International Finance Corporation
World Bank Group

In Partnership with
Government of Japan

Micro Small and Medium Enterprise Finance Market in India

This assessment was led by International Finance Corporation (IFC) Access to Finace Advisory team. The research, data collection and diagnostics were conducted by Intellectual Capital Advisory Services on behalf of IFC.

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

Micro Small and Medium Enterprise Sector in India

The Micro, Small and Medium Enterprise[1] sector is crucial to India's economy. There are 30 million[2] enterprises in various industries, employing 69 million people. Together, these account for 45% of the industrial output and 40% of the exports.

Although 95% of Micro, Small and Medium Enterprise units are informal in nature, the contribution of the sector to India's GDP has been growing consistently at 11% per annum, higher than overall GDP growth of 7-8%[3].

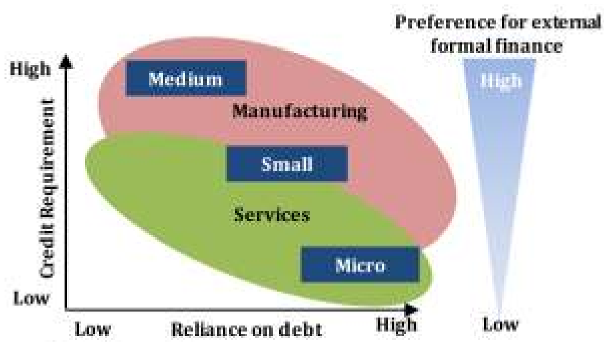
Poor infrastructure and inadequate market linkages are among key factors that have constrained the growth of the sector. However, lack of adequate and timely access to finance has continued to be the biggest challenge.

Differentiated Finance Needs

The financing needs of the sector depend upon size of operation, industry, customer segment, and stage of development (Figure 1). The smaller the entity, greater is the reliance on debt as a primary source of finance.

- Micro enterprises primarily rely on debt for both early and growth-stage financing
- Micro and small services enterprises primarily transact in cash and tend to keep minimal records
- Manufacturing enterprises and those with order-driven services tend to need more finance because of longer working capital cycle and higher capital expenditure

Figure 1: Nature of Finance Demand in Micro, Small and Medium Enterprise Sector



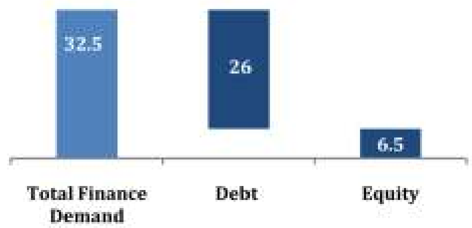
Source: IFC-Intellecap Analysis

Size of Micro, Small and Medium Enterprise Finance Demand

The sector's total finance demand is estimated to be INR 32.5 trillion ($ 650 billion[4]) (2009-10), with 80% of the demand originating from the informal sector.

- Micro and small enterprises have limited access to equity and, in many cases their ownership structure prevents infusion of external equity. Information from sector associations suggests a debt-equity structure of 4:1
- Medium enterprises have better access to finance and better capacity to absorb external equity, with an estimated capital structure of ~2:1 debt to equity

Figure 2: Total Micro, Small and Medium Enterprise Finance Demand (2009-10) (in INR Trillion)



Source: Micro, Small and Medium Enterprise Census, SIDBI, Primary Research, IFC-Intellecap Analysis

Debt and Equity Demand in the Sector

Financial institutions have limited their exposure to the sector due to a higher risk perception and limited availability of immovable collaterals. An estimated 37% of the overall debt demand is unviable for financial institutions. In addition, nearly 25% of the total estimated demand is from micro enterprises that prefer debt from the informal sector.

Table 1 : Exclusions from total debt demand[5]

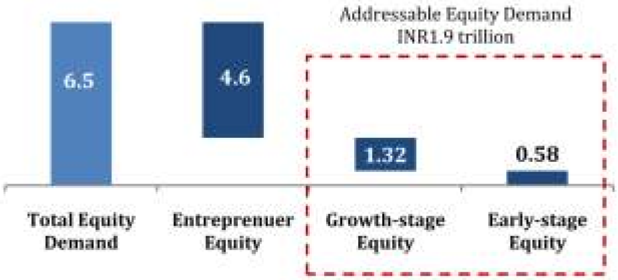
Type of Enterprises	Share of
Sick enterprises in default	13%
New enterprises[i]	23%
Rejected by formal financial institutions	1%
Voluntary exclusions by micro enterprises	25%
Total	**62%**

Source: Primary Research, IFC-Intellecap Analysis

After the above exclusions, the debt gap in the formal and informal sectors is estimated to be INR 1 trillion ($ 20 billion) and INR 8.9 trillion ($ 178 billion), respectively. Short-term debt requirement is as high as 60% of the total demand (INR 6 trillion; $ 120 billion). Challenges in access to finance are the same for both formal and informal enterprises in the sector; formal status does not always ensure better access to finance for enterprises.

