix A – Demand Estimation Methodology

The principal sources of data for the estimation of the equity demand from MSMEs are the Fourth All India Census on MSME 2007 (MSME Census), Annual Reports of Ministry of MSME, Central Statistical Organization (CSO), and Ministry Of Statistics and Program Implementation (MOSPI). Other sources include publications of the Reserve Bank of India (RBI), Government of India, Small Industries Development Bank of India (SIDBI), existing research literature, IFC publications, industry publications and primary interactions with various stakeholders.

The methodology for estimating the equity demand from MSMEs draws from the methodology and assumptions used during a similar exercise in 2012, the results of which were published in IFC's 2012 report on MSME Enterprise Finance in India¹⁸⁸. The assumptions used were re-validated through both secondary sources and primary interactions with key stakeholders in the sector such as SIDBI, public and private sector banks, venture capital firms and incubators. The estimation methodology involved the following key steps:

Key Steps in the Estimation of Equity Demand from MSMEs



Step 1: Estimating average finance demand per enterprise and overall finance demand

The underlying data for estimation is derived from the MSME Census. Trends in key metrics such as gross output per enterprise and average enterprise asset turnover ratio were used to derive average enterprise finance demand in 2017.

Average finance demand was estimated as the sum of the demand for capital expenditure and the demand for working capital of an enterprise.

- The demand for capital expenditure was taken as the annual demand to finance the increase in fixed asset per enterprise
- Demand for working capital was estimated as 25 percent (three months) of operating expenses per enterprise across manufacturing and services enterprises

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

- Enterprises were segregated by their lifecycle stage based on their vintage, as indicated in the table below. Lifecycle stage buckets were based on supply side categorization of enterprises¹⁸⁹

¹⁸⁸ http://www.ifc.org/wps/wcm/connect/region_ext_content/regions/south+asia/publications/msme+report

¹⁸⁹ Please refer to section 2.3 – Enterprise lifecycle stage framework in Chapter 2

Enterprise Lifecycle Stage Framework

Enterprise Lifecycle Stage	Vintage of Enterprise (Years)
Early	< 5
Growth	5 – 10
Mature	> 10

Source: Venture Intelligence, WBG - Intelicap Analysis

- Enterprises were further segregated by type of industry i.e. manufacturing and services sector. Top industry groups in each manufacturing and services sector were considered for demand estimation at industry group level
- The key financial metrics to be used as inputs for estimating the overall finance demand were calculated from the MSME Census 2007 raw data for each of the industry groups:
 - The gross output per enterprise in 2007 (INR crore) was calculated as - aggregate reported gross output (INR crore) for the industry group divided by the number of enterprises in that industry group.
 - The value of fixed assets per enterprise in 2007 (INR crore) was calculated as - aggregate reported value of fixed assets (INR crore) for the industry group divided by the number of enterprises in that industry group.
 - The asset turnover ratio was calculated as the aggregate reported gross output (INR crore) divided by the aggregate reported value of fixed assets (INR crore) for each industry group.
- The operating margins for each of the industry groups were estimated from secondary research about the industry.
- The gross output per enterprise for 2017 (INR crore) for each of the industry groups was derived by extrapolating the gross output per enterprise in 2007 (from above) using industry level growth rates from the Central Statistical Organization (CSO), Ministry of Statistics and Program Implementation (MOSPI) and industry reports.
- The value fixed asset per enterprise for 2017 (INR crore) corresponding to the above-estimated output in 2017 was calculated as the gross output per enterprise in 2017 (INR crore, from above) divided by the asset turnover ratio for the industry group.
- The annual increment in fixed assets (INR crore) corresponding to the above-estimated output was calculated as the CAGR of the value of fixed assets per enterprise from 2007 to 2017 for each of the industry groups. This CAGR was used to calculate the annual capital expenditure (towards the incremental fixed assets) for 2017.
- The annual capital expenditure requirement per enterprise in 2017 was adjusted for depreciation.
- The working capital expenditure requirement per enterprise was calculated as the product of average operating margins in each industry (as estimated earlier) and gross output per enterprise in 2017.
- The demand for capital expenditure was taken as the annual demand to finance the increase in fixed asset per enterprise.
- Demand for working capital was estimated as 25 percent (three months) of operating expenses per enterprise across manufacturing and services enterprises.

