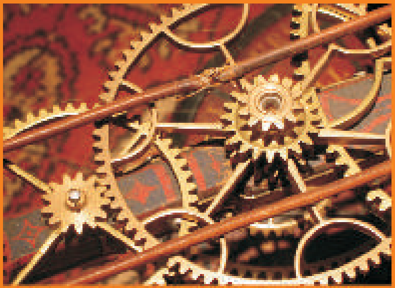
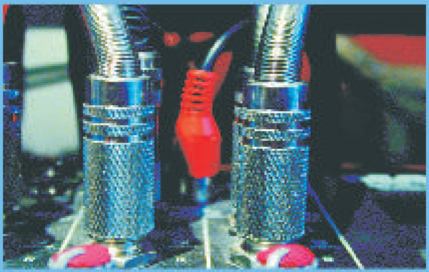
Risk Capital and MSMEs in India





SIDBI

भारतीय लघु उद्योग विकास बैंक

SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA

SME Financing and Development Project [SMEFDP]

Introduction

SIDBI is implementing a World Bank-led multi agency / multi activity Project on Financing and Development of MSMEs. While SIDBI has been assigned with the responsibility of implementing the project, the Department of Financial Services, Ministry of Finance, Government of India is the nodal agency for the same. The World Bank(WB), Department for International Development (DFID) UK, KfW and GTZ Germany are the international partners in the Project. The Project is aimed at making MSME lending an attractive and viable financing option as also facilitate increased turnover and employment in the sector. In order to achieve its aims, the Project, besides upgrading direct flow of credit to MSMEs, addresses demand side issues of credit and streamlining access to qualitative financial and non-financial enterprise oriented services. This is being done with support of Technical Assistance to be utilized for strengthening the credit information system, credit rating, structuring of innovative products, capacity building of the participating banks, policy and regulatory issues and promotion of market oriented Business Development Services for the sector.

Components

The Project has three major components:

A] Line of Credit from WB and KfW,

B] Risk Sharing Facility [RSF] and

C] Technical Assistance [TA]

The objective of the DFID TA, is to increase of employment in MSMEs in India and also to catalyze growth and competitiveness in MSMEs. It is implemented to help participating banks to gain better access to term financing for MSME lending, reduce the costs and risks related to MSME financing, improve the profitability of their MSME business and expand MSME financing while improving the quality of their MSME loan portfolios.

DFID TA inter-alia attends to MSMEs issues through a critical component of "Strengthening policy/legal/regulatory framework and its enforcement". This component aims at preparing and implementing a time bound action plan for key policy, legal and regulatory measures that are critical to establishing a more efficient framework underpinning MSME financing and development. SMEFDP intends to render thrust on areas which can foster the growth and development and create an enabling sustainable ecosystem for MSMEs.

The component emphasizes on promoting informed and evidence based dialogue in public domain for systemic change. The project will undertake study, research, workshop, seminars etc., brainstorm with stakeholders as also attempt at institutionalizing the Advocacy on important thrust/ theme areas concerning MSMEs.

DFID Department for International Development

DFID is the British government department responsible for Britain's contribution towards international efforts to eliminate poverty. DFID works in partnership with developing country Governments towards poverty alleviation. DFID supports long-term programmes to help tackle the underlying causes of poverty. DFID recognizes that the development of MSMEs is key to creating the jobs and income needed to reduce India's poverty. DFID is supporting the development of the MSME sector in India through the project. The Technical Assistance part of the project is funded by DFID.

Foreword

Indian Micro Small and Medium Enterprises (MSMEs) contribute significantly to the national priorities of employment generation, entrepreneurship promotion, backward area development and wealth distribution. The factors inhibiting the growth trajectory of MSMEs often lie in limited resources in terms of skilled manpower, finance, infrastructure and market outreach.

The advent of globalization offers both challenges and opportunity to MSMEs. The challenge for them is to remain competitive and consistently deliver value to customers. The opportunities available include tapping the global markets and growth in scale by forging strategic partnerships.

Internationally, Risk Capital forms the basis of entrepreneurial ecosystem. Risk Capital is an important instrument for not only start-ups and innovative / fast growing companies but is also critical to those looking at growth. However the sources of risk capital are limited in developing countries. It is encouraging to note that with global integration of economy, emerging markets like India are sought after destinations for successful Private Equity (PE) funds. However, the PE Funds continue to focus on larger investments and bigger corporatised units though there are more success stories of software and other new economy enterprises in the medium sector being assisted by Venture Capital [VC] Funds.

Majority of the MSMEs are owner driven with lesser inclination towards formal organizational structures. The non corporate structure and small size of the majority of MSMEs in India makes the venture capitalists and other risk capital providers reluctant to investing in them due to higher transaction costs and difficulties in exits out of such investments. Thus, it is critical to have appropriate risk capital products and focused funds for MSMEs of different size and constitution.

SIDBI has been mandated by GOI for setting up a Rs 2000 crore Risk Capital Fund for MSMEs. SIDBI, under its SME Financing and Development Project, has endeavoured to evolve policy support pillars for furthering the risk capital framework for MSMEs. The present policy paper is an outcome of the workshop organized with lead stakeholders. We are confident that it will provide better understanding and facilitate laying down of a roadmap towards institutionalization of access to such capital on a competitive and sustainable basis by MSMEs.

Rakesh Rewari
Deputy Managing Director
SIDBI

Contents

Executive Summary

Introduction

This white-paper draws from the stakeholder deliberations at "Risk Capital for MSMEs in India" held on March 5, 2008 at PHDCCI, New Delhi, as well as secondary literature.

The paper focuses on the capital constraints faced by the MSME sector in India and the associated need for developing a well funded risk capital regime for the sector. The emerging risk capital ecosystem for MSMEs is at a nascent stage and needs adequate support from Government and private sector alike to enable greater entry and spread of the MSME sector. The paper discusses the various risk capital options available internationally and at national level for development of an efficient regime. It also looks at ways to exercise these options given the diverse characteristics of the Indian MSME sector.

Non-availability of timely and adequate funds at reasonable cost is one of the most important problems facing the MSME sector. Take, for instance, credit. Since the nineties the share of commercial bank credit that goes to the SSI sector is falling (though growing in absolute terms). Some of the major causes for low availability of bank finance to this sector are the high-risk perception, inadequate data and usage of external credit rating (*there is*

need to scale up external ratings), weak corporate financial systems, early stage high transaction cost for small loans and high costs of the banks in lending to MSMEs. The lack of adequate collateral further hampers availability of funds to the sector. In such conditions, making various risk-capital options available to the MSME sector is essential.

Risk Capital Options

Some of the major risk capital options available for MSME sector internationally and in India are given below. These need to be introduced and/or strengthened:

Venture Capital

Venture funds typically provide equity and may or may not also provide tied credit. Good quality venture funding can improve the credit rating of the company allowing it to access commercial loans or other forms of finance. However, there are some expected problems with exit that can impact funds entry into these areas. For the MSME, it has possible disadvantages of reduced operational flexibility, etc.

Angel Investors

Angels are typically high net worth individuals who wish to invest some of their surplus funds in new ventures. They can prove to be a good source of capital and advice at an early stage in the development of the company. For the investor, they bring opportunity to make high returns from investing at an early stage in an MSME. The problem areas are unwillingness of MSME to bring in an external investor in case of equity sale, the high risk for investor and risk of relationship between the investor and the MSME manager breaking down.

Public Listing

MSMEs with a good track record can access funding from the public through the public listing process first through the initial public offer (IPO). A functioning IPO regime for MSMEs will enable the entry of other types of risk capital in the earlier stages. However, the IPO route is limited to bigger MSMEs having an established strong record of past performance and reputation in the market.

Following supplements to risk capital can also be explored:

Loan Funds

A pure loan fund supported by the Structural Funds can be leveraged by using private capital. While Loan schemes are a major source of capital for MSMEs, usually lenders will require collateral or will go through a credit scoring process which may discriminate against start-up companies.

Risk Capital Options......

Guarantee Associations

Guarantee Funds or Guarantee Associations issue guarantees to MSMEs in order to facilitate access to external finance (mainly loan-based, but also equity) in return for a fee to cover both the risk and administrative and processing costs. They facilitate access to loan finance on improved financial terms for MSMEs and reduce the degree of risk for the lending institution. However, they cover only part of the credit risk and often apply to only a limited range of financial instruments. Requires the creation and/or existence of strong associations which typically take many years to set-up and operationalize.

Micro Finance

Micro finance is typically designed for businesses with small financing requirements. It can meet the market failure in starting and developing micro businesses. However, apart from high cost of setting and administering loans, it caters to only small requirements and generally requires the presence of a homogenous and well networked social group.

Creating a Risk Capital Ecosystem

The required risk-credit ecosystem needs to have the following elements:

- Availability of risk capital at every stage,
- Availability of good quality entrepreneurs
- Mentoring/advisory credit with hand holding,
- Appropriate and adequate exit options for all stakeholders,
- Appropriately incentivising risk-capital providers,
- Reducing informational imperfections and
- Ability to accept risks failure in early stage financing

To enable the supply of good 'quality' entrepreneurs and projects, following areas need to be focused upon:

Creating a Risk Capital Eco......

Incubators

Business incubators need to be set in partnership with technical and higher educational institutions to help the potential entrepreneur in the early stages. They aid the creation of higher 'quality' projects for later stage funding. Recognition of incubators as a priority sector activity can help in spreading incubators both in the public and private sectors. The incubators in India primarily provide the infrastructure setup with hand holding. There is need to linkup to risk capital for incubatee companies, particularly startups, to take care of expenses relating to manpower, IPR, initial marketing, product development etc. Further, the incubators need to develop strong linkages with Angel Networks and Venture Capital Funds to provide equity at startup stage.

Angel Networks

Internationally, these have been highly successful in providing both risk-capital as well as mentoring for budding entrepreneurs, many of them at the seed stage itself. There are certain taxation and exit issues affecting the growth of this sector in India. Appropriate and adequate policy action aimed specifically at this source of funds is required.

