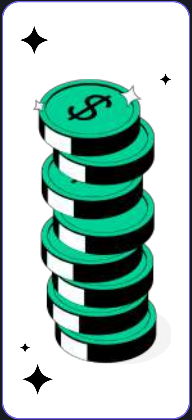
Getvantage | redseer Strategy Consultants

India Digital SME Credit Report 2023:

The $500 Bn Opportunity



Industry Partner

IAMAI

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About Redseer

Redseer is a leader in internet and new age advisory. Over the last 14 years of its operations, we have advised 200+ clients across the breadth of the internet and investment industry in India, Middle East, and Southeast Asia. Our advisory is differentiated through our high-quality IP of market insights and research, which is unparalleled in the industry. With more than 200 consultants across 5 offices, we have emerged as the largest home-grown regional consulting firm in India.

About IAMAI

Established in 2004, the Internet & Mobile Association of India (IAMAI) is a not-for-profit industry body and the country's only organization representing the digital services industry with over 500 Indian and multinational corporations as its members, which include established companies in diverse sectors of the digital ecosystem as well as start-ups. Its mandate is to expand and enhance the online and mobile value-added services sectors. It is dedicated to presenting a unified voice of the businesses it represents to the government, investors, consumers, and other stakeholders. IAMAI represents varied sectors, such as Digital Advertising, Digital Entertainment, TravelTech, Online Gaming, Digital Payments, FinTech, Digital Commerce, EdTech, HealthTech, and LogisticsTech to name a few.

About GetVantage

GetVantage is India's leading Alternative Financing (AltFi) platform for SMBs providing a powerful suite of non-dilutive capital solutions designed to make fundraising frictionless.

Built by founders for founders, the platform provides short-term growth capital between INR 2 Lakhs to INR 20 Crore for marketing, inventory, logistics, and other recurring CapEx to businesses.

In the last 3 years, GetVantage has facilitated funding for over 650+ businesses across 18+ sectors including B2B SaaS, CleanTech, Cloud-Kitchens, D2C, EV & Infrastructure, E-Commerce, EdTech, F&B, Healthtech, QSR, and many more.

Although the company pioneered the concept of tech-driven Revenue-Based Financing in India, it has quickly expanded to offer multiple equity-free funding options to suit the evolving needs of high-growth emerging businesses in the country. It has recently also established itself as the premier Embedded Financing (EmFi) partner for various enterprises looking to unlock new economic opportunities within their ecosystems.

The Mumbai headquartered company was founded in 2019 by seasoned fintech entrepreneur Bhavik Vasa and Tech & Ops veteran Amit Srivastava. GetVantage is backed by leading Indian and Japanese investors including Chiratae Ventures, Varanium, DMI, InCred, Sony and DI.

Foreword

India has seen steady digitization and growth for many years driven by strong socio-demographic fundamentals. However, in 2020, the pandemic precipitated a heavy push towards the digitization of the economy, especially affecting small scale enterprises and their workers across the nation. This has changed several facets of everyday business of Micro, Small and Medium enterprises. To understand the changes related to diversifying borrowing needs of these digitized SMEs, Redseer conducted proprietary research across a wide range of business segments and sectors.

We are pleased to present this report, which details the findings of our collaboration with IAMAI and industry partner GetVantage. Our insights suggest that there exists a huge capital gap which is essentially going to grow if the current market conditions persist. This builds a strong case for the need of alternate channels of finance such as revenue-based financing, that have the potential to do a lot more for the SME segment. The objective was to understand evolving capital needs of the digitized businesses and discover the funding challenges which inhibit SME growth. I believe the insights and takeaways contained within this report will add perspective towards the development of SME specific lending models.

Kanishka Mohan

Over the course of study, the team at Redseer brought their expertise and rigor to bear on the problem at hand, conducting interviews with key stakeholders, analyzing data and best practices, and developing a comprehensive understanding of the situation. I would like to express my appreciation for their outstanding work on this project.

I would also like to thank our empaneled experts for their valuable input and support throughout the process. Their contributions have been crucial in ensuring that the findings in this report are aligned with overarching goals and will be actionable in a specific context.

At last, I feel this report shares a path forward for these enterprises, both in essential and discretionary segments, to lead and win in the changing dynamics. We also lay out some interesting actions undertaken by these SMEs to address their versatile capital problems, to take advantage of the context. We hope you find this report informative and useful.

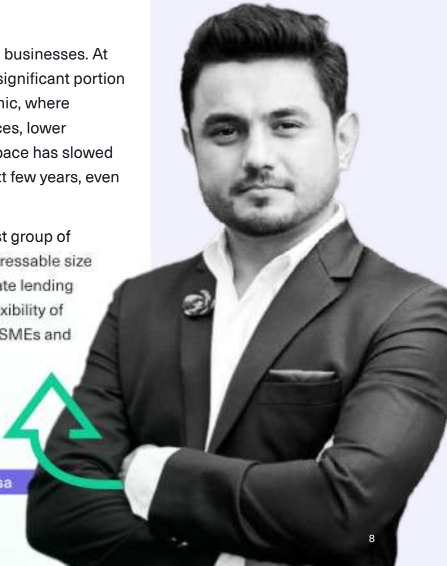
Kanishka Mohan
Partner, Redseer Strategy Consulting

Foreword

India is a nation of small businesses. The rampant digitization of commerce has also impacted small businesses. At present there are about 2.7 Mn SMEs that have been able to develop strong mechanisms to drive a significant portion of their sales through online channels. This surge in digitization was largely propelled by the pandemic, where businesses experienced the shift to online channels, access to significantly large consumer audiences, lower functional costs, and process optimization through the adoption of digital tools and systems. While pace has slowed as markets have reopened, the number of online businesses is likely to grow over 200% over the next few years, even by conservative estimates.

Until now there has been no clear data on the current and future working capital demand for this vast group of businesses fueling the economy. The report analyses the overall market to determine the actual addressable size across sectors including e-commerce, SaaS, etc., the current credit deficit, and explores how alternate lending solutions such as Revenue-Based Finance (RBF) have the potential to bridge this divide. The high flexibility of repayments, collateral-free structure, and data-driven offering are strong levers for India's emerging SMEs and e-commerce businesses to consider when thinking about fundraising for growth.

Through the research, Redseer conducted over 100+ interviews with stakeholders including banks, NBFCs, alternative-lending platforms, founders, and co-founders across sectors to identify the challenges and efforts to address the growing demand for credit amongst the vast ecosystem of India's emerging SMEs.



Bhavik Vasa

The report highlights that the current potential credit demand of digital SMEs in India is over USD 220 Bn. This is larger than the GDP of some developing nations. On the other hand, capital infused within the sector has only been able to address about 30% of this demand, creating an alarming working capital gap of over USD 150 Bn. This gap is likely to widen further, given the prevalent economic and regulatory setting. **As more businesses enter the market, it is evident that the demand for credit presents a potential to reach nearly USD 570 Bn in the next few years.**

A key outcome of the research is also the concurrent need for traditional lenders such as banks and NBFCs to partner with modern lending solutions, so as to provide quicker and more efficient access to capital to SMEs and beyond. Since traditional lenders tend to follow cumbersome procedures and require collateral and personal guarantees they are unable to meet the growing working capital demands of SMEs. **There is a distinct opportunity for banks, NBFCs and fintechs to collaborate, extend the ability of traditional lenders to reach and serve even non-conventional businesses and emerging sectors.**

I would like to thank IAMAI and Redseer through this research that not only brings to light the market gaps, but also includes nuances of the funding challenges faced by MSMEs.

Bhavik Vasa
Founder & CEO, GetVantage

Acknowledgments

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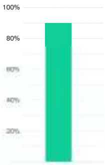
Executive Summary

India is a nation of small businesses and home to over 64 Mn MSMEs that collectively account for ~30% of India's GDP. While this sector is well accepted as the growth engine for India, it is also riddled with challenges that inhibit this growth. Limited digitization and strained access to capital are critical roadblocks that must be systemically alleviated in order to begin the development and empowerment of this sector. Digitization brings with it benefits of a larger audience, lower costs, and increased efficiency. While only 12% of MSMEs today have embraced digitization, it is expected that digitized businesses will grow sharply over the next 5 years.

Raising capital is yet another inhibitor, restraining the growth of India's small businesses. There are four major credit challenges that these businesses face: access to sufficient capital products, a lack of collateral to offer against loans, a high-risk perception among traditional lenders, and pedantic lending procedures that result in delayed loan disbursements. These challenges pose a threat to the success of digitized businesses that have an existing credit demand of USD 220 Bn (as of FY22) of which ~USD 165 Bn is serviceable. During FY'22, approximately USD 53 Bn was injected into the market through various lending channels, accounting for only 30% of the total addressable demand.

The resulting current working capital deficit of USD 112 Bn hinders businesses from innovating new products, building efficiencies, creating jobs, and scaling operations. SMEs then look towards informal lending channels and reinvest their revenues, further limiting their ability to build scalable and investable businesses.



Small businesses account for 90% of credit demand but continue to struggle to raise capital, owing to poor business metrics, limited assets, and uncertain growth projections.

If the current economic and regulatory climate continues, this gap is expected to widen significantly over the next five years.

Traditional lenders such as commercial banks have long struggled to provide adequate capital to SMEs primarily because of their need for collateral, credit history, cumbersome documentation and outdated procedures.