- Total finance demand per enterprise (capital expenditure + working capital) thus estimated was multiplied by number of enterprises in the MSME universe in 2017 for the respective industry groups. Number of enterprises in industry groups was estimated by extrapolating numbers in the MSME Census 2007 by growth rates from Annual Reports of the Ministry of MSME.

Key assumptions in estimation of average finance demand

- Average finance demand in the registered and unregistered enterprises is similar
- Asset turnover ratio of enterprises remains constant over 2007–2017¹⁹⁰

Step 2: Estimating overall equity demand

Discussions with financial institutions, MSME associations and enterprises suggested that the share of finance demand met by debt varies across MSMEs. Early-stage enterprises typically tended to fulfil a lower share of the finance demand through debt as compared to enterprises in the growth and mature stages. The following ratios were used to disaggregate the finance demand into Debt Demand and Equity Demand:

Disaggregation of Finance Demand

Enterprise Lifecycle Stage	Debt Demand: Equity Demand
Early	3:1
Growth	4:1
Mature	4:1

Source: WBG – Intelicap Analysis

Step 3: Identifying addressable subset of the MSME universe

Equity demand from all MSMEs cannot be considered amenable to external equity infusion. Assessment of addressable equity demand requires enterprise level assessment as conducted by the investors. External institutional equity investors use multiple criteria to assess enterprises for investment. Primary research indicates that demonstrated growth of an enterprise and its turnover can be considered as preliminary criteria to assess the amenability of an enterprise for investment, i.e. only MSMEs that exceed certain thresholds of turnover and annual growth rate can be considered as potential enterprises for equity infusion. Based on this understanding, the following key steps were followed to identify a subset of the MSME universe that would account for addressable demand:

- Enterprise level data from the MSME Census (2007) was filtered to retain only such enterprises that fulfilled the following conditions (which were identified based on primary interactions with equity investors)
 - Enterprise turnover greater than USD 40,000 (INR 2.5 million)
 - An annual growth rate of greater than 25 percent^{191,192}.
- The number of enterprises that would account for the addressable demand in 2017 was derived as:
 - The share of enterprises that meet the above criteria as a part of overall number of enterprises was calculated for each industry group

¹⁹⁰ Reserve Bank of India

¹⁹¹ Although angel investors often invest in pre-revenue startups, for the purpose of demand estimation from the MSME universe as a whole, certain minimum cut-offs have been assumed based on primary inputs

¹⁹² Roughly 94 percent of MSMEs are structured as proprietorships and partnerships and hence are not amenable for external equity infusion. However, interactions with equity investors suggest that legal structure is not a major factor in evaluating an enterprise, and conversion to a private limited enterprise is pre-supposed. Legal structure is thus not considered a factor in determining the potential demand for equity.

- The share thus calculated was applied to the number of enterprises in that industry group in 2017 (which was derived from the MSME Census and Annual Reports of the Ministry of MSME)
- At an overall level, only 1 percent of the enterprises accounted for the addressable demand
- The addressable subset of the MSME universe was segmented according to the enterprise lifecycle stage (Early, Growth, Mature) for further processing

Step 4: Estimating addressable equity demand

The finance and equity demand estimation methodology outlined in Steps 1 and 2 was applied to the subset of the MSME universe identified in Step 3. The equity demand thus estimated is the potential equity demand. A portion of this demand – 26 percent – is fulfilled through internal sources¹⁹³. Excluding this portion, the remaining equity demand is the addressable demand for external investors.

- The addressable subset of the MSME universe obtained from earlier Step 3 was segmented by size (Micro, Small and Medium) and by enterprise lifecycle stage (Early, Growth, Mature).

The equity demand was estimated at these segment levels – i.e. methodology outlined in Steps 1 and 2 was applied at the segment level

- Within the early-stage enterprise segment, a further subset of enterprises having a growth rate exceeding 100 percent was identified to estimate demand from enterprises demonstrating such hyper growth rates in the early stage.
- Within the growth-stage enterprise segment, a further subset of enterprises having a growth rate exceeding 50 percent was identified to estimate demand from enterprises demonstrating such high growth rates in the growth stage.
- Segregation of the addressable universe into manufacturing and service sector enterprises was used to derive demand estimates for these segments.
- Equity demand was estimated from a strictly financials-based perspective using the above methodology. It does not take into account behavioral factors such as knowledge of and access to investors or willingness to cede stake.