Small Cap Exchange

As the characteristics of small companies do not match the requirements of the stock exchanges servicing larger companies, there is a need to accelerate the setting up of a small cap exchange, either independently or as a part of the established exchanges. Equally important is ensuring easier IPOs for MSMEs as exit will make it easier for VCs and other types of risk capital providers to unlock their investment in the units.

Incentives for institutional and individual risk-credit providers

The risk capital in early stage investment particularly in small companies have a high risk high return portfolio with a small number of ventures succeeding. Appropriate tax and other incentives need to be designed for different types of risk-capital providers. Incentives of Risk capital have been devised in some countries to encourage entrepreneurship and startup ventures. Such models can be studied for possibility of replication in India.

Publishing Success Stories

Publishing success stories particularly of first generation entrepreneurs, is a high motivator for job seekers to take risk and set up ventures.

Corporatisation

Awareness needs to be created among MSMEs about advantages of conversion from Proprietorship / Partnership to a corporate entity (after reaching a certain size of stature). The corporate structure with greater transparency enables flow of capital vis-a vis Partnership / Proprietorship concerns.

Insolvency

In early stage financing, the failures due to technology, marketing etc are high. This requires a regime that allows for second chance options in case of genuine failures.

Information/Skill Gaps

Institutional solutions as outlined above would be much more effective if they are also accompanied by capacity improvements. Moreover, there are also gaps in information and skill availability both for entrepreneurs as well as finance providers. Some examples discussed were:

- Entrepreneurship development programs at graduate level
- Organizing of Business Plan Competitions in colleges
- R&D centers and technical institutions
- Institute referral services, laboratory facilities
- Process certifications via technical institutions and universities
- Promotion of greater faculty and industry interaction by building in appropriate flexibilities and incentives for research staff in research and academic institutions
- Strengthening the entrepreneurs accessibility to expertise in a range of areas such as assistance with IPR filings
- Enable access to marketing, HR and other business development services etc
- Ensuring risk-capital provider's easy access to multiple sources of information on the industry, activity and the entrepreneur (government support is required for such information to be made available on a large enough scale)

Way Forward

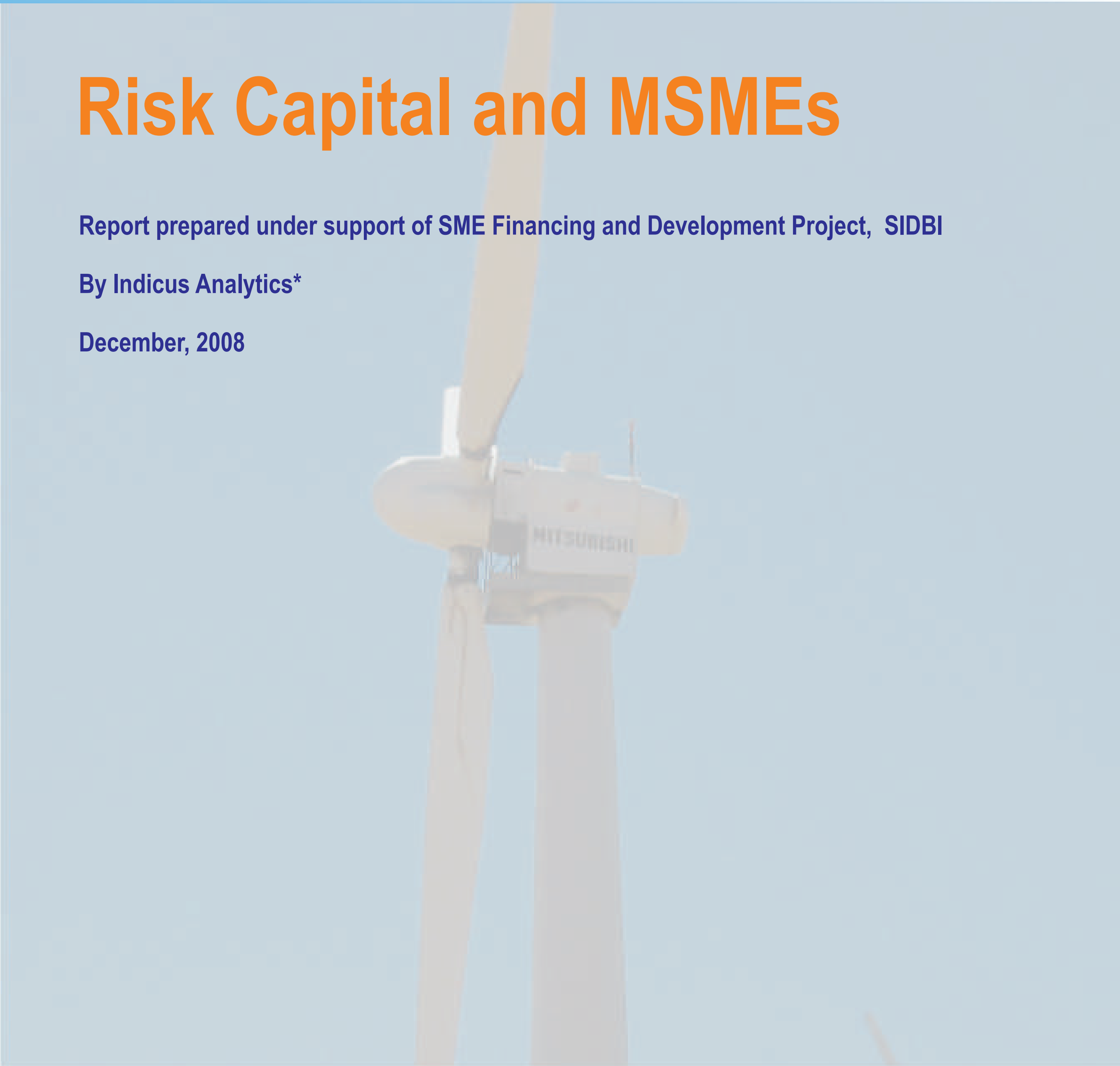
- Establish Incubator funds for emergent sectors and rural technologies.
- Capacity Building of Banks for assessing the Risk capital proposals, as also introduce risk measurement tools for MSMEs.
- Support handbooks for access to Risk Capital, Private Equity etc. particularly for startups and units in growth phase.
- A leaders forum or umbrella body on Risk Capital development and financing.
- Examine the setting up of MSME exchange.
- Adopt and adapt the successful international experience, products / services to help MSMEs effectively access the Risk Capital and introduce sustainable business practices to ensure long term profitability, growth and competitiveness.

Risk Capital and MSMEs

Report prepared under support of SME Financing and Development Project, SIDBI

By Indicus Analytics*

December, 2008



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Comments welcome at indic@indicus.net./ pmd_ndho@sidbi.in

Section 1

Background

Arguably, small industries are the most likely candidates for leading India's manufacturing growth in the coming decades. They can, provided the right environment exists, lead both output and employment growth. The question, of course, is what should this 'right environment' be? The 'right environment' would be one where the entrepreneurs have the flexibility and freedom to make full use of the opportunities of a free economy and a free trading regime. At the same time, the environment would be such that the best performers would be rewarded by way of growth and profits

Let us first identify the key constraints that are faced by all types of MSMEs and across all sectors:

1. Credit availability and their terms
2. Delays in credit availability
3. Inspector Raj – multiple inspectors, multiple inspections
4. Complex Labour Laws
5. Bankruptcy/insolvency procedures

Of course, there are many more sector specific issues, but the above span all sectors. Each of these has a direct or indirect bearing on risk-capital, and it needs to be recognized, that if the government is envisaging market based risk capital provision, then it would need to address the long term growth issues affecting the MSME sector.

Most studies on MSMEs, whether national or international, identify access to capital as a major constraint in their growth and expansion. And access to risk capital that is timely and adequate is a critical issue in India as well. What is risk capital? Why is it important? What are the solutions? How can these solutions be implemented? These are some of the questions that this exercise will attempt to address.

MSMEs have been at the center of the policy debate for many decades and there is a large literature on their functioning and significant learning on the various constraints that are faced by them and resultantly their sub-optimal contribution to the cause of equity and growth. It is now well known that:

1. A larger share of MSMEs in manufacturing is associated with greater economic growth.
2. Smaller firms are more constrained and affected by financial underdevelopment.

Box No. 1 MSMEs and Problem of Finance

There are an estimated 133.67 lakh registered and unregistered micro and small enterprises (MSEs) in the country at the end of March 2008[Provisional], providing employment to an estimated 322.28 lakh persons*. The MSE sector contributes about 39% of the manufacturing sector output and 33% of the nation's exports. Of all the problems faced by the MSEs, non-availability of timely and adequate credit at reasonable interest rate is one of the most important. One of the major causes for low availability of bank finance to this sector is the high-risk perception of the banks in lending to MSEs and consequent insistence on collaterals, which are not easily available with these enterprises.

Source: National Manufacturing Competitiveness Commission; * SIDBI Annual Report FY 2008

A large multi-country study by the World Bank (Levine et. al. 2003) has shown that there was a strong positive link between the MSME sector and GDP growth as measured by per capita GDP growth and growth in the MSME sector in the 1990s. However it was also found that there were many country level idiosyncrasies and as a result the link between MSME and poverty, or causality between MSME and economic progress was not as clear-cut. Be that as it may, both hard data and experiences have incontrovertibly established that sustained economic growth and equitable progress are difficult to achieve if the MSME sector is constrained.

Given this, why is it that equity capital remains a core gap where the MSME sector is concerned? The reasons are many, including the lack of focus of policies governing the MSME sector towards this issue, to an improper design of such means, to simply changing economic environment – the shift towards greater role of market based incentives and lesser of government fiat, etc. It is, therefore, critical that any new regime aimed at directing risk capital towards the MSME sector understands the core characteristics of the MSME sector and the entrepreneur. These issues are discussed later.

It is evident that an enabling environment for MSME financing has consequences far beyond economic growth. Innovation, employment generation, international competitiveness, inequality and inclusiveness in progress – all are associated with a more enabling MSME environment.