The potential demand for external equity is estimated to be INR 1.9 trillion ($ 38 billion). Entrepreneur equity (INR 4.6 trillion; $ 92 billion) in most cases is financed through debt from informal sources.

Figure 3: Equity Demand in Micro, Small and Medium Enterprise Sector (INR trillion)



Source: Micro, Small and Medium Enterprise Census, SIDBI, Primary Research, IFC-Intellecap Analysis

Size of Micro, Small and Medium Enterprise Finance Supply

The share of formal finance to the sector is INR 7 trillion[6] ($ 140 million) and covers only 10-11 million enterprises. An estimated 67% of enterprises remain unserved by the formal financial sector.

Debt: Largest Form of Formal Finance to the Sector

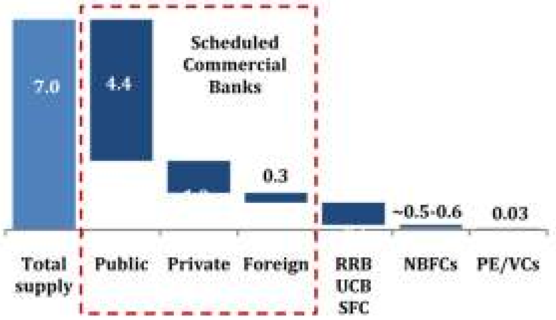
Large commercial banks account for 80% of debt supply to Micro, Small and Medium Enterprises, of which 77% is from public sector banks. There has been a strong policy focus on financing this sector.

Traditionally, private and foreign banks have used the indirect finance route (non-banking finance companies). However, as of April 2011, loans sanctioned by commercial banks to non-banking finance companies for on-lending to micro and small enterprises do not qualify as priority sector[7]; banks, hence need to re-strategize direct lending to the sector

Banks adopt conservative policies that minimize both credit risk and cost of delivery; thus, they focus more on the less risky small and medium enterprises than on micro enterprises.

Small banks[8], non-banking finance companies, and microfinance institutions serve specific segments of the market. Lower regulatory overheads and nimble structure enable shorter turnaround time and targeted products. Most non-banking finance companies provide asset finance (primarily transport), and margin finance to the sector. They are rarely the primary source of finance to the sector, due to limited access to adequate growth capital, inadequate credit default support and no priority sector incentives.

Figure 4 : Structure of Formal Finance Supply (INR trillion)



Source: RBI; SIDBI; Non-banking finance companies' Annual Report

IFC-Intellecap Research and Analysis

Collateral: Commercial Banks Prefer Secure Lending

Financial institutions insist on immovable collateral to hedge against risk of default. The typical collateral to credit ratio is estimated between 125% - 170%. Credit guarantee support has been instituted to support collateral-free debt up to INR 10 million ($ 0.2 million), however this remains underutilized at less than 5% of the overall debt to the sector. While the trend of collateral-free debt is growing gradually, collateralized debt continues to account for 95%-98% of Micro, Small and Medium Enterprise credit.

Equity: Supply to the Sector Limited

Most of the estimated INR 30 billion ($ 0.6 billion) external equity to the sector is directed toward growth-stage, mature small and medium enterprises. Early-stage equity is limited due to small deal sizes (in the range of INR 0.5 – 5 million;$ 0.01 – 0.1 million), lack of investment-worthy business models, long investment horizons and potential of high failure rates.

Informal Finance is Predominant

Informal finance dominates the sector and 95% of it originates from non-institutional sources such as family, friends, relatives, and family business. Institutional channels, comprising trade credit, chit funds, and moneylenders, tend to be expensive. Interest rates range from 25% - 60% per annum as compared to 20-25% per annum by non-banking finance companies and 13-16% per annum by commercial banks.

Size of Micro, Small and Medium Enterprise Finance Gap

The total finance gap in the sector, including debt and equity, but excluding entrepreneur's equity contribution, is INR 20.9 Trillion (USD 418 Billion). This is split between Micro (INR 16.25 Trillion; USD 325 Billion), Small (INR 3.9 Trillion; USD 77 Billion) and Medium (INR 0.78 Trillion; USD 15.4 Billion) enterprises. Following the exclusions already highlighted, the debt gap that is immediately addressable by formal financial institutions is estimated at INR 2.9 trillion ($ 58 billion) and the equity gap at INR 1.9 trillion ($ 38 Billion) (Figure 5).