Estimation of Addressable Equity Demand

	Particular	No. of Enterprises (million)	Share of Enterprises	Equity Demand (USD billion)
A	MSME Universe	55.8	100 percent	283 (18.4)
B	Addressable Subset of MSME Universe	0.5	1 percent	60.4 (3.9)
C	Demand met from internal sources			16 (1.04)
B minus C	Addressable Equity Demand			44.4 (2.9)

¹⁹³ Financing Firms in India, Allen, Chakrabarti, De, Qain, 2007

Figure in brackets is in INR lakh Cr.

Outcome: Addressable Equity Demand by Various Segments:

Segment	Equity Demand (USD billion)
Early	10.5 (0.7)
Growth	10.5 (0.7)
Mature	23.4 (1.5)
Total Addressable Equity Demand	44.4 (2.9)
Micro	18.8 (1.2)
Small	22.0 (1.4)
Medium	3.7 (0.2)
Total Addressable Equity Demand	44.4 (2.9)
Manufacturing	33.1 (2.2)
Services	11.3 (0.7)
Total Addressable Equity Demand	44.4 (2.9)

Figure in brackets is in INR lakh Cr. Totals may not match due to rounding off.

Appendix B – Supply Estimation Methodology

There exist multiple databases of private equity investments in India¹⁹⁴. Such databases track information about deals that is available in the public domain. Additionally, various publications report private equity and venture capital investment in India based on independent research and/or proprietary databases.

Venture Intelligence deal database was chosen as the primary source of data for the purpose of this study as it provides segmentation of the reported deals according to the lifecycle stage of the investee enterprise. Segmentation of investments by lifecycle stage is a key framework adopted in this study as it reflects the typical investment philosophy of equity investors. Deal data from Venture Intelligence was benchmarked to data provided in authoritative research reports and validated from both primary and secondary sources.

To identify investments made in MSMEs, the following two filters were applied to the Venture Intelligence deal database:

- **Investment filter:** Primary interactions with equity investors including angel investors, venture capitalists and PE firms indicate that investments in MSMEs typically have a deal size less than USD 10 million (INR 650 million).
- **Enterprise turnover filter:** Analysis of the MSME Census reveals that more than 99.9 percent MSMEs had a turnover less than USD 9.2 million (INR 0.6 billion) in 2007. This turnover cap was extrapolated to 2017 using the GDP growth rate. In 2017, the resultant revenue cap was calculated as USD 15.4 million (INR 1 billion).

The above two criteria were validated by the research team via both primary and secondary research. The research team conducted a roundtable of key respondents (in addition to individual primary interviews) in partnership with WBG to re-validate the filters and subsequent outcomes.

Applying these two filters reveals that **USD 1.05 billion** was invested in MSMEs in 2017.

The annual supply of other risk capital products (venture debt and business

¹⁹⁴ Such as VCCircle, Venture Intelligence, Research PE India etc.

installment loans) was estimated based on data gathered through primary research with key providers and reconciliation among them on a best-effort basis. The market for such products is still evolving and it is difficult to arrive at accurate estimates.

Appendix C – Proposed Amendments to MSME Definition

The existing definition of MSMEs was adopted under the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006. The definition is based on the investment in plant and machinery for manufacturing enterprises and on the investment in equipment for services enterprises.

The limits for each category of MSMEs are defined as below:

Existing definition of MSMEs

Categories	Manufacturing (Investment in plant and machinery)	Services (Investment in equipment)
Micro	< INR 2.5 million	< INR 1 million
Small	> INR 2.5 million and < INR 50 million	> INR 1 million and < INR 20 million
Medium	> INR 50 million and < INR 100 million	> INR 20 million and < INR 50 million

In due course, a need for revision of the definition was felt due to significant increases in the wholesale price index and cost of inputs since 2006. There has also been a change in the business environment with many MSMEs becoming part of domestic and global value chains. Subsequently, in 2015, an MSMED Amendment Bill was introduced to incorporate a new section on the change in definition for MSMEs.

The Union Cabinet in Feb, 2018 approved a proposal to change the definition of Micro, Small and Medium enterprises.

According to the new definition, a micro enterprise is a unit where the annual turnover does not exceed INR 5 crore, a small enterprise is one where annual turnover is between INR 5 crore and INR 75 crore, and a medium enterprises is where the turnover is more than INR 75 crore but does not exceed INR 250 crore. In order to give this new MSME definition into effect, the Section 7 of the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 will be amended.