India's great success in the post-reform period is not just a story of large companies. Corporates that were non-existent or would have been classified as MSME during the early reform years have been at the forefront of India's great IT sector success. Despite these successes, there is a well known problem of ensuring finances for the MSME Sector. This is reflected in the falling share of commercial bank credit that goes to the SSI sector since the

NON FOOD GROSS BANK CREDIT TO SSIs [Rs. Crore]

Year	To SSIs	Non Food Gross Bank Credit	%
1990-91	17181	113513	15.14
2000-01	56002	429162	13.05
2001-02	57199	482749	11.84
2002-03	60394	620055	9.74
2003-04	65855	728422	9.04
2004-05	74588	999788	7.46
2005-06	91212	1404840	6.49
2006-07	117880	1801239	6.54
2007-08	155804	2203038	7.07

Source: Handbook of Statistics on Indian Economy, October 08, 2008 nineties. Lending to SSI sector accounted for 15 percent of bank credit in year 1990-91 and has declined to 6.49 percent in 2006 (though not in absolute terms). However, the same has shown upward trend in 2007 and 2008 by recording 6.54 and 7.07 percent respectively. In other words, aggregate bank credit has been growing and may even have grown more rapidly in the recent past, the long term trends strongly indicate that the non-SSI sectors are obtaining a greater and greater share of credit.

There have been some approaches to overcome the MSME finance gap internationally. The first is to broaden the collateral based approach to include MSMEs and entrepreneurs with insufficient collateral. This is largely done through a third party providing the collateral or a guarantee. The second has been to broaden the viability based approach. Since the viability-based approach is concerned with the business itself, the approach is to provide business development assistance to reduce risk and increase returns. This is driven through the detailed review and assistance with the business plan. A third approach is to link capital inflows with the cash flows of the MSMEs. This takes many forms such as factoring and mezzanine finance. The following section will review these in the Indian context and provide an overview of various institutional structures that can enable the spread of such financing mechanisms to the MSME sector.

The rest of this monograph proceeds as follow:

1. Section two briefly reviews the definitional and coverage aspects of risk-capital.
2. Section three describes the various types of risk capital options that are prevalent internationally and that are possible in India as well.
3. Section four points out the directions for reform so as to create a well-functioning ecosystem of risk-capital availability for the MSME sector.
4. The concluding note follows this section. The Appendix lays out the qualitative characteristics of an MSME that have a bearing on the market for risk- capital emerging, and consequently MSMEs' ability to access risk capital. Any discussion on providing greater risk capital options to the entrepreneur needs to be based on these realities of small business.

Section 2

Risk Capital: A Brief[1]

Risk capital denotes the provision of capital where the provider reduces the risk burden of the entrepreneur, and in turn bears some part of the overall risk involved in a productive activity. As per a definition widely used in India – The term 'risk capital' includes equity as well as mezzanine/ quasi equity financial products that have features of both debt and equity. The mezzanine instruments rank behind senior debt, but ahead of ordinary equity, in terms of payment of interest/dividend in the event of winding up or liquidation. Quasi/ mezzanine finance is generally an unsecured structured investment/ debt with a component of cash income (from interest/ dividend) and benefits from additional potential upside return from equity participation (from warrants, convertibles, options, royalties or some other hybrid structure). Within these broad definitions, there are yet other types of risk capital and these vary depending upon the stage and activity of the MSME. Broadly, however, these can be divided into two categories: 'Collateral' based and 'Information' based. Apart from debt based on collateral, there also exists the factoring based finance where future inflows based on reliable contracts are used as a means to guarantee repayment. Information based financing has been the traditional way for friends and family to provide finance to the MSMEs based on their perception and expectation of the entrepreneurs ability and intention to repay. However, newer forms of finance such as venture capital also essentially depend upon the information provided through financial statements, entrepreneurs' abilities and credit scoring techniques, to provide finance.

The most significant problem with the collateral based approach is the lack of adequate assets for collateral for a large number of entrepreneurs and potential entrepreneurs. Therefore, various forms of information based (or non-collateral) approaches are becoming more popular. However, the non-collateral based approaches have significant informational requirements required to derive the viability of the project and the associated costs required to provide business development assistance. Such credible and verifiable information is difficult and costly to generate. But as technology and information sharing improves over time, this approach will become increasingly important. Notwithstanding the forms of risk capital, it is evident that the type is also closely linked to the stage of development of the MSME.

Financing Source of MSMEs by Stage of Development	
Seed Stage	Informal equity from founder and associates. FI/Bank loan/equity, if available and needed.
Start-up Stage	Informal equity from founder and associates and contacts. Bank loan, if available. Leasing for equipment.
Expansion Stage	Equity from original sources, plus trade investments or venture capital. Loans from banks. Other sources of finance including leasing and factoring.

1 This and the following section draws from (I) en.wikipedia.org/wiki /SME_finance, and (ii) SIDBI Report on Small Scale Industries Sector of various years.

Moreover, in several countries, the state (government) supports risk capital programs for smaller businesses (especially start up and growth stage) by providing long term funds at concessional rates. German sub-ordinate capital program is one example of such initiatives.

A commercial bank may be unable to provide finance to a viable MSME because of:

- Lack of a track record
- Inadequate security;
- Breach of a threshold limit;
- A credit rating outside an acceptable range.

Compounding this often is 'information failure' - even where appropriate (public or private) schemes exist, MSMEs may not be aware of them. Furthermore, sometimes the process of applying for finance may be so complex and time-consuming that even where MSMEs are aware of schemes, they are unwilling to make use of them.

Type of Instrument	Typical Source Internationally
Formal Equity - Venture Capital	Venture Capital Funds, Banks
Informal Equity – Business Angels	Networks of investors and individual investors
Loan Finance	Banks and funds operated by development agencies
Micro Credit	Specialist funds
Guarantees	Guarantee funds and mutual guarantee associations

Note that to meet the needs of MSMEs, funding sources supported by public authorities often offer a range of financing solutions and do not just concentrate on one instrument. Similarly, funding organizations often concentrate on assisting particular types of MSMEs (e.g. firms at different stages of development or in priority sectors as the case may be).

Relationship between Financing Instruments and MSME stage of Development

Venture Financing Method

	Formal Equity	Informal Equity	Loans	Guarantees
Micro Credits			X	X
Seed Capital	X	XX	XX	X
Start Up	X	XX	XX	XX
Expansion	XX	X	XX	XX

Box No. 2: Risk Capital Requirement

It is generally known that there is a gap in risk capital requirement in India vis-à-vis its availability for technology start-ups, in particular for an early stage start-ups. The gap is for both: Equity and Debt capital. Though pure debt capital is not included in our ambit the constraints on obtaining adequate debt capital further enhances the importance of the risk capital mechanisms considered here. It is extremely difficult to avail debts from banking channels for small and medium enterprises, both due to regulatory and other institutional requirements. Even Government agencies that have programmes for commercial lending tend to depend on collateral. This reduces the ability of the MSME entrepreneur to access debt and, therefore, makes it more difficult for him to efficiently leverage debt-equity. Similar issues affect his ability to access working capital requirements. The dependence on risk-capital mechanisms such as equity therefore is further enhanced.

Equity Capital

There is a positive trend for availability of early stage equity funding in India, with some institutional VCs having entered in this space. However, the availability is not in ample while the demand for venture capital is growing very fast. Also, current focus of early stage investors is limited in proven areas such as IT, communication (mobile, internet etc.) and software areas. Whereas new ventures are coming up in other engineering branches, including technology hardware which require larger amount of investment, and some cases for longer duration. Risk capital is also needed for creation of early stage firms which becomes a competitive pipeline for later stage VCs.

Following are some of the examples which justify need of the risk capital in the form of equity on various fronts:

1. **By and large, there is no equity capital available for pre-revenue companies even in proven technology domains, let alone other technology areas. Angel network is almost non-existent in this space.**
2. **For IP and product base companies, time duration of idea-to-product and product-to-market is relatively longer. This requires early stage equity for their survival. Further, for hardware companies, amount of investment is also relatively larger, which is generally not available at an idea level.**
3. **For the sectors which do not have a history of VC investment in India (e.g. auto components or similar other traditional engineering branches), there is a lesser understanding of these sectors. These sectors do not attract VC funds. On the other side, entrepreneurial ventures are coming up in these sectors that call for need of early stage funding in these sectors.**
4. **Sometimes, VCs are willing to take risk in lesser explored domains or at a very early stage provided that there is another funding agency which is willing to share the risk. Also there is a need to involve large corporates investing in MSME. So is the case for global VCs who do not invest in early stage. Government resources can be effectively utilised for encouraging global institutional VCs and corporates.**
5. **In some cases, debt capital is available. However, there is also a requirement of margin money in equity form. Government resources can contribute to meeting this requirement.**
6. **Risk capital from Government resources can also be utilised to fund R&D activities to technically competent team even if such team operates independent of academic & research institutes.**
7. **Specific funds for successful incubators to cater to at a very early stage or at the point of the graduation of the companies**

Source: SIDBI

Section 3

Risk Capital and Supplementing Mechanisms[2]

3.1 Risk Capital

3.1A Venture/Equity Funds

Venture funds typically provide equity and may or may not also provide tied credit. Good quality venture funding can improve the credit rating of the company allowing it to access commercial loans or other forms of finance.

ADVANTAGES	DISADVANTAGES
• For MSMEs, a source of risk capital which will improve the balance sheet structure and may enable the company to access further finance through loans etc. • For the investment fund, a high risk investment which may offer the possibility of high returns.	• For MSMEs, the sale of a part of the business will both dilute the proprietor's interest and bring in a minority owner whose interest must be respected. • Reporting to and getting permission from the finance provider reduces operational flexibilities. • For the investment fund, a minority stake in a business that may be difficult to sell when the fund is looking to exit its investment.

The investment conditions and restriction in respect of Venture Capital Funds(SEBI Guidelines) appear in Appendix I

Critical Issues

In the equity based approach, a critical issue is the exit route for the finance provider. The most successful investments will be the subject of a trade sale, or an IPO. It is likely, however, that the fund will be left with a number of small equity stakes in MSMEs which cannot be disposed of in this way. Some funds make arrangements for these investments to be transferred into a separate entity at the end of the life of the fund and for the investments to be managed by another entity. However, expected problems with exit has a serious impact of funds' entry into these areas.