- The gap in debt finance is primarily due to un-served micro enterprises and underserved small enterprises
- Gap to demand ratio for equity is ~100% , particularly for small and medium enterprises that are constrained for both early-stage and growth capital

Figure 5 : Immediately Addressable Finance Gap (INR trillion)

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

Micro Enterprises Debt Gap - INR 2.3 trillion ($ 46 Billion)

- Micro enterprises tend to be too large for microfinance institutions and too small for large commercial banks.
- Cost of acquiring and maintaining accounts is very high
- Banks have limited information on micro enterprises and no access to alternative tools for assessment
- Micro-entrepreneurs lack adequate collateral

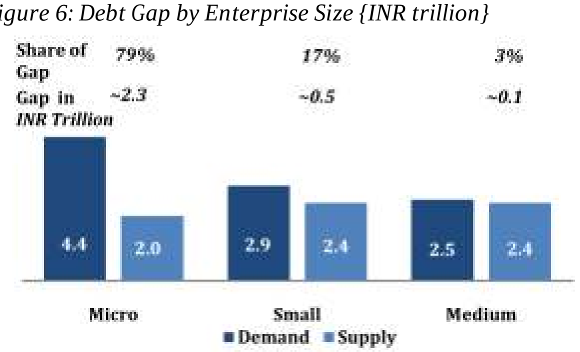
Small Enterprises Debt Gap - INR 0.5 trillion ($ 10 billion)

- Insufficient short-term financing
- Use of industry averages to determine financing requirements, not taking into account working capital cycles of specific industries and service enterprises.

Medium Enterprises Debt gap - INR 0.1 trillion ($ 2b billion)

- 'Mid-corporate' debt needs are well served, and hence they have been excluded from priority sector lending targets
- Policy efforts are now focused on reinforcing the flow of equity to the sector through the SME stock exchange.

Figure 6: Debt Gap by Enterprise Size {INR trillion}



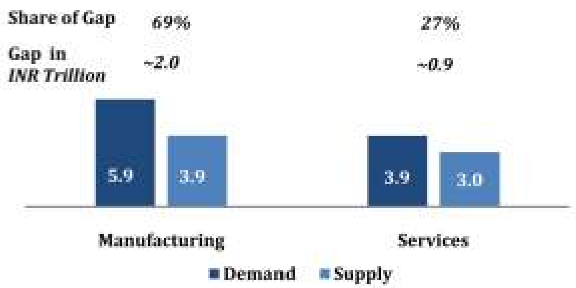
Source: MSME Census, SIDBI, Primary Research, IFC-Intellecap Analysis

Manufacturing Sector Debt Gap - INR 2 trillion ($ 40 billion)

The debt gap in the manufacturing enterprises is twice that of the services sector for the following reasons:

- Manufacturing has longer working capital cycle, payments are realized with significant delay (~100 days median)
- These enterprises are susceptible to economic downturns and pose a greater challenge with regard to liquidation of collateral

Figure 7: Debt Gap by Industry of Operation {INR trillion}



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

Services Sector Debt Gap - INR 0.9 trillion ($ 18 billion)

Key reasons for the shortfall in the services sector are:

- Services sector is diverse with 14 key industries and several sub-industries[9]. Financial institutions have limited understanding of business models or financing benchmarks
- Operations are intangible and entrepreneurs do not have either primary security or immovable collateral
- Knowledge-based services such as software and consultancy have higher than average financing requirements

Enabling Environment

Micro, Small and Medium Enterprises face stiff competition and require a comprehensive enabling environment to sustain growth (Figure 8).

Legal and Regulatory Framework

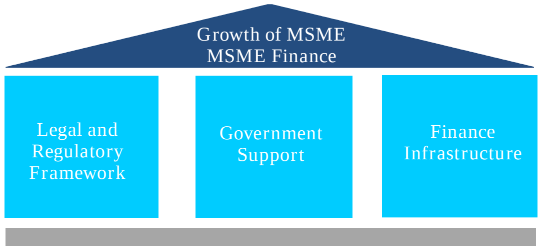
Key legal and policy interventions to date include:

- Setting up of a separate Micro, Small and Medium Enterprise ministry for the sector.
- Enactment of Micro Small, Medium Enterprises Development Act (MSMED Act 2006)
- Inclusion of Micro, and Small Enterprises under the purview of priority sector lending

However, despite considerable progress, gaps exist:

- Lack of a sector specific framework to revive enterprises
- Limited incentives for innovative financing structures such as factoring and securitization

Figure 8: Schematic- Key Enabling Environment Elements



Source: IFC-Intellecap Analysis

Government Support

The government's multi-pronged support program for the sector includes:

- Focus on skills development, cluster development market linkages, technology-adoption and infrastructure
- Financial support to sector through Small Industries Development Bank of India, credit guarantee scheme under Credit Guarantee Trust and National Small Industries Corporation

Finance Infrastructure

Both public and private sector institutions have attempted to facilitate flow of finance to the sector. Key initiatives include:

- Formation of credit bureaus to track credit history
- Formation of collateral registry for immovable assets
- Setting-up credit rating agencies, asset reconstruction companies and an Small and Medium Enterprise stock exchange

Potential Interventions

Potential interventions in the following areas could have a positive role in expanding available finance to the sector.