Proposed definition of MSMEs

Categories	Manufacturing (Investment in plant and machinery)	Services (Investment in equipment)
Micro	< INR 5 million	< INR 2 million
Small	> INR 5 million and < INR 100 million	> INR 2 million and < INR 50 million
Medium	> INR 100 million and < INR 300 million	> INR 50 million and < INR 150 million

Primary interviews reveal that the single criterion of fixed assets for the purpose of defining MSMEs has some constraints:

1. It is difficult for most MSMEs to have a precise estimate of investment in fixed assets due to robust book-keeping practices.
2. In MSMEs structured as proprietorship firms, the line differentiating business assets and personal assets is often blurred, leading to mismatches in calculation of investment in assets¹⁹⁵.
3. The correlation between investment in fixed assets and size of the enterprise varies widely with the industry and business model.

Global experience suggests that the MSME definition should also include other factors such as turnover, employment and industry benchmarks, to formulate targeted policies more effectively.

For example, in the United States, the Small Business Administration defines a small business either in terms of the average annual receipts over the past three years or average number of employees over the past 12 months. Definitions also vary across industries to reflect different size standards.

The size standards take into account the structural characteristics within individual industries, including average firm size, the degree of competition and federal government contracting trends to ensure that size definitions reflect current economic conditions within those industries¹⁹⁶.

In China and most European Union countries, the SME definitions are based on annual turnover, number of employees and total assets¹⁹⁷. The definitional segregation may also be made flexible depending upon the end purpose. For example, in Malaysia, SMEs are defined on the lower of turnover and number of employees¹⁹⁸. The MSME Committee Report, 2015 also suggests that a mechanism can be instituted whereby the definitional limits could be linked to an appropriate inflation benchmark for automatic adjustment on a periodic basis.

Appendix D – Details of Primary Research

This study draws on primary interviews conducted with various risk capital providers, MSMEs and other key stakeholders to understand the MSME financing landscape in general, validate estimates of data, and receive insights on gaps and recommendations. The interviewees are listed as follows¹⁹⁹:

¹⁹⁵ MSME Definition in India: The Present State and the Imperatives – FICCI Report

¹⁹⁶ U.S. Small Business Administration website

¹⁹⁷ MSME Definition in India: The Present State and the Imperatives – FICCI Report

¹⁹⁸ Ibid

¹⁹⁹ Please note that the lists are not exhaustive and does not contain the names of stakeholders who have requested anonymity and do not want their or their organizations' names to be disclosed.

Supply side

Sr. No.	Organization	Type
1	Acumen Fund	Venture Capital
2	Asian Healthcare Fund	Venture Capital
3	Dena Bank	Bank
4	Ask Pravi	Venture Capital
5	Aspada Investment	Venture Capital
6	Banyan Tree Finance	Private Equity
7	Capital Float	NBFC
8	Dr. Malpani	Angel investor
9	Kotak Bank	Bank
10	IDBI Bank	Bank
11	IntelleGrow	Venture debt
12	IntelleCash	NBFC
13	Ivycap Ventures	Venture Capital
14	Lighthouse Advisors	Venture Capital
15	Magma	NBFC
16	RBL Bank	Bank
17	responsAbility	Venture Capital
18	Samir Shah	Angel investor
19	Sequoia Capital	Private Equity
20	SIDBI	Apex body for MSMEs
21	SIDBI Venture Capital Ltd.	Venture Capital
22	Tano Capital	Venture Capital
23	Indostar	NBFC
24	Trifecta Capital	Venture debt
25	Zephyr Peacock	Private Equity

Demand side

Sr. No.	Organization	Type
1	A****on Technologies	Services
2	A***r Enterprises	Services
3	A*****g India	Manufacturing
4	B***a Delivers	Services
5	C****e Salt	Manufacturing
6	C*** Bakery	Services
7	D***a Enterprises	Services
8	Edu*****	Services
9	G**** Enterprises	Services
10	G**** Engineering Works	Manufacturing
11	H***n Clockworks	Manufacturing
12	H**** A** View	Services
13	I***	Services
14	I*****n Filters	Manufacturing
15	K****k Instruments	Manufacturing