2 This section draws extensively from (I)Guide to Risk Capital Financing in Regional Policy, 2002, Centre for Strategy and Evaluation Services, European Commission

3.1B Angel Investors

Angels are typically high net worth individuals who wish to invest some of their surplus funds in new ventures. Often, the individuals concerned are highly motivated entrepreneurs who have considerable experience of running their own companies. In many cases they also are networked with the entrepreneur either through family or friends' networks.

ADVANTAGES	DISADVANTAGES
• For the MSME, a source of capital and advice at an early stage in the development of the company. The right advice can also help in strengthening the company. • For the investor, the opportunity to make high returns from investing at an early stage in an MSME. • For public authorities, angel schemes can increase the supply of risk capital and advice at little cost to public funds.	• For the MSME, there is a need to sell part of the equity stake in the company. Some companies are unwilling to bring in an external investor. • For the investor, there is a high level of risk. Research suggests that only one investment in five provides significant profits internationally. And a minority stake in an MSME provides little control and may be difficult to sell. • For both the investor and the MSME, there is a risk that the relationship between the investor and the MSME manager might break down and formal arbitration is rarely feasible in such cases.

3.1C Public Listing

MSMEs with a good track record should also be able to access funding from the public through the public listing process first through the initial public offer (IPO). However, the IPO route is limited in that it is only possible for those who have established a strong record of past performance and reputation in the market. Most importantly, however, having a functioning IPO regime for MSMEs is essential as it enables the entry of other types of risk capital (for instance VC or Angel investors) in the earlier stage and make an exit in their investment through listing gains.

The above are some of the most popular means of MSME financing internationally. Whether they are successful or not, depends critically on whether they are in sync with the idiosyncrasies of a small business, and the larger institutional framework in the financing sector for MSMEs. The following section briefly lists some of the idiosyncrasies that any new MSME risk-capital regime will need to build-in.

In summary therefore a range of mechanisms exist in India and abroad that can be introduced or strengthened. Of course the basic characteristics of the smaller scale productive activity need to be kept in mind as well as specificities related to operating in India need to be built in. The next section discusses the various options that are required.

Box No.3 [Small Company] Shares Find a Home on London Exchange

LONDON, March 30 - One company's top product is a numbing aerosol spray, which it claims can help some men improve sexual performance. Another business strategy involves stripping abandoned cargo from sunken ships. And a third says it plans to explore for oil in a field that the Sudanese People's Liberation Movement, a former rebel group, claims it controls. None of the three companies have ever made a profit but they have all gone public recently on London's Alternative Investment Market, the British small-company stock exchange.

The market, known as AIM, bills itself as "the most successful growth market in the world," and it has been living up to the slogan in recent months. In 2004, 335 new companies listed on AIM, more than double the year before. More than 100 of these came from outside the United Kingdom. The exchange's overall market capitalization reached $60.9 billion by year-end, outstripping Tokyo's small-cap market, its closest stock exchange competitor, by almost $30 billion.

Stock exchanges for small companies are often shunned by mainstream investors, who view them as speculative and unregulated markets, potentially ripe for corruption and misrepresentation. Similar markets in Germany and Vancouver started out well and then failed, or had to merge to survive. But so far, the investor frenzy at AIM shows no sign of slowing this year. Fifty new companies, including Plethora Solutions, the spray drug company, plan to list on AIM in March, a record month for the decade-old market.

Since it was founded in 1995, AIM has evolved from a tiny offshoot of the London Stock Exchange, popular with private investors with an appetite for high risk, to a market that draws half its capital from institutions. A host of small companies now look to AIM when they need money to grow, rather than to venture capital, private equity or bank investors.

"AIM has re-emerged as a market of first choice for companies seeking development or expansion finance," said a recent report by the accounting firm, Deloitte & Touche. AIM suffered a setback, along with other major markets, in 2001. But some investors and bankers are starting to ask whether AIM's popularity, which owes much to an unabashedly unregulated structure, could ultimately become its undoing.

"How long the AIM flotation window remains open, I'm not sure, because it only takes one high-profile blow-up" to hurt the market, said Simon Raggett, a managing director at Strand Partners, a London financial firm that advises AIM companies.

The unique quality of the companies offering shares and the concern over the nature of those companies both stem from AIM's unusual listing rules: although a company has to prepare a prospectus to join the market, it does not need to demonstrate an operating history, meet a minimum listing size or have its financials vetted by the London Stock Exchange, which oversees the alternative exchange.

What they need to have instead is an exchange-approved "Nomad" or nominating adviser, generally a bank, accountant or law firm, which vouches that a company's reports are factual and that its business and growth plans are sound. In return, the company pays what is often a six-figure fee to the Nomad. In 10 years, only a handful of AIM companies and Nomads have been publicly fined by the stock exchange for wrongdoing, and just 3 percent of the companies listed on AIM have gone bankrupt.

Source: New York Times, March 31, 2005, Heather Timmons
Update: Till October 2008, approximately 1600 companies were listed on AIM

3.2 Supplement to Risk Capital

3.2 A Loan Funds

Like venture capital funds (which also often provide loan finance), a pure loan fund supported by the Structural Funds can be leveraged by using private capital to create a greater impact. A loan fund will typically seek to avoid displacing the commercial provision of loans – if an MSME borrower can obtain funding from a commercial source, it should do so. Accordingly, MSMEs with the lowest credit risks (including those offering adequate collateral) are likely to be excluded. The objective for the fund is to find the most appropriate borrowers from the remaining group.

ADVANTAGES	DISADVANTAGES
• Loan schemes are a major source of capital for MSMEs seeking developmental finance. • Some loan schemes can offer loans on an unsecured basis, thereby facilitating MSME access to finance. • For public authorities, a medium risk investment which may offer good leverage to other sources of capital with the prospects of all or some of the original investment being available for re-use.	• Usually, lenders will require collateral or will go through a credit scoring process which may discriminate against start-up companies, which often lack collateral, and may, therefore, have to pay a guarantee premium to obtain credit. • Loans must be seen in the context of other forms of finance, including an adequate amount of equity capital.

3.2 B Guarantee Associations

Guarantee Funds or Guarantee Associations issue guarantees to MSMEs in order to facilitate access to external finance (mainly loan-based, but also equity) in return for a fee to cover both the risk and administrative and processing costs. Guarantees are an appropriate financial instrument in cases where MSMEs are unable to provide the lender – typically a bank/FI or a leasing company with the necessary collateral to gain access to finance on reasonable terms. The guarantee instrument is typically used by new business start-ups and fast-growing, innovation-oriented companies. There are two main types of guarantee schemes, with some similarities between the two:

- Guarantee Funds – these are usually publicly funded by regional or national authorities. They provide guarantees either directly to MSMEs, or indirectly by counter-guaranteeing loan commitments made by mutual guarantee associations. Some guarantee funds also offer loans targeted at MSMEs/ micro-enterprises. [See Box No.4].
- Mutual Guarantee Associations - established by MSMEs, business federations or Chambers of Commerce, sometimes in partnership with banks. By grouping together as a cooperative, mutual guarantee associations are able to negotiate bank loans on preferential financial terms and are often also able to provide professional business support services to clients, drawing on their in-depth specialized knowledge of the business sectors in which they operate.

Box No.4: Credit Guarantee Fund Scheme

Micro and Small Enterprises, particularly the first generation of entrepreneurs, face difficulties in accessing bank credit because of their inability to provide adequate collateral security for loans. Considering this, the Government launched the Credit Guarantee Fund Scheme for Small Industries on 30th August, 2000 with a view to alleviating the problem of collateral security and impediment to flow of credit to Micro and Small Scale Industries (SSI) sector.

The Government approved the Credit Guarantee Fund Scheme for Small Industries on 19th May, 2000 with the objective of making available credit to SSI units, particularly tiny units, for loans up to Rs. 10 lakhs without collateral/third party guarantees. The Ministry of Micro, Small and Medium Enterprises and Small Industries Development Bank of India (SIDBI), established a Trust named Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) to implement the Credit Guarantee Fund Scheme for Micro and Small Enterprises. The corpus of CGTMSE is being contributed by the Government and SIDBI in the ratio of 4:1 respectively. The Settlors have contributed Rs.1736.68 crore to the corpus of the Trust (as on November 30, 2008). [GoI's share – Rs. 1389.34 crore and SIDBI's share – Rs. 347.34 crore]

The scheme was formally launched on August 30, 2000 and is operational with effect from 1st January, 2001. Subsequently, the Government decided to increase the eligibility limit of loans to be guaranteed from Rs. 10 lakhs to Rs. 25 lakhs and Rs 50 lakh thereafter. Both the existing and the new enterprises are eligible to be covered under the scheme. Eligible institutions include all scheduled commercial banks and Regional Rural Banks (categorized under "sustainable viability") or such of those institutions as may be directed by GOI.

As on November 30, 2008, 122888 proposals from micro and small enterprises have been approved for guarantee cover for aggregate credit of Rs. 3717.51 crore. As a result of increased awareness campaigns of CGTMSE and active support of all the stakeholders, the pace of proposals being accepted for guarantee cover has gone up significantly. A year-wise growth position is indicated in the table below:

Period	Number of proposals Approved	Credit Amount Approved	Cumulative Guarantee Approved
FY 2000-01	951	6.06	6.06
FY 2001-02	2296	29.52	35.58
FY 2002-03	4955	58.67	94.25
FY 2003-04	6603	117.60	211.85
FY 2004-05	9516	326.77	538.62
FY 2005-06*	16284	461.91	1000.53
FY 2006-07	27457	704.53	1705.06
FY 2007-08	30285	1055.84	2701.59
FY 2008-09**	26210	1062.12	3717.51

* For FY 2005-06 the data is being culled facility-wise; **Data as on November 30, 2008 [8 Months]
Source: CGTMSE

The name of the fund was changed to Credit Guarantee Fund Trust for Micro and Small enterprises[CGTMSE] w.e.f. July 2, 2007 consequent to the enactment of the MSME Act.