Alternate finance has emerged as a lifeline for small business owners comprising innovative lending models such as revenue-based finance, trade receivable financing, and so on. The models provide a high degree of flexibility, collateral-free lending, and are completely aligned with business growth, making them best suited for small businesses. Alternate finance presently constitutes ~5% of the lending market. Private credit is also continuing to grow at a fast pace due to a plethora of factors.

The shift of Non-Banking Financial Companies towards the retail sector is undoubtedly boosting the momentum of recently established private credit funds on the Alternative Investment Fund (AIF) platform. Additionally, there are indications of domestically sourced funds being utilized in successful credit strategies.

Bridging this capital deficit also requires targeted interventions on the financial, marketing and inclusion fronts. SME focused lending schemes that allow for collateral free loans, credit guarantees, and repayment of dues have become core action areas for the Government. The recent budget also postulates similar provisions comprising infusion of higher capital for SME welfare, extension of credit guarantees to the tune of USD 25 Bn as well as pushing for one stop digital repository of SME documentation.

As the MSME segment matures and penetration of digitization increases, lenders will receive deeper insights into businesses functions, making credit extension faster and transparent. This is where alternate finance is likely to add significant value owing to their platform first approach, technology and data-driven solutions, and highly flexible repayment models. Traditional lenders will also need to partner with new age fintechs and innovative financing platforms to give higher credit to a wider base of emerging businesses and meet their growing credit capital requirements.

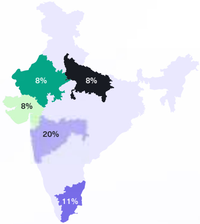
01

Micro, Small & Medium Enterprises (MSMEs) are experiencing rapid digitization

India is one of the world’s fastest growing economies and an independent GDP powerhouse with a thriving business ecosystem. At the center of this vibrant business ecosystem are MSMEs. Today, between ~64 Mn micro, small and medium sized enterprises are operating in India. These MSMEs collectively have contributed roughly one-third of India’s GDP over the last decade. Leading economists have pegged the sector to be the backbone of the Indian economy, contributing ~50% of India’s exports. MSMEs have also been responsible for the socio-economic development of semi-urban and rural areas of India.

In the coming five years, the Indian government plans to grow the economy to USD 5 Tn. Career options for the young must be created to accomplish this goal, and MSMEs have the ability to play a significant role in galvanizing employment.

As a result, the government has begun to promote MSMEs to add new jobs to the industry. The government also aims to increase MSME export participation and GDP output. India has 5 key MSME clusters spread across the states of Maharashtra (20%), Tamil Nadu (11%), Gujarat (8%), Uttar Pradesh (8%) Rajasthan (8%).



To guarantee sufficient liquidity is maintained in business operations, small and medium scale businesses need a significant financial stimulus from the government and financial institutions in the form of favorable working capital loans.

As per the provisions of the Micro, Small & Medium Enterprises Development (SMED) Act, 2006, MSMEs can be classified into two broad classes i.e., Manufacturing enterprises and Service enterprises. This report lays focus on the service sector enterprises that have embraced digitization.

Digitization of small and medium businesses has the potential to add USD 150–200 Bn (~0.05%) to India's GDP by 2024 and contribute to the economic recovery post COVID19 pandemic.

It is well received that MSMEs that are digitally mature enjoy twice as many benefits in terms of revenue and productivity compared with those that have an indifferent approach to digitization.

The digitized SMEs that have been considered for the purpose of this report have been defined as enterprises that have already or are planning to digitally transform their business to introduce new products and services or even sell through their own platforms. These businesses have further been classified based on their registered annual turnover as:

(a) **Small businesses** - Annual turnover of INR 50 Lakhs to 10 Crore

(b) **Medium businesses** – Annual turnover of INR 10 Crore to 150 Crore

The underlying reasons for the definition of small and medium businesses are driven largely by the lens through which formal lenders such as banks and NBFCs view this segment. Businesses with low turnovers, generally do not have enough traction to qualify for credit or even track information systematically to meet the filing requirements for formal lending. Therefore, in order to achieve a realistic estimate of the demand for credit, there was a need to select those enterprises that have achieved a reasonable proof of concept indicated by their recurring revenue stream.

Anmol Jaggi | BLU SMART MOBILITY

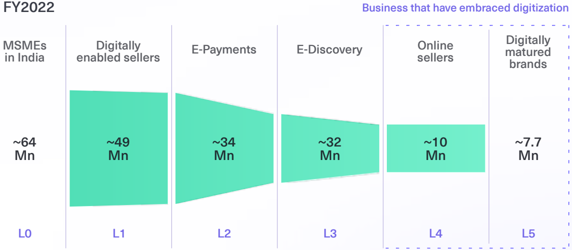
Access to timely and adequate credit can be a game-changer for SMEs, enabling them to seize growth opportunities, invest in innovation, and scale their operations. Tailored financial solutions can empower entrepreneurs to navigate obstacles and fuel their ventures' success.

1.1

Around *12% of MSMEs* in India are digitized

The Indian MSME funnel can be broken down by the level of digitization that businesses have embraced. Each level distinctly represents a cross section of the MSME universe as presented below:

MSME segmentation funnel
FY2022



L0 - Number of SMEs in trade and services
L1 - Sellers with internet connectivity
L2 - Sellers using QR code for payments
L3 - Sellers across major players like Indiamart & Justdial
L4 - Ecommerce and social commerce sellers
L5 - Brands that have the developed capabilities to drive a large share (~30%) of their revenues through online channels

For context :
MSMEs in FY17 were 44 Mn of which 1.3 million (~3%) were digitized

Source(s): Redseer IP, Expert Inputs, RedCore analysis

The SME market can be outlined across 6 key levels, which also indicates the digital maturity journey for an MSME. These levels can be understood as:

All MSMEs in India *(L0)*

This stage is the super set of all businesses available in the manufacturing and services sector of the ecosystem falling under MSME definition. This also includes local merchants such as those running Kirana stores and small shopkeepers.

Digitally Enabled Sellers *(L1)*

These merchants have access to the internet, limited digital needs, and rely largely on traditional processes for tracking and monitoring their business operations. There are about 50 Mn MSME falling in this category.

E-Payments *(L2)*

Merchants that have gone beyond the scope of basic internet search activity and accept payments via leading fintech platforms such as Google Pay, Paytm, Phone Pe etc. via QR codes installed at their outlets are considered under this section. About 60% of L1 lenders have adopted such payment mechanisms, precipitated largely by the pandemic.

E-Discovery *(L3)*

This segment of merchants, represents those businesses that have invested in digitization of their sales through digital marketing expenditure. These merchants often spend on advertisements and other bundled services to increase their reach and attract higher revenues via B2B or B2B2C channels.

Online Sellers *(L4)*

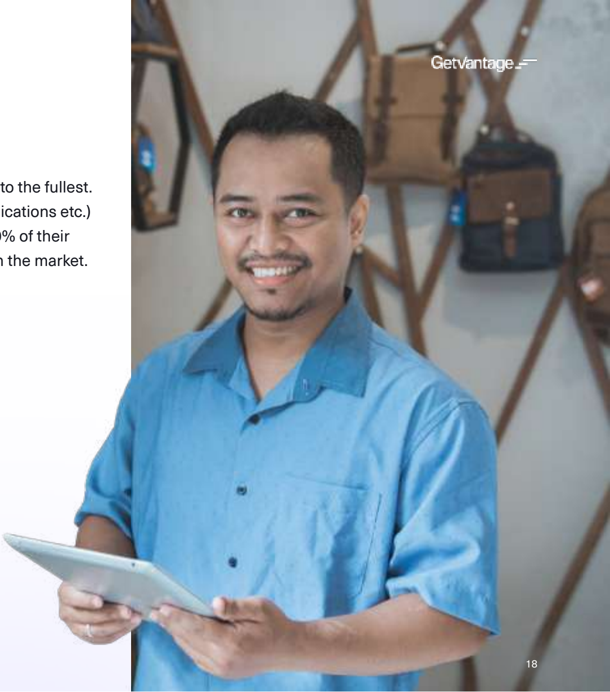
Merchants that actively use digital services such as marketplaces like Amazon, Flipkart, IndiaMart etc. to market and sell their goods are considered under this layer. These merchants may exclusively sell online; however, they bank on intermediaries to provide platforms for the sale of their products and services to the end consumer. These sellers collectively make up the e-commerce and social commerce micro markets.

Digitally Mature Brands *(L5)*

This category of merchants represents those that have leveraged digitization to the fullest. These merchants have already designed their own platforms (websites / applications etc.) to market and sell their products. These evolved businesses generate over 30% of their revenues through online channels, and there are about 7.7 Mn such brands in the market.

Small and medium-sized businesses are using digital solutions to improve their access to clients, enhance company efficiencies and create better outcomes. However, there are critical challenges that stand in the way of MSMEs digitization journey. Despite these challenges, supportive efforts including various government initiatives and digital solutions offered by startups are proving effective.

These digitized SMEs are considered for the purpose of market sizing cut across these 6 categories to indicate those enterprises that are seeking digitization or are already on their way to digital maturity.