16	M.R. M****I	Services
17	M*** C**** Guide	Services
18	My*****	Services
19	R****n Systems	Manufacturing
20	S** A*** I****	Services
21	S** K***** Electronics Pvt. Ltd.	Manufacturing
22	Su***** F*****r	Services
23	S**** P**** M****	Manufacturing
24	T*****s Systems	Services
25	T****r India	Manufacturing
26	V**** S*****	Services
27	W* N*****	Manufacturing

Other stakeholders

Sr. No.	Organization	Type
1	National Stock Exchange	SME Exchange
2	Federation of Indian Micro and Small & Medium Enterprises (FISME)	Association
3	Foundation for MSME Clusters (FMC)	Association
4	Centre for Innovation, Incubation and Entrepreneurship – IIM Ahmedabad	Incubator
5	SIDBI Innovation and Incubation Centre – IIT Kanpur	Incubator
6	MSME Board	Ministry of MSME

Appendix E – Government Schemes for MSME Financing

Scheme	Details	Financial Terms	Services
Start-Up India	<ul style="list-style-type: none"> Fund of Funds Scheme - corpus INR 10,000 crore Provide funding for development & growth of innovative enterprises 	<ul style="list-style-type: none"> LIC is a co-investor Max 50% contribution of daughter fund size Daughter fund to raise the balance 50% 	<ul style="list-style-type: none"> Startup India Hub for Startup queries and handholding support Online learning module
Stand-Up India	<ul style="list-style-type: none"> Bank loans between INR 10 lakh and INR 1 crore to at least one SC/ ST borrower per bank branch 	<ul style="list-style-type: none"> Composite loan (term loan + working capital) 75 % of project cost Repayable up to 7 years 	<ul style="list-style-type: none"> Stand-Up India Connect Centers arranges for support to trainee borrowers
Technology Acquisition and Development Fund (TADF) Direct & In-Direct Technology Acquisition	<ul style="list-style-type: none"> Applicable to All Existing & new MSMEs For Outright purchase of Technologies and IPR for large scale deployment of relevant technologies 	<ul style="list-style-type: none"> Reimbursement of 50% of technology transfer fee or 20 lakh Indian rupees In-direct acquisition: 50% of the project value (max INR 20 lac) 	<ul style="list-style-type: none"> Scheme technically & administratively managed by the GITA TADF Helpline & Live Chat
TADF Subsidy for Manufacturing Equipment / Technology	<ul style="list-style-type: none"> Applicable to All Existing & new MSMEs including those in the National Investment and Manufacturing Zones 	<ul style="list-style-type: none"> Subsidy up to 10% of capital expenditure incurred on new Plant & Machinery (max INR 50 lac); INR 25 lac to INR 50 lac 	<ul style="list-style-type: none"> Same as above

Credit Linked Capital Subsidy Scheme (CLCSS) for Technology Upgradation	<ul style="list-style-type: none"> • Enable MSMEs to adopt modern technology for improving their productivity, through technology upgradation 	<ul style="list-style-type: none"> • 15% capital subsidy up to a maximum of INR 1 crore 	<ul style="list-style-type: none"> • Scheme provided through concerned banks/ nodal agencies of eligible financial institutions
Promoting Innovations in Individuals, Start-ups and MSMEs (PRISM) Phase I Category I & II	<ul style="list-style-type: none"> • Category I: <ul style="list-style-type: none"> • Support micro budget innovations. • Initiate a promising development, prove functionality in a lab • Category II: <ul style="list-style-type: none"> • Convert an original idea into working prototypes 	<ul style="list-style-type: none"> • Category-I: <ul style="list-style-type: none"> • Proof of Concept/ Prototypes/ Models • Max: INR 2 lac • Category-II: <ul style="list-style-type: none"> • Fabrication of working model • Max: INR 20 lac or 90% of project cost 	<ul style="list-style-type: none"> • Provided by TePP Outreach cum Cluster Innovation Centre (TOCICs) for promoting and implementation of PRISM in their regions
PRISM Phase II - Enterprise Incubation	<ul style="list-style-type: none"> • For scaling up technology based innovations, including patenting/design registration/technology transfer to develop a marketable product 	<ul style="list-style-type: none"> • Subsidy of 50% of the project value (max INR 50 lac) • Project cost more than INR 35 lac and up to INR 1 crore 	<ul style="list-style-type: none"> • Same as above