BoX No. 5 Risk Sharing Facility

World Bank led SME Financing and Development Project (SMEFDP) of SIDBI has supported a pilot initiative on Risk Sharing Facility (RSF) through CGTMSE. RSF aims at accelerating bank financing to MSMEs. Under the scheme, CGTMSE is providing partial credit guarantees, sharing up to 50% of the credit risk (Principal only) on a pari passu basis (for loans between Rs 50 lakh to Rs 100 lakh) with participating commercial banks / FI who have signed MOU with CGTMSE for implementing of RSF. The loans eligible for RSF guarantees include loans to MSEs across sectors, including manufacturing and service sector entities. By sharing credit risk of participating banks and other Financial Institutions, while at the same time making participation contingent on better credit assessment and risk identification by banks, the RSF will help the participating banks / Financial Institutions build up a track record of good MSME lending. This is expected to encourage banks to scale-up lending to MSMEs, and to price these loans more appropriately, with sector-wide demonstration effects. The scheme has already gone on stream. Depending on the outcome of the above pilot initiative, scaling up RSF would be considered by the Project.

Guarantees work on the principle of shared risk between the lending institution and the guarantee association, which typically covers between 40 and 80% of the loan value, significantly reducing the degree of risk for the lending institution.

ADVANTAGES	DISADVANTAGES
• Facilitates access to loan finance on improved financial terms for those MSMEs (i.e. self employed, micro-enterprises, start-ups) which cannot easily get access to finance (poor credit history, little or no collateral, lack of trading record). • Principle of risk sharing between the guarantee association or fund and the lending institution reduces risk and leverages private sector lending. • For Public Authorities, guarantee associations and guarantee funds help to leverage private sector finance for MSME promotion. • Rigorous screening procedures and detailed knowledge of the business sectors in which clients operate reduces risk of MSME default. • Guarantee associations and guarantee funds provide local input and sometimes tailored business support and advice • Guarantee associations and guarantee funds revolve the use of their own funds.	• Guarantee Associations and Guarantee Funds usually cover only part of the credit risk and often apply to only a limited range of financial instruments. • By reducing the exposure of banks to risks, guarantee schemes may also reduce the extent to which banks vet new loan applications. • Requires the creation and/or existence of strong associations that can ensure ethical practices on the part of the entrepreneur. • Such groups typically take many years to set-up and operationalize.

3.2 C Micro Finance

Micro finance is typically designed for those businesses that are unable to access the formal banking system because of the small financing requirements. The high cost of providing a small loan and associated credit assessment and high risk associated with the start-up phase of the enterprise may lead this to be the preferred option.

Micro finance is typically aimed at very specific target groups of individuals or very small businesses. An instance is finance for disadvantaged social groups – for example, credit schemes for women, young people, the unemployed, people with special needs, ethnic minorities, etc (this is also sometimes referred to as 'social' finance).

ADVANTAGES	DISADVANTAGES
• Meets a market failure in starting and developing micro businesses • Some micro finance schemes can offer loans on an unsecured basis, thereby facilitating MSME access to finance • For public authorities, a means of developing micro businesses and reaching disadvantaged people.	• The costs of setting up and administering loans will be high in relation to the loan amounts involved • Only addresses very small requirements • Requires the presence of a homogenous and well networked social group whose members can then be financed.

Section 4

Enabling a Proactive Risk Capital Ecosystem[3]

There are some critical qualitative characteristics of MSMEs that make them very different from the larger corporate sector (see Appendix). These include: the need for flexibility in operations, the importance of tacit or implicit contracts sustained through personal relationships of the entrepreneur, importance of involvement of friends and family as creditors, guarantors, knowledge providers, dependence on a single credit provider, supplier and/or client, difficulty in accessing professional advice and expertise, susceptibility to minor shocks not within the control of the entrepreneur and difficulties associated with restructuring and graceful exit.

These affect the incentives, operations as well as the overall direction that the entrepreneur can take. Financers also recognize this, which in turn affects the ease and terms with which they are able to grant financing options to the entrepreneurs. A completely smooth ecosystem would be one that recognizes these as inherent to the functioning of MSMEs, and builds-in appropriately designed institutions and mechanisms of credit availability.

Previous sections have discussed the various options that are available along with their strengths and weaknesses. This section puts forth various recommendations on how they need to be instituted in India and strengthened. The last part of this section discusses the importance of certain over-arching principles that need to be a part of a good risk-capital ecosystem.

Broadly, the following stages exist in the development of a typical MSME – Seed, Start-up, and Expansion. The expansion stage can be further divided into different sub-stages. At each stage the requirements are different and what the entrepreneur can 'bring-to-the-table" also differ. A good ecosystem should also build in exit options for the entrepreneur and investor. The exit options in turn need to be present for both eventualities – whether the activity is successful or ends in financial failure.

The required risk-credit ecosystem, therefore, needs to have the following elements:

- Availability of risk capital at every stage
- Mentoring/advisory credit, with handholding
- Appropriate and adequate exit options for all stakeholders

The key characteristic of a good ecosystem is that various incentives for each of the stakeholders and players – both upstream and downstream – be synchronized and be in line with the requirements of the MSME and the entrepreneur.

Growth and efficiency objectives, as is well known, are best served when there is ease

3 This section draws from seminar on Risk Capital for SMEs held at the PHDCCI, New Delhi, on March 5th 2008, and from the Report of the Committee on Technology Innovation and Venture Capital, Planning Commission, July 2006.

of entry and exit, and where the environment facilitates and rewards efficiency. The openness of the Indian economy does provide some of elements. However, there are significant gaps that need to be addressed. An enabling ecosystem needs to address both issues simultaneously. That is, the supply of good 'quality' entrepreneurs and projects and the supply of risk-capital. These are discussed below.

Enabling ease of entry and exit of all players

Incubators[4]

Set up and energize incubators where technology and other higher educational institutions are partners. This will ensure that greater number of higher 'quality' projects can be created for later stage funding. Incubators help in many different ways; apart from helping the potential entrepreneur in the early stages, they also introduce the potential entrepreneur to the networks, commercial mind-set, mentoring, etc. Incubators can be setup as a part of existing institutions of higher learning, companies, or stand alone entities. A formal recognition of incubators as a priority sector activity is, therefore, another possibility in spreading incubators both in the public and private sectors. Some of the Indian initiatives are in Appendix II. For success of incubators the linkages with Angel networks and VC Funds needs to be strong. The incubators need to develop suitable mechanism to make available initial equity capital to the incubatees to take care of the initial expenses of manpower, product development, initial marketing, IPR cost etc.

Box No.6: Govt plans to set up business incubators for MSMEs

KOLKATA: To help spawn new ideas and technologies for the benefit of micro, small and medium enterprises (MSMEs), the concerned ministry is playing facilitator for setting up a host of incubating centres across the country.

The ministry has invited proposals from IITs, NIITs, technical institutions and universities to facilitate the setting up of business incubators. The proposals have been invited from those ones which already have in-house R&D and laboratory facilities.

The move has been taken by the ministry as part of its initiative to set up 100 business incubators across the country for Rs 80 crore during the 11th Plan period.

The scheme provides early stage funding for establishing incubators for innovative products/process to improve efficiency of MSMEs and enhance their competitiveness. Educational institutions, which would be chosen as incubators, would get central grants to the tune of 85% of the innovation cost, up to a cap of Rs 8 lakh per idea.

All the targeted business incubators will be located within established R&D institutes. So far, the mandate for each business incubator is to spawn 10 new ideas on process technology or product development or help setting up similar number of new units embracing innovative product lines.

Source: The Economic Times, 21 Jun, 2008, 0021 hrs IST,Ratna Ganguli, ET Bureau
http://economictimes.indiatimes.com/News/Economy/

4 Incubators are support programs designed to accelerate the successful development of entrepreneurial companies through a range of business support resources and services. These resources/services may be offered either in the incubator or through its network of contacts. Unlike research and technology parks incubators are dedicated towards start-up and early-stage companies. In 2005 alone, North American incubation programs assisted more than 27,000 companies that provided employment for more than 100,000 workers and generated annual revenues of $17 billion. See 2006 State of the Business Incubation Industry. L. Knopp, Athens, Ohio: National Business Incubation Association, 2007.

Angel Network

There are many different types of Angel clubs existing internationally; these have been highly successful in providing both risk-capital as well as mentoring for budding entrepreneurs, many of them at the seed stage itself. In an angel network, initially the business plan is seen by all the members briefly and a subset of the members may agree to finance the business. Each member puts in a relatively small amount but given adequate numbers the venture receives adequate financing. The angel network allows various 'angels' to coordinate their activities informally. The credibility of each angel becomes quite important and, therefore, each potential new member has to have the approval of all old members before he is admitted into the network.

Box No. 7: The Indian Angel Network, Delhi

The Indian Angel Network, for example, started in 1996, and brings together senior managers and successful entrepreneurs from a range of sectors. As per the networks' website, it has nearly 70 members who have made 12 investments in the last 24 months in multiple sectors like Information Technology, Mobile, Education, Internet, Intellectual Property and Hospitality, Advisory Services. The Network looks at investing from USD 100,000 to about USD 1 mn, and exiting over a 3 to 5 year period through an IPO, M&A or strategic sale. The Network may consider investments over a million dollars but is likely to do so through syndication.

The objective is 'to create disproportionate value' by bringing together those with expertise in India and internationally and from a range of sectors. This allows the network to access high quality and wide-ranging expertise, information and advice form its own members; and in turn allows the network to provide constant access to high quality mentoring, vast networks and inputs on strategy as well as execution to the entrepreneur. The network, therefore, considers proposals over a range of sectors, activities, and cities.

Source: http://www.indianangelnetwork.com

Despite the success of the angel network model internationally, there are very few angel networks in India as of now. There has been an expansion in such networks in the recent past, and this process will continue as greater and greater number of professionals achieve successes and start to invest their funds and expertise in other businesses. However, there are certain taxation and exit issues that affect the growth of this sector (see discussion below). Since the benefits from accelerating the growth of angel networks are quite large, appropriate and adequate policy action aimed specifically at this new source of funds is required.

Small Cap Exchange

Accelerate the setting up of a small cap exchange, either independently or as a part of the established exchanges. The characteristics of small companies do not match the requirements of the stock exchanges servicing larger companies. The example of AIM in the UK can be taken as a model. Ensuring easier IPOs for MSMEs is important, as easy exit will make it easier for VCs to enter. The entry of early stage investors, in turn, will be facilitated as the expectation of easier VC entry at later stages will ensure easier exit for them. This, in turn, will have a beneficial impact on entrepreneurial activity. SEBI has recently published a discussion paper in this regard and has invited comments. Accelerating the process of setting up a MSME stock trading mechanism is crucial.