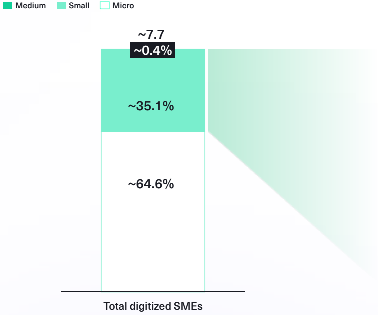
1.2

Segmentation of digitized businesses

Among these, 7.7 Mn MSMEs are those that have adopted digital tools for procurement, discovery, logistics, payments, bookkeeping, inventory, sales, marketing, communication among other business processes. These SMEs have further been segmented on the basis of Small & Medium businesses.

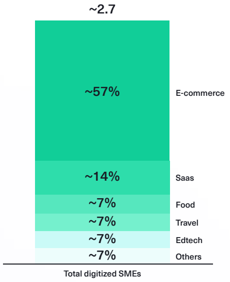
of digitized SMEs — selection of enterprises

FY22, in Million



% of digitized SMEs split by sector

FY22, in Million



Note: Micro enterprises have been excluded from the analysis as lenders do not extend loans to companies with turnovers under INR 50 lakhs

Source(s): RedCore analysis, Expert Inputs

Micro enterprises account for ~65% of the digitized SMEs and have been excluded from the analysis because banks and NBFCs usually do not extend credit to enterprises with turnovers under INR 50 Lakhs.

Therefore, there are about 2.7 Mn enterprises that were considered for a deep dive and computation of the demand.

These 2.7 Mn enterprises have also been split across 6 sectors as follows.

E-commerce

Business selling to customers via website/ marketplaces.

Software as a Service

SaaS and subscription-based.

Food & food related technology

Cloud-kitchens, QSR, and F&B establishments.

Travel

Online travel agents, tour operators and flight aggregators.

Edtech

E-learning platforms for both students and employees.

Others

E-pharma, cleantech, and trading firms amongst others.

E-commerce

SaaS

Edtech

Food

Travel

Other emerging sectors

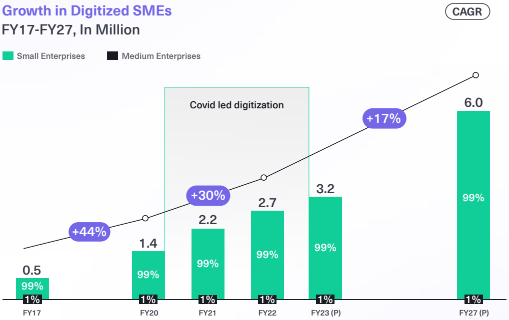
Source(s): Redseer Research, RedSeer analysis

*This is an indicative list only for representational purposes.

Historically, digitized SMEs have been on the rise since before the pandemic. However, a large delta was observed since FY21 as shown below:

Growth in Digitized SMEs

FY17-FY27, In Million



Note: The split of small and medium business for FY17 has been kept consistent with the split for FY22 as this distribution has not changed over the last 8 years

Source(s):
Expert Inputs, MSME AR 2016-17, RedCore analysis

Prior to the pandemic, the extent of digitization amongst SMEs was limited and considered capital intensive. Since the technological adoption prompted by the pandemic, SMEs have experienced lower transformation cost, increased utility, increased revenue, improved communication, flexibility etc. In the modern setting, digital tools have influenced consumer buying behaviors to a considerable extent creating an opportunity for businesses to expand their reach exponentially.

At 780 Mn, India is home to the second-largest internet user base in the world, which is more than 2X of the US population. Online shoppers are likely to double by 2030 to reach ~600 Mn. Mature users will add an additional ~120 Mn to the Indian online user pool over the next 7-8 years making India a hotbed for digital growth. Businesses, therefore, will lean more towards digitization, to cater to a broader customer base and embrace digital transformation over the next 5 years.

However, certain market interventions and regulations on the lines of digitization can further improve digital accessibility and infrastructure amongst SMEs. These interventions have been detailed further in the subsequent sections.

02

SMEs demand for credit is rising *exponentially*

2.1

SMEs need for *working capital* is paramount

Like traditional SMEs, digitized SMEs require capital for 6 key reasons. However, the deployment of this capital varies with the level of digitization across businesses. For instance, businesses with a high level of digitization may have higher marketing spends so as to gain an edge in increasingly cluttered markets and growing customer acquisition.

Other such needs have been explained below:

Capital deployment use—cases for digitised SMEs

Working Capital

Operational requirements
Refers to the funds that a business needs to cover its day-to-day expenses such as inventory, payroll, and other operational costs.

Marketing & Advertisement
Needs to create and execute marketing campaigns. This may include website development, social media advertising, or search engine optimization.

Hiring & Training
This includes need to hire new employees or provide essential training to existing workforce which can improve productivity enhance growth.

Maintence, Renewal & others
This is to purchase equipment or upgrade technology and may include computers, software, machines, or other specialized equipment.

Capital Expenditure & Others

Expansion of plant and machinery
This includes additional funding to support the growth, opening new locations, adding new products or services.

Research & Development
Need to innovate and improve the products or services or for research and development activities. This may include funding for product development, prototyping, or testing.

Source(s): RedCore analysis, Expert Inputs

Marketing & Advertising

Digitized SMEs that operate online or rely heavily on digital marketing may need funding to create and execute marketing campaigns. This may include funding for website development, social media advertising, or search engine optimization. For instance, video advertisements are now dominating the digital advertisement segment primarily because of their interactivity and personal appeal. Furthermore, e-commerce businesses are amongst the largest advertisers (other than Alphabet and Meta ecosystem), and look for non-traditional platforms such as OTT, gaming services, music, and entertainment applications to source leads and build a customer funnel. These efforts require higher marketing spends and offer a more tailored approach to tap into the target market.

Estimates suggest that more than 40% of every venture capital dollar is spent on marketing/ digital marketing.

The advent of fintech companies that are providing RBF and other debt products have made it extremely easy for businesses to raise capital and work towards the growth of the SME sector on a macro level. Creating a brand now and finding the right investor is easier than earlier times. Now we even have varying options of raising the right kind of capital the business needs, basis the stage, revenue model, growth graph, sector and more.

Dhruv Madhok | ARATA

Operational Requirements

This refers to the funds that a business needs to cover its day-to-day expenses such as inventory, payroll, cost of materials and other operational costs. The large base of digitized SMEs in India, that have a mix of both variable cashflows and highly predicatable recurring revenue, need accessible working capital financing to maintain and grow their operations. This type of financing can include short-term loans, invoice financing, or lines of credit.

Hiring & Training

As digitized SMEs grow; they may need to hire new employees and provide training to existing employees. This can be a significant expense, and businesses may need funding to cover these costs. They may opt for short-term loans, lines of credit, or even crowdfunding.

Maintenance, Renewal & Others

Digitized SMEs that operate in industries such as e-commerce, technology, or manufacturing may need funding to purchase equipment or upgrade technology. This may include computers, software, machines, or other specialized equipment. These companies may opt for equipment financing or leasing.

Expansion

As digitized SMEs grow and expand their operations, they may need additional funding to support that growth. This could include opening new locations, adding new products or services, or for their horizontal and vertical growth. Expansion financing may include term loans, equipment financing, or cashflow based financing.

Research & Development

Digitized SMEs that are looking to innovate and improve their products or services may need funding for research and development activities. This may include funding for product development, prototyping, or testing. For this, they may opt for angel investment or even crowdfunding.

Shuchir Suri | jade forest

As a founder, I understand the critical role that credit accessibility plays in enabling the growth and success of digital SME, and a few founder-friendly platforms in the industry are facilitating the much-required credit to the founders to grow. These platforms offer solutions tailored to the unique needs of digital SMEs, fueling their growth and contributing to the $500 Bn credit opportunity.

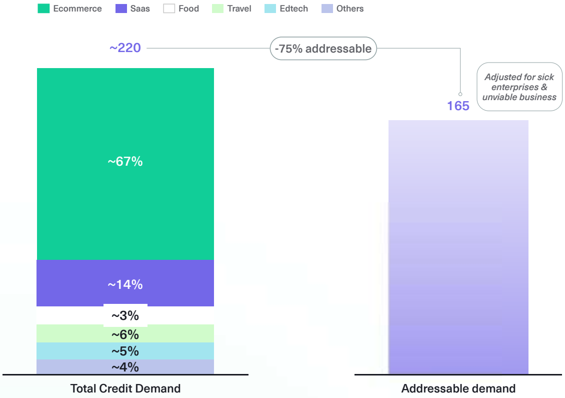
2.2

Digitized SMEs require over *USD 200 Bn* in credit today

These businesses have a potential credit demand of ~USD 220 Bn dollars, where e-commerce businesses account for ~70% of the demand.

Credit demand - by segments

FY22, USD Bn



Note: Addressable demand has been assumed at 75% based on historical trends

Source(s): Expert Inputs, RedCore analysis

This demand is representative of the working capital requirements of this vast group of digitized businesses in India. Addressable demand excludes enterprises that exclusively seek informal finance, are not commercially viable, sick enterprises or are on the verge of closure. These enterprises have historically accounted for ~25-30% of the total demand; a proportion that is likely to continue over the next few years.