Enabling infrastructure

- Encourage securitization of trade-receivables through conducive legal infrastructure
- Promote institutions to syndicate finance and provide advisory support to Micro, Small and Medium Enterprises in rural and semi-urban areas
- Incentivize equity investment, particularly in small and medium enterprises, by providing seed equity (through government funds or a public-private-partnership structure)

Liquidity management

- Improve debt access to non-banking finance companies focused on these enterprises and provide regulatory incentives for participation in the sector
- Develop an IT-enabled platform to track receivables to facilitate securitization of trade receivables
- Provide credit guarantee support for Micro, Small and Medium Enterprise finance to non-banking finance companies

Risk management

- Develop a better understanding of financing patterns of service enterprises in the sector
- Expand the scope of the sector's credit information bureau to collate and process important transaction data (e.g. utility bill payment)
- Centralize the collateral registry efforts, and track both immovable and movable collateral

Finally, the total Micro, Small and Medium Enterprise finance demand can be expanded to encompass current exclusions by:

- Providing funding and policy support to help sick enterprises revive operations; incentivize financial institutions to participate in the revival process
- Building greater financial awareness among entrepreneurs on financial products and services through a structured approach by the government on financial awareness building among Micro, Small and Medium Enterprises

1. *Definition of Micro, Small and Medium Enterprise is based on initial investment of the enterprise in plant and machinery per the MSMED Act, 2006*
2. *Ministry of Micro, Small and Medium Enterprise, Government of India estimates the population of Micro, Small and Medium Enterprises in India to be 29.8 Million; the sector may also have a larger number of micro livelihood enterprises, estimated to be ~20-25 Million in number*
3. *Source: Report of the Working Group on Sick Micro, Small and Medium Enterprises, Reserve Bank of India (RBI), 2009-10*
4. *1USD = INR 50*
5. *New Enterprises: Defined as enterprises with less than one year of operational history*
6. *Reserve Bank of India 2008, Intellecap Analysis*
7. *Master Circular –Lending to Priority Sector, Reserve Bank of India, 2011*
8. *Small Banks – Urban Cooperative Banks, Regional Rural Banks and State Finance Corporation*
9. *Ministry of Statistics and Program Implementation, 2009*

India-

New Delhi
Maruti Suzuki Building
3rd floor
1 Nelson Mandela Road
Vasant Kunj, New Delhi 110 070
Tel: +91 11 4111 1000/ 3000
Fax: +91 11 4111 1001/ 3001

Mumbai
Vibgyor Towers, 6th Floor
G Block, C-62
Bandra Kurla Complex
Bandra East
Mumbai - 400 051, Maharashtra
Tel: +91 22 4230 2400
Fax: +91 22 4230 2401

Kolkata
4A, Nandalal Basu Sarani,
2nd Floor
(Little Russel Street)
Kolkata - 700 071
Tel: +91 33 4401 1000
Fax: +91 33 4401 1001

Chennai
31, Sudha Center, 1st Floor
Dr. Radhakrishnan Salai
Mylapore
Chennai – 600 020, Tamil Nadu
Tel: +91 44 4566 4000
Fax: +91 44 4566 4001

Bangladesh
United House, 10 Gulshan Avenue
Gulshan, Dhaka - 1212
Bangladesh
Tel: +880 2 883 3752-66
Fax: +880 2 989 9255

Bhutan
UN House, PO Box 162
Samten Lam
Thimphu, Bhutan
UN PABX: +975 2 322 424

Nepal
The World Bank, P.O. Box 798
Yak & Yeti Hotel Complex
Kathmandu, Nepal
Tel: +977 1 4268 123
Fax: +997 1 4223 443

Sri Lanka
15th Floor, DHPL Building,
42 Navam Mawatha,
Colombo 2, Sri Lanka
Tel: +94 11 2300 310-11
Fax: +94 11 479 5017

Stay connected
http://www.ifc.org/southasia
www.facebook.com/IFCwbg
www.facebook.com/IFCsouthasia
www.twitter.com/IFC_org
www.twitter.com/IFC_SouthAsia
www.youtube.com/IFCvideocasts
www.ifc.org/SocialMediaIndex

IFC International Finance Corporation
World Bank Group