Incentives for institutional and individual risk-credit providers

Different types of risk-capital providers, such as, VCs and individual angel investors need to be recognized as undertaking an activity with short-term losses and long-term gains. Appropriate tax and other incentives therefore need to be considered, which are in line with the objectives of a simple and unified taxation framework.

The Capital Gains taxation structure will also need to build-in the difference between earlier investments and mutual fund type investments. Each stage of development of the MSME requires a different type of investment, and the existence of a large number of investors that specialize in each stage would enable higher overall efficiency of the risk-capital ecosystem. In some cases, individual angels may bring in the right combination of funds and expertise, at others it may be a VC firm. Further, investors typically make profits only on a limited set of investments. And profits typically are received only in the long term. Moreover, the difference between long term and short-term capital gains is also not entirely appropriate for this sector[5]. This is because these investments are not purely speculative as they involve the transfer of knowledge, advice and also handholding; this holds even if the investor has invested only for a short period.

Consequently, the capital gains tax regime needs to be appropriately structured for this industry.

- This will need to distinguish between purely speculative investments and those where financial investments are also accompanied with some transfer of skills and expertise to the entity.
- Just as the government treats credit to the SSI sector as a priority sector activity in its financial policy, so must it treat it differently in its capital gains tax structure.
- Capital gains tax should typically not apply to early stage funding as the returns to the investor are not merely coming from the supply of finance but also from the supply of expertise, advice, as well as know-how. The fact that these are not measureable does not take away from the fact that they are critical in the success of the business. Having a one size fits all capital gains tax regime, therefore, works against growth of an adequate risk-capital ecosystem in the country[6].

Creating Examples

In areas such as seed stage funds, or funds devoted to specific economic activities, or

5 The economic rationale for the distinction between long and short term capital gains tax is that short term capital gains is more speculative in nature and therefore needs to be taxed more. But early stage, seed-stage, VCs, provide their expertise and knowledge in addition to the risk-capital.

6 As per Indian Venture Capital Association petition to the Finance Minister in March 2007, effectively there is only a deferment of capital gains tax at the hands of an investor, and not an exemption.

funds concentrating on specific geographical areas could be set-up with government support. However, such funds will need to have a time bound program of government support, after which market forces should decide their continuance. The overriding objective here is to create examples of successes in areas that private funding is reluctant to enter. If, however, successes are not generated, such funds will need to be wound down. An example is the long history of supporting development financing through semi public sector institutions, some of which are now considered to be within the private domain. A similar structure like the government attempted with housing finance, infrastructure finance, historically, needs to be strengthened for risk-capital funding for the MSMEs.

In the budget of 2008-09, GOI has announced setting up of a "Risk capital Fund for MSMEs" in SIDBI with a corpus of Rs. 2000 crore. SIDBI has set up an SBU (SIDBI foundation for Risk Capital) to manage the fund operations. SIDBI would use appropriate risk capital instruments for providing risk capital to the MSMEs keeping in view the nuances of the local conditions. A brief on the fund is annexed (Appendix III).

The key issue here is that risk capital for MSMEs is a high risk activity. Financial Institutions and Banks primarily do debt financing backed by assets. There is a need for channels to provide risk capital which will supplement the promoter contribution. Consequently, such high risk investments would be much better addressed by specialized institutions focused towards and risk capital for MSMEs and separate from conventional FIs.**

Insolvency

A financially unsuccessful MSE still has to repay all its creditors, workers, suppliers, FIs, government agencies, etc. Significantly, the labour and government dues are including the interest charges on the unpaid dues (which keep on adding up through lengthy procedural battles) and are recovered as land dues. Penal action (imprisonment) can be undertaken for the following class of outstanding dues:

- Financial dues (from State Finance Corporation, Bank, etc.)
- Utilities such as electricity, water etc.
- Tax related arrears like sales tax, income tax, etc.
- Social security arrears like wages, PF, bonus, etc.

Genuine failure of a small-scale industrial unit may be looked up as an economic problem. There is a need to remove the stigma associated with the business failure in social circles and a second chance needs to be offered to the genuine failures.

The regime-governing exit of the entrepreneur from a failed project needs to be overhauled. In most developed countries for instance the entrepreneur of a failed unit is not looked down upon, instead the failed unit is wrapped up and the entrepreneur is free to start again. Such an insolvency regime needs to be put in place for the Indian entrepreneur as well.

** Action proposed by SIDBI for the Risk Capital Funds in Appendix III

Enabling efficiency of entrepreneurs and credit providers

Venture Capitalist is one part of a long chain

Though the venture capitalist is an important provider of risk-capital, he is not the only one. A typical VC needs to be invested in a 3-5 year period, requires high return with easy exit, will rarely invest in early stage requirements, tends to be concentrated in a few areas/regions, etc. There should not, therefore, be over-arching reliance on VCs, but also on other forms of risk-capital providers. Consequently, efficiency in the risk-capital ecosystem will be best served if the needs of all types of credit providers are met. For instance, early stage investors typically have smaller investments, and, therefore, are more susceptible to high transaction costs.

Entrepreneurship 'Capital'

Entrepreneurship development programs in management institutions, R&D centers and technical institutions need to be instituted on a large scale. Historically in India, most MSME owners tend to be from families with business backgrounds. This works against the objective of an economy that supports individual ability and initiative. Educational programs can provide to the many who come from diverse backgrounds, the concepts critical to the success of small businesses. Such programs are available currently in a few institutions, but the total seats would be far below the requirements.

Box No. 8: Creating Facilitating Agencies

Assuming that the Government resources are available to make an enabling environment for technology and innovation based entrepreneurship, some of the suggestions are:

1. **Venture creation: Agencies that could facilitate technology commercialisation out of academic/ research institutes. These agencies could be linked to academic/ research institutes. They will have database of various technologies in these institutes, and competence to advise on venture feasibility, network of professional service providers and so on.**
2. **Patents and IP protections: IP protection, specially outside India require good amount of equity funding in the initial stages. Government agencies can fund such IP protections.**
3. **Exit mechanism: One of the major concerns for investors in early stage is an exit mechanism, specially when the invested start-up does not do too well. Nevertheless, there could be some residual value in these ventures. Information centres with database of various ventures, their technologies on one hand and potential acquirors, human skills sets etc. on the other hand can facilitate such tasks.**

Source: SIDBI

Certification and Testing: Reducing informational asymmetries

Institute referral services, laboratory facilities, process certifications via technical institutions and universities. Access to credible information is critical for the success of any venture. And high quality certification can aid both the entrepreneur as well as the credit provider and better understanding the strengths and weaknesses of the products and / or the venture.

Improving technology

Promote greater faculty and industry interaction by building in appropriate flexibilities and incentives for research staff. This will ensure better quality projects as well as generate a stronger technology backbone for new projects. Most MSMEs report insignificant or zero interaction with academic, R&D, and technical institutions; though MSMEs may have the incentive to improve their technologies, those in academia and doing research need to be similarly incentivised.

Technology improvement will also improve the efficiency of credit providers. Credit scoring and good quality ratings of the MSME sector would help risk capital providers in screening and prioritizing the better investment options. Such services are currently under development or nascent stage in the country. The participation of conventional FIs in sharing information as well as better coordinating their information gathering will accelerate this process.

Box No. 9: Improving Financial Technology for Credit to the SME Sector

Rapid strides within a short span of time have been made in recent times where financial technologies are concerned. The passage of the Credit Information Companies (Regulation) Act 2005 (CICRA 2005) through the parliament will further catalyse these activities, by improving access to information by ratings agencies.

Most small and medium companies rely on extremely expensive funds sourced from the unorganised financial sector. Part reason why bank credit is denied to many small units, despite repayment capacity not being suspect, is that lenders often do not have the capability to assess their risk. Rating agencies are a step in this direction. The Small and Medium Enterprise Rating Agency (SMERA) was launched in September 2005, as a joint initiative of SIDBI, Dun and Bradstreet and 11 banks. It has made significant progress in a very short span of time, with support from SMEFDP.

The Credit Information Bureau (CIBIL) is another example of the developments in this space. CIBIL's activities have gathered momentum since it launched its consumer bureau to provide credit information on individuals in 2004. The SME sector is serviced through CIBIL's Commercial Bureau, which has credit information on non-individual borrowers. This was launched in 2006, with a database of 6.73 Lakh accounts contributed by 37 members. Subsequently, its database has grown over 20.55 Lakh accounts contributed by 78 Members. The objective is that by providing greater, better and more exhaustive credit information on SMEs to the credit providing organizations, CIBIL is able to improve the overall credit flow to the under penetrated SME sector, and at the same time increasing FIs' profitability and penetration (due to better credit decisions) and reducing non-performing loans (via credit information tools).

Source: www.smera.in and www.cibil.com
Update: Till November, 2008

Entrepreneur's Access to Expertise

Strengthen the entrepreneur's accessibility to expertise in a range of areas

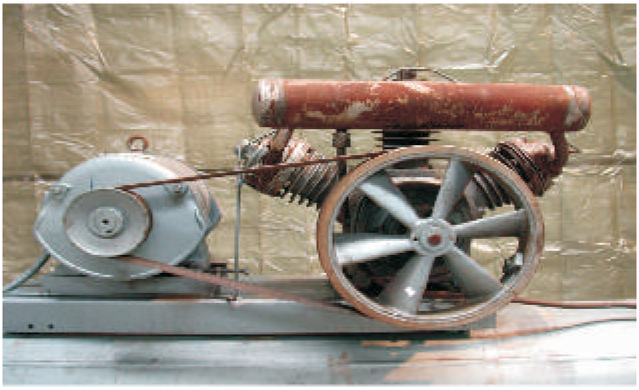
- Assistance with IPR filings
- Enable access to marketing, HR and other business development services for the MSME entrepreneur
- Enable formal and informal links between risk-capital providers, technology providers and entrepreneurs
- Overall business advice

Risk-capital Provider's Access to Expertise

Ensure that risk-capital providers have easy access to multiple sources of information on the industry, activity and the entrepreneur. This would require access to multiple and credible information sources on:

- Credit history,
- Payment history,
- Compliances,
- Record as an entrepreneur.