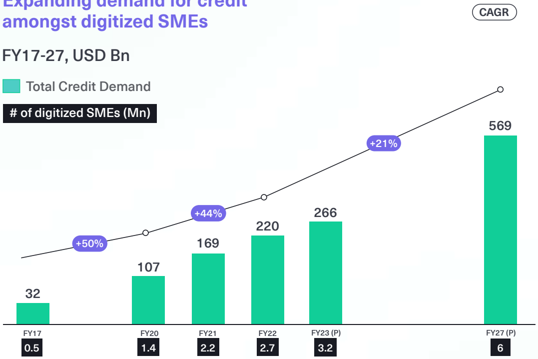
With growing digitization, the working capital requirements of businesses have also evolved. Small and medium sized business-owners that have been able to shift part of their operations online, have been able to achieve scale and take advantage of the cost efficiencies. This is evident through e-commerce businesses, which command the lion's share of the demand for credit. This is mainly because of the technology enabled bridging of logistics gaps and development of payment infrastructures that make starting an e-commerce business easier.

Prior to the pandemic, the demand for working capital was growing at a steady pace, amounting to an increase of ~USD 70 Bn over a period of 4 years. This changed drastically during COVID, where the demand grew by USD 100 Bn+ in a matter of 2 years alone, owing to the forced digitization.

This trend is likely to continue and the SME credit demand is predicted to reach ~USD 570 Bn over the next few years, as more businesses grow online.

Expanding demand for credit amongst digitized SMEs

FY17-27, USD Bn



Note: Demand represents the working capital requirements has been calculated as a percentage of average annual turnover for each selected sector

Source(s): RedCore analysis, MSME AR 2016-17, Expert Inputs

This demand grew sharply between FY21-22 because of the limited revenues being generated by SMEs. Additionally, digitized businesses scaled tremendously during this time period and the need for more sophisticated systems and tools became necessary, thereby adding to their working capital requirements. While some businesses could not bear the brunt of the pandemic and had to shut down, those that embraced digitization were able to weather the storm.

Over the next few years, the demand for working capital is expected to rise steadily at a CAGR ~20% and is projected to reach ~USD 570 Bn.

As the number of digitized SMEs are likely to double over the next 5 years, the consequent demand for working capital is also likely to follow a similar trend.

2.3

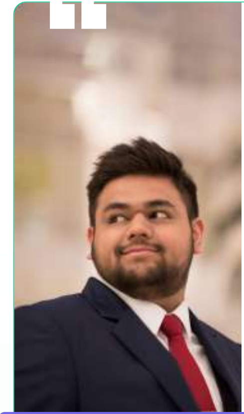
Funding challenges faced by SMEs

The SME market has been plagued by funding challenges over the last several decades. These challenges range from accessibility to red-tapism and have inhibited the growth of this sector. Although the government has laid special emphasis on addressing the liquidity challenges of small and medium enterprises, only limited progress has been made by traditional financial institutions in truly resolving the accessibility challenges for these businesses.

Some of these key challenges include:

Lack of Tailor-Made Solutions

Unlike large businesses, the capital requirements for SMEs are smaller and more frequent as they need to meet their on-going and evolving working capital requirements. The extension of credit within the traditional lending channels is centered around large businesses that borrow large sums of money and typically over long periods to finance their capital expenditures and does not duly consider the unique needs of SMEs. Additionally, these businesses operate across multiple business models, take different kinds of risks, and adhere to non-conventional payment terms that may not be fully accepted by traditional lenders. This underscores the evident absence of a separate lending solution for SMEs and highlights the roadblocks in the smooth disbursement of funds to SMEs.



Economic growth in India has been fuelled by SMEs as they play a vital role in generating employment and contribute to the overall GDP. As digitalization is increasing rapidly, having access to this credit opportunity will alleviate fund-raising challenges that smaller business generally face, and help with their rapid expansion. New-age credit platforms are keeping the business' goals at the forefront. This along with the credit opportunity will help build a healthy financial ecosystem for SMEs & MSMs to thrive in.

Harsh Somaiya | THE BEAR HOUSE

Risk Perceptions of Banks & Financial Institutions

Traditional lenders have often positioned SMEs at a higher risk profile than large businesses owing to their limited revenue streams and evolving business metrics. Their need for unsecured loans and absence of a credit profile, make lending to SMEs a high-risk proposition for banks and financial institutions. Even if loans are extended, they are offered at substantially higher interest rates that increases cost of borrowing, which in turn limits the benefits of having access to credit to begin with.

Timely Access to Capital

Since SMEs require capital largely for their operational needs, the timeliness of disbursement becomes critical. Banks and other financial institutions can often take up to 90-120 days to discharge loans to SMEs or adopt a tranche-based approach owing to the higher risk profile of these businesses. This levies additional burden on the already cash strained businesses, which are eventually stretched too thin with almost no runway, as they, as they await their access to credit.

03

Capital invested
in digitized SMEs is also on the rise

Over the last decade, SMEs have constantly struggled with having timely and reliable access to capital. The formal lending system comprising of public and private banks, has only been able to service about 30% of the overall demand for capital, creating a positive demand supply gap that has also opened the door for NBFCs and third-party lenders (e.g. P2P lenders, Trade financiers etc.) to enter the market. Consequently, about 40% of the overall capital invested in the SME market, was diverted towards digitized SMEs (12% of total MSMEs by volume).

redseer
Strategy Consultants

3.1

Typical fundraising journey for SMEs

Digitization led growth and increasing productivity of SMEs has been coherent with their capital needs. Increased market accessibility is offering new opportunities to these enterprises which in turn reflects in their versatile capital needs.

Many SMEs do not qualify for traditional bank loans and have limited fundraising options. This makes it difficult for them to find the right credit solutions to meet their specific needs. Problems related to short-term working capital access for SMEs can be solved by providing an alternate source of lending that does not require collateral, credit history and is more flexible than traditional bank loans.

This value proposition is attracting thousands of emerging businesses towards innovative tech-first financial solutions.

However, the capital needs of SMEs vary across stages of business namely Start-up stage, Survival Stage, Growth Stage and Sustenance Stage.

SMEs understanding of different types of funding sources at various stages of business is explained below in detail:

Typical funding journey of a digitized SME

Start-up Stage

Early stage businesses raise money to use as working capital from personal sources, friends, and family as well as banks. The second prominent application of an institutional source was used for collateral financing by state banks. This suggested that launching a business required a high level of readiness, risk aversion, or both.

During the startup stage, a business typically does not have a track record of financial performance and is unlikely to have credit history required to secure a loan from a traditional lender. Moreover, many new-economy businesses are digital-first meaning they have no collateral to give. Here, equity financing can be a good option as it allows the business to raise funds from investors in exchange for a share of ownership in the company coupled with the benefit of investor knowledge and expertise. This can be particularly beneficial for businesses that have a strong business plan and a high potential for growth.

Survival Stage

Working capital, short-term loans, and overdrafts are the three main financial assistance needs for businesses in the survival stage. Businesses at this stage prefer a mix of both traditional and alternate lenders for the majority of their working capital needs. Private banks and personal funds come next. In addition, short-term loans and overdraft capabilities of private banks are also utilised. Businesses acknowledged using moneylenders as well, albeit at a lower scale. Businesses at this stage look to pay off debts, for which they need efficient day-to-day operations and sufficient working capital availability.

Growth Stage

At this stage, businesses need ready access to different working capital solutions including cash advances, supply chain finance, revolving credit facilities, etc. Working capital is generally obtained from traditional banking channels as well as new age alternative lenders. This is because their need for capital is immediate and urgent owing to its correlation with business growth or losses. This may suggest that businesses are more concerned with their individual financial requirements and the resources needed to meet them. The prevalent use of alternate finance and banking systems to satisfy working capital requirements, are signs of the importance of trust in securing this kind of financing.

Sustenance Stage

Enterprises in this stage use personal funds, NBFCs, Public banks, and Private banks for the purpose of working capital. Working capital, collateral financing, and short-term loans seem to dominate the landscape of requirements of enterprises at this stage. This continues the trend, noted above, of using finance from sources that are perceived to be trusted by Enterprises. As businesses mature and establish a track record of financial performance, it becomes more attractive to traditional financial institutions and potential investors, allowing them to also raise capital through equity financing on more favourable terms.

However, it's worth noting that equity financing can still make sense in later stages of the business if the company is looking to raise capital for a specific project or initiative, such as an acquisition or expansion, and if it would dilute the ownership of existing shareholders, or if the company is not profitable and does not generate enough cash flow to service debt. Therefore, equity financing becomes critical for businesses to finance varied needs at different stages so as to manage risk, develop capabilities and other such endeavors.

Consequently, the digitized SMEs choose lenders in accordance with their stage of business maturity. The figure below represents a high-level overview of how lenders see different businesses and extend credit vs. when SMEs reach out to different lenders based on their capital need.

Sameer Seth | THE BOMBAY CANTEEN

The potential and opportunities the startup ecosystem provides us today are immense. This also includes the capital options that a founder gets, be it equity financing, quasi-equity funds or others. The growth challenges faced by millions of MSMEs today have in a way helped shape the ecosystem, making it easier for businesses to raise capital and be much aware of what kind of capital to be raised when. This is how India is reshaping credit accessibility within the Founder community.

