

Risk Capital for MSMEs in India

Kaushik Gala

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Background:

During February – August 2010, I explored the idea of a new venture that focuses on providing risk capital to innovative Micro, Small and Medium Enterprises (MSMEs) in India. This was done as part of my consulting engagement with Venture Center, since an important aspect of business incubation services is the provision of early-stage funding (eg. grants, debt, equity) to entrepreneurs. This document summarizes my findings and conclusion that an investment management venture focused on MSMEs in India isn't yet a viable option.

Target Market:

Per the 2006-07 census, there are over 2.6 crore MSMEs in India. Of these, over 98% are 'Micro' enterprises - 'one-man shows' that provide services to local markets with minimal investment. They use antiquated technology, have no formal management practices, operate with poor productivity & lack access to bank credit. Of the remaining 5 lakh SMEs, a majority are unlikely to be significantly better in terms of technology or productivity, but it is possible that there are at-least 10,000 enterprises across India that are truly innovative (via technology or business model) and are worthy of risk capital investments.

Problem:

Most MSMEs rely on family, friends & personal networks for funding. Only a select few have access to risk capital from angels, venture capitalists (VCs), and certain schemes from government/banks. For example:

- On average, ~ 100 Indian companies get VC funding every year.
- On average, angel networks (eg. Mumbai Angels) fund ~ 50 startups every year.
- On average, government schemes (eg. DSIR's TePP, TDB seed funds) fund ~ 100 enterprises every year.
- On average, ~ 50 companies get listed via IPOs on our stock exchanges every year.
- On average, bank lending to MSMEs accounts for < 10% of total commercial lending. It's usually in the form of secured, collateralized debt - not 'risk' capital.

Moreover, the average investment by VCs is ~ Rs 20 crore, while that by angels is ~ Rs 2 crore. Thus, MSMEs that seek equity-like investments in the range of Rs 20 lakh – Rs 2 crore have essentially nowhere to go.

Various government schemes try to address this funding gap, but with limited success, due to delays in approvals & disbursements, limited bandwidth to process applications, lack of investment experience, etc. As for VCs, their investment corpus is usually so large that investments below Rs 5 crore do not make economic sense for the investment managers. Moreover, angels & VCs have limited exit options for their investments in MSMEs. Finally, entrepreneurs exhibit preferences that are unfriendly to investors, such as reluctance to share equity, desire to build a family empire, aversion to technology risks, and lack of ethics in some cases.

Solutions:

There are a few seed-stage VCs that seek to address this gap but their focus is limited to technology enterprises. Banks such as SIDBI have launched new schemes to address the fact that most MSMEs cannot post collateral and need customized debt arrangements. Other attempts include seed funds at business incubators, networks of angels, crowd-sourced investing, online match-makers and seed-stage advisors. However, the sheer number of MSMEs that need risk capital implies the need for a highly scalable solution.

Hypothesis:

In looking for a scalable model, I came across an interesting new venture fund called Right Side Capital Management (RSCM) that turns the traditional VC model on its head. Instead of spending significant time & money on due diligence and then investing in <1% of potential candidates, RSCM funds many more start-ups, but using checklists & processes that reduce the time-frame for a deal from several months to a few weeks. This provides capital to a much larger number of MSMEs than the traditional VC model. Also, since the average amount per startup is lower, funds can be sourced from HNIs instead of institutions.

I investigated a similar model for India where funds are sourced from HNIs/NRIs and deployed into a large number of MSMEs using standardized checklists and rapid filtering of candidates. Reductions in transaction costs allow investment managers to operate profitably, despite smaller investments. I also looked into the use of rating services (eg. SMERA) & insurance (eg. SIDBI credit guarantee) to address concerns about fraud.

Challenges:

Besides the usual aversion to risk capital, investors face several issues w.r.t. funding MSMEs, such as asymmetric information, lack of collateral, inability to recover funds via legal due process in case of fraud, limited pool of CAs & lawyers who understand venture funding, high costs of due diligence, limited exit (IPO, M&A) options for MSMEs, entrepreneurs' attitudes towards professional investors & management, etc. Industry insiders have no incentive to target MSMEs as investment candidates, whereas industry outsiders face the hurdle of demonstrating a successful track record of past investments in order to raise capital.

Conclusion:

For the viability of a for-profit investment management venture that focuses on the Rs 20 lakh – Rs 2 crore range, we need several, positive changes in the regulatory & legal environment, such as:

1. Tax incentives for angel investors that allow offsetting of capital losses against other income
2. Matching funds and/or principal guarantees by government that act as leverage for investors
3. Government schemes to reimburse costs of rating & credit guarantee services
4. Government schemes to reimburse costs of legal agreements, due diligence, background checks, etc.
5. Strict & prompt enforcement of law against MSMEs who defraud investors

References:

In my research, I have referred to various books & articles from the Venture Center library, as well as weblogs, online essays, presentations, government reports, etc. To capture these sources, as well as summarize what I learnt, I have written a few essays that can be accessed online here:

- Risk mitigation for investors in MSMEs, <http://www.galatime.com/essays/risk.html>
- Why don't (Indian) MSMEs get risk capital?, <http://www.galatime.com/essays/challenges.html>
- Angel Investing - Will It Work for Indian MSMEs?, <http://www.galatime.com/essays/angel.html>
- What's so special about innovative MSMEs?, <http://www.galatime.com/essays/theory.html>
- Where do Indian/NRI (V)HNIs invest?, <http://www.galatime.com/essays/hni.html>
- Funding Options for Innovative MSMEs in India, <http://www.galatime.com/essays/financing.html>
- Innovative MSMEs in India, http://www.galatime.com/essays/innovative_msme.html

Contact: kaushik@venturecenter.co.in