Currently there are few sources of credible information on specific sectors and productive activities that creditors can access. Some private information and consulting firms are attempting to bridge such gaps; however, government support is required for such information to be made available on a large enough scale. Sources such as the Registrar of Companies and Annual Survey of Industries provide information that is too outdated or sparse to be of much help.



Concluding Note

With greater emphasis on a market based economy that addresses the requirements of rapid and equitable progress, the role of MSMEs has only become more important. However, this also requires that there be greater entry and spread of the MSME sector. This, in turn, requires their access to financing with minimal transaction costs.

It is well recognized that unlike in many developed countries, Indian MSMEs do not currently have access to a well funded ecosystem of risk-capital availability. India, therefore, needs a properly designed and adequately resourced risk-capital regime. It will need to be a combination of many different routes. However, it will need to be based on Indian realities and the reality of the Indian MSME sector.

Merely creation of greater number of financing bodies is not the solution. The systems, rules, procedures, and practices governing the granting of capital, monitoring, and exiting will need to be thought through carefully. This, in turn, will require a multi-dimensional and multi-departmental approach, where human capital, expertise, financing, legal regimes, all need to be changed to suit the requirements of India's new MSMEs. These will not be dependent on government largesse and subsidies, but on the entrepreneurs ability to harness all available technologies and resources.

Already with government support, and also newer private initiatives, such an ecosystem is emerging. The government needs to catalyze these activities by removing the bottlenecks that prevent the market for risk capital from evolving.

Appendix: Generic Characteristics of MSMEs[7]

As mentioned before, qualitative issues related to the character of MSME and MSME operations need to be understood for a proper system of risk-capital allocations to be put in place. These are briefly addressed below.

Flexibility – Small businesses need to be highly flexible; they need to have the ability to quickly gauge new opportunities and to meet them. This, however, requires that the rules and permissions of the various partnerships/relationships allow them to do so. This tacit dimension, or the informality, is extremely important in setting up and expanding a small business that saves time, reduces costs, and makes the businesses highly flexible. At the same time, interactions in the formal dimension are highly time intensive. This, of course, goes against the major advantage of small businesses – that of rapid responses to temporary opportunities. The entrepreneur needs to be able to change the focus or the product or input mix, or the market being serviced without recourse to time consuming permissions from others. This is an extremely critical part of the MSMEs strengths and external risk capital needs to address this.

Personal Relationships – Credit facilities from financial institutions of any type are availed by any business on the basis of the project viability. However, that is not the only criteria. Though funds are granted on the basis of the viability of the project, they are almost always backed with personal relations of the entrepreneur with the fund giving staff. Given that a project is found to be financially viable by the financial institution (FI), the entrepreneur may still not be able to access the funds. This is because the 'character' of the entrepreneur plays an important, albeit, implicit role in credit transactions. If the FI staff is comfortable with the entrepreneur (which may be due to the entrepreneur being very good at selling his idea) funds may be granted. Associations and groups of MSME entrepreneurs are able to address this issue to some extent.

Family Involvement – Most small businesses have a very high level of family and friends' involvement. This is not idiosyncratic to India. Family and friends give credit, they stand as guarantors, they may provide general advice, etc. In most cases, unless required by law, there are no contracts, no paperwork that accompany this help. It is based on a general understanding of mutual dependence and informally shared benefits. The key point here is that, transaction costs are minimal in such interactions.

Single Credit Provider – As things stand today, few financial institutions are ready to finance an enterprise having a liability with some other financial institution. Once an entrepreneur takes a loan from an institution he is tied for most of his future financial requirements. This reduces the options for the entrepreneur. He has to function within the credit limits set by this institution, stifling his risk taking ability.

7 This section draws from Small Scale Industry in India: Large Scale Exit Problems, ed. Bibek Debroy and Laveesh Bhandari, Academic Foundation, New Delhi, 2005.

Lack of Professionals – Small businesses can rarely afford experts and professionals. This is not only true of technical experts, but also legal and financial experts, management consultants, project consultants, etc. Such business and engineering services are too costly for a small business. Their scales do not justify such costs. Even if some were available, because of their low ability to pay, good quality professionals cannot be accessed. That market is missing. As a consequence, small business in India depends only on the experiences of those personally networked with the entrepreneur.

Dependence on a single client – Many small businesses cater to the requirements of a single large organization. Many small firms have developed as a formal or informal ancillary unit of a large organization. This considerably reduces their bargaining power. Further, any turbulence in the large organization gets reflected on the functioning of the small unit. The existence of the small business unit, thus, becomes a function of the larger organizations performance, the entrepreneurs relationship with functionaries in this organization, and of course, the performance of the unit itself.

Susceptibility – Small units are highly susceptible to a single small shock. And given the generic way of operations of most financial institutions in India, there is not enough flexibility in the system; even a single shock is enough to drag a successful unit towards sickness. The entry of risk capital of any type will be highly dependent on the ease of exit. However, the bankruptcy and insolvency procedures make exit quite difficult. This, in turn, will affect the ability of the MSME entrepreneur to access risk capital. Unlike in the case of larger businesses, MSMEs cannot approach the BIFR. Unlike small entrepreneurs in USA, small firms in India cannot approach the government for a Chapter 11 like rehabilitation package. Rules and procedures prevent the entrepreneur from going to other banks for a rehabilitation package that his own bank does not offer.

Problem with Restructuring – The government had incorporated a number of committees to look into this aspect, but most of these committees have passed the baton to the RBI. The RBI has issued guidelines to enable banks to go for restructuring of Micro and Small Enterprises. But again, these guidelines are not mandatory and the decision rests with the concerned bank officials.

In order to deal with the problems of co-ordination for rehabilitation of sick small scale units, State Level Inter-Institutional Committees (SLIICs) have been set up in all the States. The meetings of these Committees are convened by Regional offices of RBI and presided over by the Secretary, Industry of the concerned State Government. It provides a useful forum for adequate interfacing between the State Government Officials and State Level Institutions on the one side and the term lending institutions and banks on the other. It, inter alia, reviews general problems faced by industries and sickness in SSI sector based on the data furnished by banks. Among others, the representatives of the local state level SSI associations are invited to the meetings of SLIIC which are held quarterly. A subcommittee of SLIIC looks into the problems of individual sick SSI unit and submits its recommendations to the forum of SLIIC for consideration.

Appendix I

1. Venture Capital Funds (VCF)- INVESTMENT CONDITIONS AND RESTRICTIONS – SEBI guidelines

SEBI Venture Capital Funds (Amendment) Regulations, 2000 as amended in 2006

- **Minimum investment in a Venture Capital Fund.**

(1) A venture capital fund may raise monies from any investor whether Indian, Foreign or non-resident Indian [by way of issue of units].

(2) No venture capital fund set up as a company or any scheme of a venture capital fund set up as a trust shall accept any investment from any investor which is less than five lakh rupees : Provided that nothing contained in sub-regulation (2) shall apply to investors who are,

(a) employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust;

(b) the employees of the fund manager or asset management company; or

(3) Each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors for contribution of an amount of at least rupees five crores before the start of operations by the venture capital fund.

- **Investment conditions and restrictions.**

Following conditions, namely:

(a) venture capital fund shall disclose the investment strategy at the time of application for registration;

(b) venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking;

1[(ba) venture capital fund may invest in securities of foreign companies subject to such conditions or guidelines that may be stipulated or issued by the Reserve Bank of India and the Board from time to time.]

(c) shall not invest in the associated companies; and

(d) venture capital fund shall make investment as enumerated below :

(i) at least 3[66.67%] of the investible funds shall be invested in unlisted equity shares or equity linked instruments 4[of venture capital undertaking].

(ii) Not more than 6[33.33%] of the investible funds may be invested by way of :

(a) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed;

(b) debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.

(c) preferential allotment of equity shares of a listed company subject to lock in period of one year;

(d) the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

Explanation 1.— For the purpose of these regulations, a "financially weak company" means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year."

(e) Special Purpose Vehicles which are created for the purpose of facilitating or promoting investment in accordance with these Regulations.

Investment by a Foreign VC

All investments to be made by a foreign venture capital investors shall be subject to the following conditions: -

(a) It shall disclose to the Board its investment strategy.

(b) It can invest its total funds committed in one venture capital fund.

It shall make investments as enumerated below:

(i) at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking.

(ii) not more than 33.33% of the investible funds may be invested by way of:

(a) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed;

(b) debt or debt instrument of a venture capital undertaking in which the [foreign venture capital investor] has already made an investment by way of equity.

(c) preferential allotment of equity shares of a listed company subject to lock in period of one year.

(d) the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

Explanation 1 - For the purpose of these regulations, a "financially weak company" means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year."

(e) Special Purpose Vehicles which are created for the purpose of facilitating or promoting investment in accordance with these Regulations.