Source of finance vs stage of business maturity

Growing working capital requirements

Sources of finance used by SMEs at different stages of business

Sources of Finance	Business Stage: Start-up	Survival	Growth	Sustenance
Public Banks	✓	✓	✓	✓
Private Banks	✗	✓	✓	✓
NBFC's (includes Fintech)	✗	✓	✓	✓
Personal Wealth	✓	✓	✗	✗
Friends, Family and Fools	✓	✗	✗	✗
Microfinance Institutions	✓	✓	✗	✗

Source(s): Expert Inputs, RedCore analysis

While most SMEs may follow similar channels, it must be noted that the choice of finance is highly individualistic and depends upon a host of factors to be evaluated by the founders.

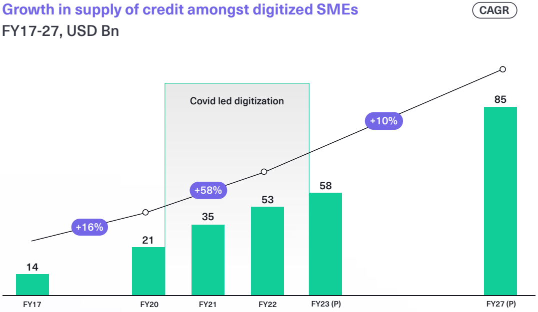
3.2

Digitized SMEs attract *40%* of the invested capital

Over the last few years, these lenders have contributed billions of dollars towards the SME segment. During FY22 alone, USD 132 Bn was invested in the SME segment, of which ~USD 53 Bn went to digitized SMEs.

Growth in supply of credit amongst digitized SMEs

FY17-27, USD Bn



Source(s): Expert Inputs, RedCore analysis, MSME Pulse August 2022 (TransUnion CIBIL and SIDBI)

As indicated above, the supply of credit to digitized businesses was fairly limited prior to FY20. However, over the course of the covid led pandemic, formal institutions were able to significantly increase supply owing to SME focused credit schemes launched by the government (e.g., MUDRA, CGTSME etc.). NBFCs in particular, were also able to make a difference by servicing the niche credit demands, taking a different approach to credit assessment often without the requirement of property collateral. SMEs have also opted for debt funding through banks and NBFCs because of their clear and transparent procedures and government oversight. Therefore, as new credit reforms galvanize lending to SMEs and banks innovate new lending models, we expect the supply of credit to grow at 10% for the next couple of years.

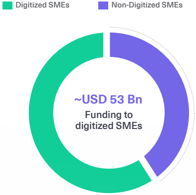
3.3

E-commerce businesses have *attracted maximum lender interest*

The supply side landscape is largely controlled by both public and private sector banks. While private banks have been able to offer attractive schemes to SMEs, nationalized banks still contribute the largest portion of this pie, as most of the government scheme fund flow happens through these banks.

Funding to SMEs - digitized vs non digitized SMEs

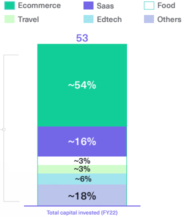
FY22, USD Bn



Note: 3rd party investors includes channels such as family, offices, angel investors, private financers etc.

Digital SME funding - by sectors

FY22, USD Bn



Source(s): Expert Inputs, RedCore analysis, MSME Pulse August 2022 (TransUnion CIBIL and SIDBI)

The digitized SMEs received a total of USD 53 Bn during FY22. A substantial portion of this was made up of e-commerce investments, which accounted for ~54% of the overall pie. This was prompted by the fact that e-commerce businesses generally follow a similar business model that is easily understood by traditional lenders. In fact, lenders also believe that the share of e-commerce in the lending pie could rise to ~75% in the next 5 years.

3.4

SMEs lean more towards *traditional debt*

Of the 3 potential funding sources available to SMEs, FY22 saw a clear preference for debt over equity. As per industry experts, debt accounted for ~80% of the funding that went to SMEs, while equity accounted for~15%. Outside of these models, alternate finance accounted for ~5% of the overall funding to digitized SMEs; a number that is likely to grow exponentially over the next 5 years. This is because of the immense benefits offered by innovative alternate financing solutions like revenue-based funding, trade receivable financing, subscription-based financing, etc. Alternate sources of finance offer significant cost advantages over traditional funding sources of debt and equity. The most significant being the convenience of application and disbursement.

While, traditional lenders require substantial documentation and organized evidencing, that may not necessarily be available with all SMEs, alternate finance mechanisms adopt a more proactive approach and are usually integrated with the businesses infrastructure to process applications and repayments.

The illustration below sheds light on the key benefits and downsides to raising capital across the 3 potential modes of raising funds:

Comparison between lending options

Comparison of various ending options available to SMEs

Key Factos	Lending Models: Traditional Debt	Lending Models: Equity	Lending Models: Alternate Finance
Key Players	SBI, Aditya Birla Finance, pnb, ICICI Bank, HDFC Bank, Tata Capital	Chiratae Ventures, DSG, Fireside Ventures, Accel	Getvantage, Recur, klub, Velocity
Ownership dilution	✗	✓	✗
Collateral Required	✓	–	✗
Flexible repayments	✗	–	✓
Fast loan disbursal	✗	–	✓
Procedural transparency	✓	✓	✓
Large funding amounts	✓	✓	✗
Value added services tailored to SME needs	✗	✗	✓
Processing Times (approx.)	upto 60 days	upto 120 days	7 to 10 days

Source(s): Expert Inputs, RedCore analysis

It must be noted that the needs of a business govern the choice of funding of any enterprise. Founders must carefully evaluate the pros and cons of each form of funding and identify the method best suited to their circumstances. Alternative finance is relatively more suited to the requirements of SMEs who can leverage the inherent flexibility to their advantage, and significantly reduce their exposure, while increasing their runway.

Even globally, the alternate financing model has exploded in popularity. Numerous fintech platforms providing quasi equity and innovative working capital solutions based on performance and cash flows have emerged to fill the void left by traditional financial institutions and serve new-age businesses.

More mature markets including the US and many across Europe have seen a multifold increase in number of Revenue-Based Financing providers along with a significant uptick in the number of businesses that are opting for such solutions.

3.5

Alternate finance is gradually picking pace

India's SME sector has made great strides since then by leaning towards digitization, which proved to be essential for developing a new corporate climate, particularly after Covid. Digitization was used to ease problems and speed up recovery by enabling remote transaction administration, effective product distribution, and simpler access to financial services. The industry gained in the short to medium term from adopting digitally enabled operations.

After the financial crisis of 2008, the global private credit market grew strongly. The expansion of private credit as an asset class was largely driven by three factors. First, the supply-demand imbalance in the middle market segment resulted from banks' decision to stop lending to smaller or riskier borrowers during the crisis due to tighter capital requirements. Second, from the borrower's perspective, a personal loan offered more flexible loan terms and longer loan terms that better fit the company's cash flow characteristics. Finally, from an investor's perspective, the higher yield and diversification benefits of the private credit asset class make it attractive. Investors benefit from high returns, especially given the persistently low interest rates offered globally.

Today, it has become necessary for digitized SMEs to have access to adequate capital, capacity building, and an understanding of dealing with digital banking and trade networks. Many can reach and serve clients more effectively by streamlining workflow and processes.

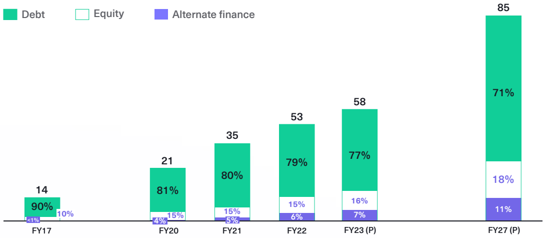
In the last couple of years digitization has penetrated across the segments and sectors that make up Indian GDP. For SMEs, digitization came as a game changer giving them access to wider markets and enhanced productivity.

The number of digitized SMEs is expected to more than double by FY'27 that is indicated by the changing business environment which also has an impact on their capital needs.

From a borrower's perspective, alternate finance models like Revenue-Based Financing offered by fintech platforms serve as strong enablement engines for meeting their evolving working capital needs.

Funding to digitized SMEs - by investment type

FY17-FY27, USD Bn

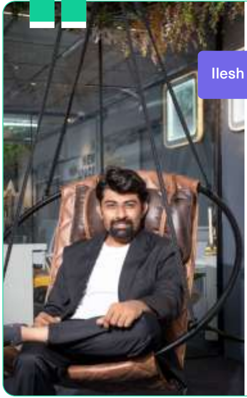


Source(s): Expert Inputs, RedCore analysis, MSME Pulse August 2022 (TransUnion CIBIL and SIDBI)

SMEs have always preferred debt through instruments such as overdrafts and fixed interest loans, that help them meet their credit demand. Alternate finance channels such as revenue-based financing and trade receivable financing, are still lesser known to a vast majority of SMEs and are viewed with skepticism.

However, in contemporary times these enterprises have found several use cases of alternate finance wherein traditional lenders fail to understand their many evolving working capital needs. As the segment becomes more aware of new age funding models, it is expected that the share of alternate finance will increase drastically (2X) in the coming five years, because of their SME first approach and benefits of convenience and accessibility.

Early signs of this come from public reports that private credit firms have raised at least USD 3 Bn in 2022 through sector-specific strategies focused on real estate, data centers, sector-agnostic strategies, and unique situational strategies to be deployed in the Indian market. In addition, several international funds have pledged to invest more than USD 3-4 Bn dollars from their Global/Asia funds across the SME and startup landscape in India. With the emergence of these models. SMEs are beginning to see the immense benefits in opting for private capital as a more versatile and impactful source of funding.



Ilesh Ghevariya

Clothing industry is very volatile in nature and it works on seasonality. In such cases we need to stock up just before festive season and that's where we need temporary funds. In such cases short term credit favilities are very useful. Such facilities help the SME sector to grow tremendously.

Below mentioned factors have precipitated the growth of alternate finance models amongst SMEs.

Increasing digitization of the country's economy. The growth of e-commerce, online marketplaces, and other digital platforms has made it easier for SMEs to reach customers and generate revenue. Consequently, the need for working capital has diversified and financing solutions for digitized businesses are unavailable with traditional lenders, making a compelling case for alternate finance channels.

The Indian government's efforts to promote entrepreneurship and small business growth has also contributed to the growth of alternative financing models. Lots of fintech solutions have come to fore that provide lending to digitized SMEs and are able to design products with an SME first approach.

Some alternate finance platforms have also begun offering value added services that provide SMEs a lot more than just access to credit. Specifically, some platforms offer credit cards that allow SMEs to have a ready credit limit, to take advantage of in addition to reward points and discounts on payments to incentivize their usage. Others also offer deep business insights to SMEs, that are essentially analyzed using their data to provide business owners a detailed breakdown of their expenses, overheads, and revenues on a daily basis. These tools have further propelled the demand for alternative funding solutions.

It is worth noting that while these options can be good for some businesses, it can be more expensive than traditional forms of long-term financing and may not be suitable for all types of businesses. It is important for small business owners to carefully evaluate their options and choose the financing that best meets their needs.

04

The widening credit capital gap has been inhibiting *SME growth*

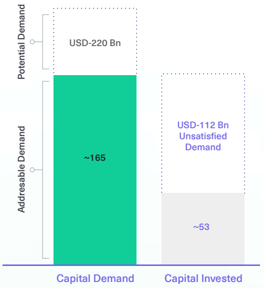
4.1

There exists a *~USD 112 Bn* credit deficit today

An investigation of the current funding landscape clearly reveals a consistent undersupply across each of the selected sectors. At the overall level, the addressable credit capital deficit is ~USD 112 Bn, which excludes sick enterprises and businesses that voluntarily want to be excluded from formal funding channels.

Total capital deficit - split by segments

FY22, USD Bn



Source(s): Expert Inputs, RedCore analysis

Implications of unsatisfied demands on SMEs

Limited to no growth

As the demand for credit goes unsatisfied, businesses struggle to grow as they have to juggle between maintaining operations and business growth

Plateauing of Revenues

The limited capacity development, restricts businesses from locking in exponential revenues and gaining higher profits

Limited Innovation

The lack of working capital makes it difficult for SMEs to leverage technology and innovate further to gain an edge over their competition

As the figure above indicates, the total demand for capital across digitized SMEs exceeds the available supply of credit offered through formal channels including banks, NBFCs and other new age lending platforms. **In other words, ~33% of the overall demand is serviced and about 67% remains unaddressed creating a massive divergence in the potential economic output of India.**

This gap has only widened over the last 5 years, where it used to be ~29% during FY17. This growing gap over the years indicates that the supply of credit is outpaced by the demand for credit, which is likely to widen in the future.

The gap is significant for e-commerce businesses where the demand for credit capital is the largest. Owing to the seasonal nature of the business, e-commerce brands have a large portion of their working capital invested in inventory management and marketing aspects. These businesses incur high costs of customer acquisition and therefore frequently require working capital to improve their top line. While e-commerce businesses are a preferred sector for lenders, they are unable to frequently finance such enterprises, given their fluctuating revenues and low profit margins .

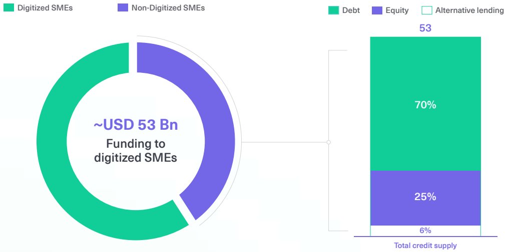
SaaS businesses suffer the same plight despite lower working capital requirements. These businesses are unable to receive funding owing to their inability to produce tangible assets to offer as collateral.

Funding to SMEs - digitized vs non digitized SMEs

FY22, USD Bn

Digital SME funding - by investment type

FY22, USD Bn



Source(s): Expert Inputs, RedCore analysis, MSME Pulse August 2022 (TransUnion CIBIL and SIDBI)

Additionally, they operate across multiple business models that are often new and untested which can make it difficult for them to demonstrate a track record of success to lenders and investors. The problem is further compounded by the high competition in the segment that can make it difficult for new businesses to stand out and attract funding.

The situation remains unchanged, across other sectors such as food, edtech and travel where regulatory challenges, competition and long break-even periods pose a challenge to smooth and seamless funding cycles. Plugging these white spaces requires specialized products that factor in these challenges and can still enable finance for these businesses.

Across the formal lending ecosystem, there is an evident need to enable digitization and align business funding with the growth of these businesses. This moat has been identified and addressed by new age funding channels that offer growth linked finance as well as seamless access to capital for upcoming businesses.

Businesses that are unable to access capital often struggle with their growth journeys. They are unable to scale as they often struggle with keeping the business going or striving to scale. Consequently, businesses have been known to report similar revenues for multiple years. This flatlining of revenues, makes it difficult for these businesses to raise funds, even from traditional sources. A lesser discussed aspect is also the lack of innovation that results from limited research and development efforts that themselves require sizable investment. The operational loopholes and gaps are sometimes accepted as business practices and hinder business evolution altogether.

4.2

The expanding *demand gaps*

Over the last decade, SMEs have been able to raise debt from all formal lenders, including Banks, NBFCs and 3rd party investors, this has been disproportionately skewed towards banks. This is largely because new age funding / alternate funding models are still lesser known amongst SMEs. Additionally, most of the government schemes are channelized through banks, which makes it mandatory for SMEs to seek out PSUs and private banks to meet their funding needs,

However, over the last 2-3 years, this scenario has been changing significantly. NBFCs have been able to provide sizable capital to SMEs, owing to their higher risk-taking capacities.

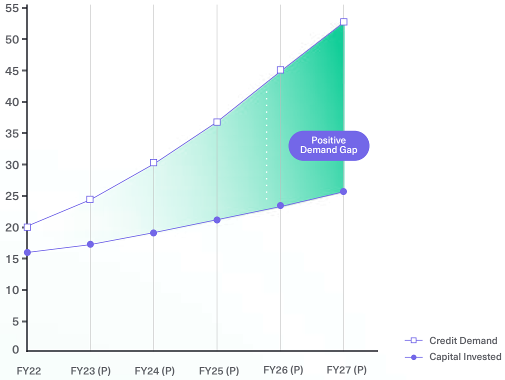
These NBFCs have been able to design SME specific products and have closely understood their need for capital. They have been able to offer higher unsecured loans at attractive interest rates and have also partnered with fintech platforms to leverage technology in disbursing faster and more efficient loans to SMEs. Looking at FY22 alone, USD 53 Bn was invested through these channels, with ~70% of this coming through banks. NBFCs come in as a close second, accounting for over 25% of this invested capital. The remainder 5% has been invested by 3rd party investors such as family offices, angel investors and trust funds. This share of NBFCs is expected to rise even further, as more and more SMEs are leaning towards these lenders owing to their relaxed lending criteria, which allows SMEs with less established credit histories to access funding.

Despite the evolving scenario, the deployment of capital is insufficient at best. As the demand for credit rises steeply, supply is projected to grow at a much slower place. This will result in a consistently expanding market gap, where the excess demand may shift towards informal channels of funding or necessitate the need for new and more efficient tools for capital deployment.

The figure below illustrates this for both small and medium enterprises, if the current economic and regulatory climate prevails for the coming few years:

Small enterprises – demand vs supply | FY22, USD Bn

Medium enterprises – demand vs supply | FY22, USD Bn



As shown in the figure above, the positive demand gap is likely to widen majorly for small businesses as they struggle with raising funds the most. Owing to their limited credit history and higher risk exposure, banks exercise extreme caution when sanctioning loans to such enterprises. Even NBFCs charge higher interest from such enterprises and keep a close watch on their repayment capacities.

Medium sized businesses, however, struggle comparatively less with capital financing. This is because of their stronger business metrics, reasonable credit history and validated growth projections, which makes them safer applicants. Consequently, the demand gap for this segment is relatively narrower, however as more enterprises achieve scale, the gap is likely to widen at a steady pace over the next 5-7 years.

"The absence of tangible assets made it difficult for us to raise 'growth capital.' The convenience offered by new age funding models helped us accelerate the growth of our distribution network."

COO, Food Brand

Vedant Lamba | The Mainstreet Marketplace

India is just about scratching the surface of utilising credit effectively for cashflow management and balance sheet health. If deployed sensibly - debt is one of the most incredible instruments when it comes to driving business growth. Companies like GV are raising the bar with the quality of support and seamless process building for several businesses across the board including ours.