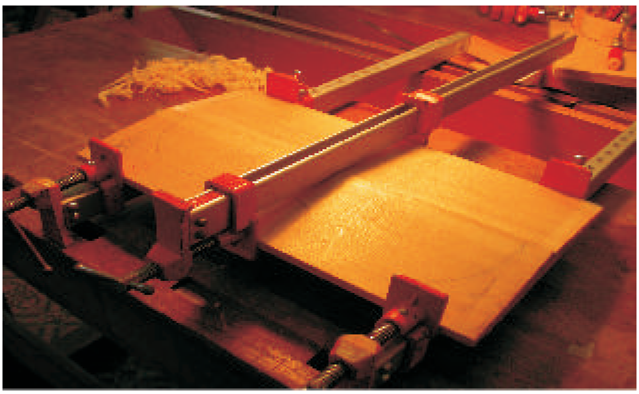
Note: For updations/application please visit SEBI website (www.sebi.gov.in)

1 Few Committies on Venture Capital

S. No.	Head	Chairman of the committee	Institution	Source
1	SEBI Venture Capital Guidelines	-	SEBI	www.sebi.gov.in
2	SEBI Guidelines for Venture Capital A. Domestic VCFs B. Foreign VCFs	-	SEBI	www.sebi.gov.in
3	Report on Technology Innovation and VC	Shri Nitin Desai	Planning Commission	www. planningcom mission.nic.in

2 Research/Studies on Venture Capital/Risk Capital/TI/Startups

S. No.	Name	Conducted by	Source
1	Survival of technology based small start-up companies	Centre for International Trade and Technology (CITT), IIFT	www.India.smetoolkit.org
2	Overcoming Barriers to Innovation for Indian SMEs	Stuti Kacker, IAS Joint Secretary, Government of India, Ministry of MSME New Delhi-110 011, INDIA	www.insme.org
3.	Assessing Early Stage Risk Capital in India	Rafiq Dossani, Stanford University & Asawari Desai, TiE Inc.	www.aparc.stanford.edu



Appendix II

INCUBATORS

1. National Small Industries Corporation (NSIC) – Training cum Incubation Centers

NSIC Training-cum-Incubation Centres (NSIC –TIC) are operated at various locations across the country. It provide an opportunity for first generation entrepreneurs to acquire skill on basic technical trades and gain exposure in all areas of business operations such as business skills development, identification of appropriate technology, hands on experience on working projects, project / product selection, opportunity guidance including commercial aspects of business. In order to expand its reach and impart such training to large number of unemployed people, NSIC plans to set up a number of franchise NSIC-TICs under Public-Private Partnership (PPP) mode in the country. website www.nsic.co.in

2. Incubation Support by DST

National Science & Technology Entrepreneurship Development Board (NSTEDB), Department of Science & Technology, **[source www.dst.gov.in]**

NSTEDB is an institutional mechanism to help promote knowledge driven and technology intensive enterprises. It has several schemes and Technology Business Incubators (TBI) is one of such unique initiatives. TBIs, besides providing a host of services to new enterprises (and also to existing SMEs in the region), also facilitate an atmosphere congenial for their survival and growth. The essential feature of a TBI is that the tenant companies leave the incubator space within 2-3 years. Each TBI focuses on not more than 2-3 thrust areas. Regarding legal status of new TBIs, they have to be registered as an autonomous body functioning as a society registered under societies act of 1860/or as a non profit making section 25 company. Each TBI is expected to become self sufficient within a period of five years from the date of sanction of the project.

NSTEDB provides financial assistance for creating state-of-art facilities in the identified thrust areas. It also offers partial /full support for recurring/operational cost for a period of five years.

3. SIDBI Innovation and Incubation Centre (SIIC)

SIDBI Innovation and Incubation Centre (SIIC) has been set up at Indian Institute of Technology, Kanpur carrying the objective of fostering entrepreneurship and developing industries in knowledge and technology-based areas, particularly for small enterprises. As on March 31, 2008, while four companies had graduated from the centre, another seven companies were working as incubatees in the diverse areas of state-of-art technologies and software development, etc. As on November 30, 2008, eight units had graduated from the centre.

Appendix III

SIDBI Foundation for Risk Capital (SFRC)

In the budget of 2008-09, GOI has announced setting up of a “Risk Capital Fund (RCF) for MSMEs” in SIDBI with a corpus of Rs. 2000 crore.MSMEs are traditionally dependant on promoters' equity and secured loans from banks for their long term capital requirements. SIDBI proposes to use the RCF to create an Institutional framework for providing long term risk capital to MSMEs of different size, constitution and segments, which would complement the promoters financial resources and available bank finance to MSMEs and help them in their growth and sustenance. SIDBI has set up an SBU (SIDBI Foundation for Risk Capital) to manage the fund operations. The foundation would, interalia, study successful models for risk capital for MSMEs in other parts of the world. SIDBI would use appropriate risk capital instruments for providing risk capital to the MSMEs keeping in view the nuances of the local conditions.

Keeping in view the large geographical spread of the MSMEs, SIDBI would use various channels for dispensing the risk capital assistance, including SIDBI's own branch network, SIDBI Venture Capital Ltd. [SVCL] and other MSME focused venture funds, Banks, etc. SIDBI also proposes to create a mentor network for supporting start up and early stage enterprises in the country.

Other References

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Kawai, Hiroki, and Shurijo Urata. (2002). "Entry of Small and Medium Enterprises and Economic Dynamism in Japan." Small Business Economics 18, 41-51.

Kumar, Krishna B., Raghuram G. Rajan, and Luigi Zingales. (2001). "What Determines Firms Size?" University of Chicago. CRSP Working Paper No. 496.

Small and Medium Enterprises, Growth, and Poverty: Cross-Country Evidence, Thorsten Beck, Asl1 Demirgt, and Ross Levine, World Bank Policy Research Working Paper 3178, December 2003

Small Industries Development Bank of India [SIDBI]

SIDBI was established on April 2, 1990 under an Act passed by Indian Parliament as the Principal Financial Institution for Financing, Promotion and Development of industries in the small scale sector and to coordinate the functions of other institutions engaged in similar activities.

Mission

"To empower the Micro, Small and Medium Enterprises (MSME) sector with a view to contributing to the process of economic growth, employment generation and balanced regional development".

Vision

To emerge as a single window for meeting the financial and developmental needs of the MSME sector to make it strong, vibrant and globally competitive, to position SIDBI Brand as the preferred and customer – friendly institution and for enhancement of share – holder wealth and highest corporate values through modern technology platform.

Since its inception, SIDBI has been endeavouring to meet the diverse needs of the MSMEs through various tailor – made schemes and fulfil its Vision as stated above.

Direct Finance

Term Loan Assistance – For setting up of new projects & for technology upgradation, diversification, expansion etc. of existing MSMEs, for Service sector entities & infrastructure development & upgradation.

Various other schemes e.g. working capital, Inland Letter of Credit, Guarantee Scheme, Equity Support, Vendor Development Scheme & bill discounting facility etc.

Equity Support – Provided to well run MSMEs to enable them to scale up their operations & take advantage of growth opportunities offered by the economy.

Strategic Business Initiatives – Vendor Development Scheme provides finance for capital Expenditure, Working Capital Term Loan & Customized invoice discounting/Bill discounting facility.

Equity Assistance Scheme

SIDBI has introduced a scheme for providing equity assistance to well performing MSME. The support is considered towards businesses set up by entrepreneurs with good track record, preferably in the same business line for A] modernization/expansion/ diversification, B] For marketing/R&D/ product development expenses, C] Working capital requirements, D) For acquisitions in India and abroad and E] Any other expenditure required for growth of the company.

SIDBI Foundation for Micro Credit [SFMC]

SFMC is a specialized deportment of SIDBI setup in 1999 for Micro credit with a mission to create a national network of strong noble and sustainable Micro Finance Institution [MFI] catering to poors. SFMC is an apex wholesaler for micro finance in India with a complete range of financial products such as loan, grant, equity, quasi equity etc. It has setup a risk fund with support of DFID for small NGOs /startups and unreserved states. It has been investing in MFI through equity/quasi equity instruments under SIDBI Growth Fund for MFIs [SGF-MFIs].

In keeping with its mission, SFMC identifies, nurtures and develops select potential MFIs as long term partners and provides credit support for their micro credit initiatives. Under the present dispensation, annual need based assistance is provided to enable MFIs to expand their scale of operations and achieve self sufficiency at the earliest. Lending is based strictly on an intensive in-house appraisal supplemented with the capacity assessment rating by an independent professional agency. Relaxed security norms have also been adopted to reduce procedural bottlenecks as well as to facilitate easy disbursements.

SIDBI Branch Network

Head Office: SIDBI Tower, 15 Ashok Marg, Lucknow - 226001, Uttar Pradesh, India
Tel: 0522-2288546-50 Fax: 0522-2288455-59 Telegram :LAGHUVIKAS

SIDBI has country-wide network of 79 branches to service the MSME sector efficiently:

Eastern Zone Branches										
Kolkata	Raipur	Patna	Durgapur	Gangtok	Jamshedpur	Rourkela	Bhubaneswar	Ranchi	Dhanbad	Bilaspur
Northern Zone Branches										
New Delhi	Chandigarh	Noida	Faridabad	Gurgaon	Dehradun	Ludhiana	Baddi	Jammu	Jaipur	Jalandhar
Jodhpur	Aligarh	Okhla	Rudrapur	Kundli	Janakpuri	Alwar	Bareilly	Roorkee		
Southern Zone Branches										
Chennai	Bangalore		Hyderabad	Visakhapatnam	Kochi	Puducherry	Ambattur	Hosur	Erode	Trichy
Hubli	Kozhikode	Peenya	Tirupur	Coimbatore	Balanagar	Vijayawada				
Western Zone Branches										
Nariman Point	Bandra-Kurla Complex		Andheri	Thane	Pune	Nagpur	Aurangabad	Panaji	Ahmedabad	Baroda
Chinchwad	Gandhidham	Kolhapur	Surat	Vapi	Indore	Bhopal	Nashik	Rajkot	Jamnagar	
UP Zone Branches										
Kanpur	Varanasi	Agra	Lucknow							
Guwahati Region										
Agartala	Guwahati	Itanagar	Aizwal	Imphal	Shillong	Dimapur				

For further details please contact nearest SIDBI branch

Toll free number: 1800226753
Website: www.sidbi.in and www.smefdp.net
Small Industries Development Bank of India

SIDBI has also setup following Associate Organizations to cater to specific needs of MSME sector:

SIDBI Venture Capital Ltd.(SVCL)	Credit Guarantee Fund Trust for Micro and Small Industries (CGTMSE)	SME Rating Agency of India Ltd. (SMERA)	India SME Technology Services Ltd. (ISTSL)	India SME Asset Reconstruction Company Ltd. (ISARC)
www.sidbiventure.co.in	www.cgtmse.in	www.smera.in	www.techsmall.com	www.isarc.in

edgecommunication@gmail.com

Project Management Division
Small Industries Development Bank of India
LGF, R. K. Khanna Tennis Stadium, Africa Avenue, New Delhi - 110029
Tel: 011-26186759 & 61 Fax:011-26186733
Email: pmd_ndho@sidbi.in, Web: www.smefdp.net