05

New age solutions are now available for SMEs to consider

5.1

Alternative funding models – *Global practices*

Funding options available to businesses today, are spread across a wide spectrum, each with a different risk and return ratio. SMEs have multiple options to begin their funding journeys. While some of these practices are not as prevalent in India, the market is ripe to welcome most of these alternative models.

Not all these alternatives may make sense to digitized SMEs in present time, however, are worth discussing further:

Securitized Debt

In the case of SME loan securitization, a bank ("the originator") extends loans to its SME customers, bundles them in a portfolio and sells the portfolio to capital market investors through the issuance of notes, by a Special Purpose Vehicle (SPV) backed by the loan portfolio. These asset-backed notes, rated by agencies, are placed with capital market investors, but can also be retained, at least in part, by the originator banks.

Crowdfunding

Crowdfunding is a technique to raise external finance from a large audience, rather than a small group of specialized investors, where everyone provides a small amount of the funding requested. Through online platforms, the task, traditionally performed by contractors or employees, can be undertaken by individuals for free or in exchange for some specified return, whose value is decided by the borrower beforehand.

Warehouse Receipts

Under this arrangement, commodity producers and traders deposit commodities at a warehouse, which offers secure storage and issues a receipt that certifies it is in possession of a specified quantity of a commodity that meets specified standards. The receipt can then be used by the depositor as collateral for a loan, whereby the lender places a lien on the commodity, so that this cannot be sold before the loan is repaid.

Factoring

Factoring is a supplier short-term financing mechanism, whereby a firm ('seller') receives cash from a specialized institution ('factor'), in exchange for its accounts receivable, which result from the sales of goods or provision of services to customers ('buyers'). Factoring is thus a transactions funding technology, based on 'hard' data, like asset-based lending, as the financing depends on the value of an underlying asset, rather than on the creditworthiness of the firm.

Participating Loans

Participating loans are loans whose remuneration is contingent upon the results of the debtor firm rather than being fixed. The remuneration can be linked to the firm's sales or turnover, profits or share price. On the other hand, participating loans do not share losses. In the event of bankruptcy, providers of participating loans share in the results of the liquidation in the same way as other loan creditors.

Purchase Order Finance (POF)

POF funds the production stage of an SMEs activities, as it considers a working capital advance to cover part of the production of a good or service demanded by one or more specified customers. the SME obtains a verified purchase order from a customer and estimates the direct costs required to produce and to deliver the product, which may include labour, raw materials, packaging, shipping, and insurance. The purchase order is submitted to a financier. If the loan is approved, the financier advances a share of the total order value, typically paying the approved costs directly to the suppliers.

Aside from these models, there are several other models that have surfaced in recent years such as covered bonds, private placements and convertible debt that are likely to gain higher traction as the lending system matures overtime.

5.2

High fidelity models *for India*

Looking at the evolving lending landscape in the market, it is critical to understand their potential for application across India. Fidelity can be measured based on the types of businesses and market enablers that provide confidence in the acceptance of these models. Meeting these criteria is a new age funding model that operates on the participating loans model viz. revenue-based financing.

Revenue-Based Financing (RBF)

Revenue based or revenue-linked finance is a method of extending short term loans to borrowers based purely on their turnovers and revenue cycles.

Lenders charge a minimal processing fee and are able to offer credit without additional collaterals, making it an attractive proposition for SMEs.

Taking non-dilutive capital is a great and yet under utilized opportunity for founders in the SME space to access growth capital. With the advent of a few platforms that offer quasi-equity financing, raising funds has become easier, often helping customize tranches to empower founders.

Bhavisha Dave | Capsul.

Businesses that have subscribed to revenue-based models claim to have benefited from their convenience and collateral free lending practices. Through revenue-based financing, businesses are able to gain fast and fair access to finance based on their revenue streams. This becomes critical to SME success as they require frequent infusion of funds to keep the wheels moving.

For a minimal flat processing fee, usually ranging between 6-12%, lenders are able to provide short term loans to SMEs, without excessive documentation or mortgages. These loans are then repaid over a 6–12-month period in conjunction with the real-time cash flows of a business. The flexibility offered by revenue linked finance is unparalleled, as the repayments are a function of the inflows. They reduce with lower revenues and increase with higher revenues. Moreover, the proportion of payouts are capped in order to ensure that SMEs do not suffer revenue losses.

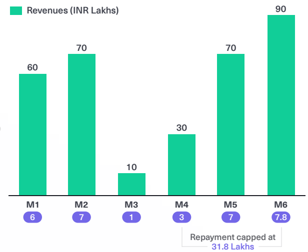
The illustration below explains the concept in detail:

Typical Revenue Based Finance Offer

Parameters	Amount
Amount borrowed	INR 30 Lakhs
Fee	6%
Revenue share cap	10%

Terms of repayment

Parameters	Amount
Amount to be repaid	INR 31.8 Lakhs
Loan term	6 months



Note: 'M' represents months. Numbers in circles represent amount repaid in INR Lakhs

The graph represents a typical revenue-based financing offer, where a short-term loan of INR 30 Lakhs is repaid over 6 months, based on the revenues earned by the business.

It is clear that revenue-based financing offers significant benefits over traditional debt as discussed hereunder.

Flexibility of repayment

Unlike traditional loans, there are no fixed payments or interest rates with revenue-based financing. This allows SMEs to make payments based on their current cash flow, which can be especially beneficial during times of slow growth or uncertainty.

Ease of access

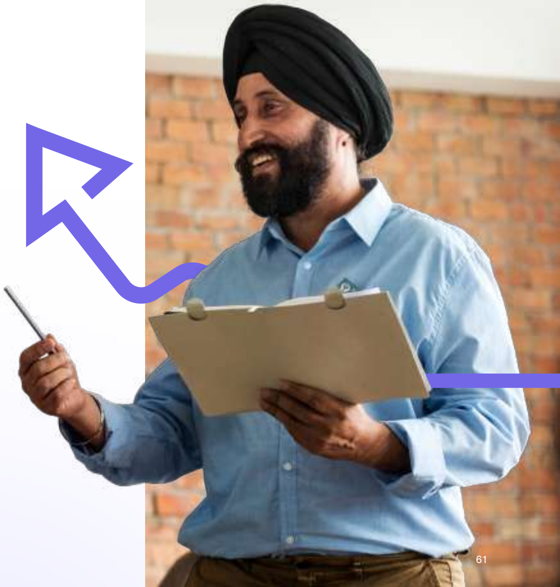
Revenue-based financing is easier to access than traditional loans or venture capital, as the underwriting is completely data-driven and linked to current and future revenue and growth.

No collaterals

Borrowers need not mortgage a part of their assets, or deposits to avail these loans, which makes them exceptionally suited to digitized SMEs, which do not have hard assets such as plant and machinery to offer as collateral.

Aligns interests

The lender's returns are closely tied to the company's performance, which aligns the interests of the lender and the borrower.



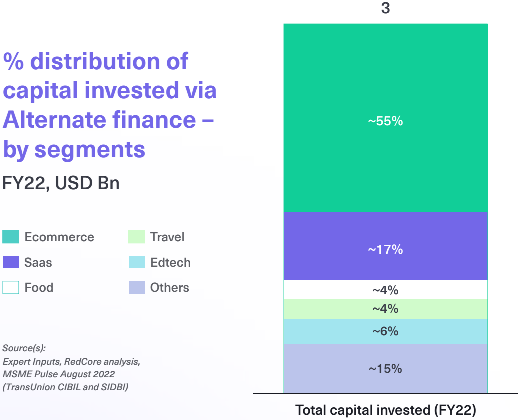
5.3

Receptivity of emerging *funding models*

New age funding models have created a buzz within the SME market. Although nascent, these models have picked up traction since the pandemic, because of the growing digitization amongst SMEs. While there is still significant ground to be covered in terms of market awareness, leading brands have already opted for financing through these new age funding models. Revenue based financing for instance has helped many businesses steer the ship into their growth phase and sustain through challenging times.

% distribution of capital invested via Alternate finance – by segments

FY22, USD Bn



Source(s):
Expert Inputs, RedCore analysis, MSME Pulse August 2022 (TransUnion CIBIL and SIDBI)

"The timely access to funds through revenue-based finance helped our business remain ours as we did not want to lose a part of it, just to maintain the status quo."

Founder, Beauty & Personal Care Brand

"Investors usually just see the risks associated with a business. New age funding models consider a more objective approach, by relying on business growth and enabling better financing opportunities for SMEs."

Co-Founder, Travel Enterprise

"New age funding models have truly understood the challenges faced by SMEs and addressed critical stressed points enabling greater accessibility to credit."

Co-Founder, SaaS Enterprise

Over the last few years, new age funding models have enabled unique funding journeys mated to the needs of SMEs. Not only have they been critical in bridging the credit capital deficit, but they have also bolstered SME growth and offered a lifeline to cash strapped businesses. While revenue-based financing has emerged as one of the most preferred models, other modes such as trade receivable financing and crowdfunding are expected to draw equal attention over the next few years.

5.4

Emerging themes *of interest*

In addition to the sectors highlighted through the report, a few other sectors have shown high potential for growth and are on the cusp of becoming the focal point of investment thesis for future investor portfolios. Some of these sectors have been discussed hereunder.

Cleantech & Climate Tech

Renewable energy comprises ~12% of India's total installed energy capacity. The policy initiatives taken by the government have not only enabled large scale cleantech investments but have also shifted focus across sectors towards ESG interventions. Sub segments such as electric mobility, smart grids, hydro power, low carbon constructions etc. have attracted huge investments in the recent past and are poised to grow substantively over the next decade. Even globally, the next breakthrough themes rest with innovators with the technologies and determination to change commitments to actions in the sprint to net-zero. By 2030, the global market is projected to surpass the value of the oil market, as it is playing an increasingly transformative role in achieving the vital goal of 'green recovery'.

Generative AI

Of the many applications of artificial intelligence, generative AI is perhaps the most tangible model that has taken the world by storm. With tools like Chat GPT, generative AI has been able to solve math problems, design complex models, compose music and debate politics with individual users. Conversational AI tools have been around in limited shapes and forms over the last several years, however, are now being deployed across industries to deliver higher value to the users and investors alike. It is quite likely to attract investor attention as the penetration of AI increases to enter everyday tasks and allow better utilization of human consciousness.

Blockchain & Web 3

The recent rise and fall of crypto currency have all but ensured that the concept of blockchain percolates down to retail investors who were never aware of such remarkable technologies. The concept of decentralization of currency, applications and networks has created an impact within the investor circle, where a significant amount of capital has been pushed towards these platforms. It is evident that substantial innovation within these segments has led to the emergence of ground-breaking technologies that have been monetized by fast movers and this trend is likely to continue over the coming years.

Low Code / No Code Tools

No code platforms are essentially built to turn everyone into programmers. The intuitive nature of these solutions is based on power packed digital environments that can help create applications, websites, and tools. Investors have also parked sizable capital across these businesses owing to the potential of the sector. In fact, the educational benefits of low code tools have also penetrated the K12 curriculum, where coding is increasingly becoming recognized by teachers and regulators as an effective tool to help develop logical thinking, problem solving and first principle thinking.

Entrepreneurial grind and startup culture in India is on the rise, but funds that come through financial foundations are not easily accessible for SME players. SMEs in India make a chunk of the underserved segment when it comes to loans. The digital revolution in lending is set to change all this and more. Promising optimization of payments, an increase in revenue, and cross-selling are possible with the use of technology in lending. Digital lending is a positive outcome and will change the way SME seeks monetary resources.

Manish Chowdhary | WOW

06

Policy interventions can bolster *SME growth*

Since 2014, the government of India has been pushing for digitized infrastructure across industries, where SMEs are a key area of focus. They have also come out with the Indian Digital Stack that is a set of Application Program Interfaces (APIs) that enable instant communication between servers and devices.

Another landmark initiative of the government that kickstarted the move to digitization for SMEs was the Unified Payments Interface (UPI) that was introduced in 2016. This was followed by a demonetization drive that sparked a nationwide shift away from a cash-based economy towards a digital one. Demonetization and UPI both sparked a rapid increase in digital payments in India.

Even the Goods and Services Tax (GST) was introduced to streamline company taxes and boost tax reporting. Millions of SMEs have already been encouraged to formalise by the GST proposal. Over 9.2 Mn SMEs in India are currently registered for the GST, an increase of more than 50% from the previous tax system. With the move to online tax reporting via GST, SMEs now have access to a wealth of digital data that is current (monthly/quarterly filing), granular (invoice level details are provided), validated (invoices are matched), and electronically accessible.

6.1

Existing schemes/ policies of the government for SMEs

In 2015, government revised SME classification so that they can further expand their operations while continuing to avail the SME benefits. Also, the 'Make in India' initiative and the 'Atmanirbhar Bharat Abhiyaan' (Self Reliant India Campaign) have played a key role in promoting business and digitization, giving special thrust to SMEs, also referred to as the backbone of the Indian economy. The revision of SME classification allowed for scaling of business and increased healthy competition among businesses.

There are multiple schemes offered by the central and state governments to empower SMEs across the country.

Some of the prevalent schemes are mentioned below:

Scheme	Objective	Benefits	Eligibility
Credit Linked Capital Subsidy Scheme (CLCSS)	To increase small businesses' access to subsidized financing and increase their output.	15% capital subsidy on loans up to INR 1 Crore taken out with financial institutions.	Micro and small Enterprises (MSEs) having a valid UAM number.
Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)	To make available collateral-free credit to the micro and small enterprises and strengthen credit delivery system to facilitate flow of credit.	Credit facilities up to INR 2 Crore per eligible borrower are covered under the scheme.	New and existing Micro and Small Enterprises engaged in manufacturing or service activity.
Pradhan Mantri MUDRA Yojana (PMMY)	To address the working capital requirements of small and micro businesses.	Collateral free loans of up to INR 10 Lakhs for working capital requirements.	Non-corporate, non-farm small and micro enterprises.
SIDBI Make in India Loan for Enterprises (SMILE)	To support new & existing MSMEs for purchasing growth opportunities and provides SME loans with flexible or soft terms to meet the debt-equity ratio of MSMEs.	Loans between INR 10 Lakh to INR 25 Lakh.	Any MSME in operation for the last 3 years having a satisfactory financial position is eligible for this loan.
Performance Credit Rating Scheme for SMEs	To provide a trusted third-party opinion on the capabilities and creditworthiness of the SMEs.	Good rating enables MSEs to access to funds at cheaper rates and better terms.	Open to all MSMEs.

Source(s): Expert Inputs, Redseer analysis, Desk Research

Apart from financial support through varied channels, the government of India addressed the holistic needs of SMEs such as technology, automation, digitization among others and created an environment for growth and productivity. For example, three products, "**Shishu**," "**Kishore**," and "**Tarun**," were **developed by MUDRA** under the auspices of PMMY to denote the degree of development and funding requirements of the recipient micro unit or entrepreneur and to serve as a benchmark for the subsequent stage of graduation or growth.

Other schemes targeting overall development of SMEs in India are mentioned below:

Financial Support to SMEs in ZED Certification Scheme

The programme is a comprehensive effort by the Indian government to increase SMEs competitiveness on the global market by offering them financial assistance in the evaluation, rating, and support of their manufacturing processes regarding quality and environmental factors. The program's goals include ensuring continuous improvement and incorporating Zero Defect & Zero Effect practices into production processes.

Micro & Small Enterprises Cluster Development Programme (MSE-CDP)

As a fundamental strategy for boosting productivity and competitiveness as well as capacity building of MSEs and their collectives in the nation, the Ministry of SME has embraced the Cluster Development Programme. Additionally, grouping of units enables service providers, such as banks and credit agencies, to offer their services more affordably, lowering costs and increasing service accessibility for these businesses.

Prime Minister Employment Generation Programme (PMEGP)

The Prime Minister Employment Generation Programme is a government of India-backed credit linked scheme. This SME loan scheme focuses on generating self-employment opportunities through micro-enterprise establishments in the non-farm sector by helping unemployed youth and traditional artisans. Under this program, SMEs can get a subsidy amounting to 15-35% of their project cost from the government.

TReDS – Trade Receivables Financing for SMEs

Trade Receivables Discounting System (TReDS) is an electronic platform for facilitating the financing / discounting of trade receivables of Micro, Small and Medium Enterprises (SMEs) through multiple financiers. TReDS platform enables both receivables factoring and reverse factoring. These receivables may be owed by businesses and other purchasers, such as government agencies and PSUs (PSUs). The participants on the platform include:

- **Seller:** Only SMEs are allowed to register as sellers
- **Buyer:** Corporates, Government Departments, PSUs, and other entities
- **Financier:** Banks, NBFC - Factors and other financial institutions as permitted by the Reserve Bank of India (RBI)

Performance and Credit Rating Scheme for SMEs

Launched in April 2005, the scheme was introduced to enable SMEs to receive credit quicker and on better terms from banks and other institutional lenders. Under this scheme the operational, financial, business, and management risks are measured using metrics as part of the rating process used by the Scheme. According to the plan, which is being adhered to by all rating agencies that have been granted accreditation, a uniform rating system that considers both credit and performance factors is prescribed. SMEs are free to choose from any of the rating agencies. The rating agency must finish the full rating process within a month of receiving all relevant information from the applicant unit. More than 30 banks / financial institutions have signed MOU with the Rating Agencies / NSIC to extend the benefits to the units rated under the Scheme.

Budget 2023 – *Key Takeaways*

Improving small businesses' access to affordable credit remained the top request from experts in the country's MSME ecosystem in the union budget 2023-24. While the government has implemented several policies post-Covid, such as the emergency credit scheme ECLGS, subordinate debt scheme, revised the MSME definition, SRI Fund, and others, there is certainly room to expand the scope of existing measures to address the vast credit gap in the MSME sector.

Multiple schemes covered under the budget include not only financial support, but also access to advanced skill training, knowledge of modern digital techniques and efficient green technologies, brand promotion, linkage with local and global markets, digital payments, and social security.

This will help small businesses to improve the quality, scale and reach of their products by integrating the MSME Value chain of the country. Few of the initiatives addressing the credit capital challenges of MSMEs are mentioned below:

Credit Guarantee for MSMEs

The CGTMSE for MSME will be revamped. Credit guarantee for small & micro enterprises scheme will be revamped with a INR 9,000 Crore infusion, effective April 1, 2023. It significantly supports MSMEs by facilitating additional credit of INR 2 Lakh Crore, lowering credit costs by 1%, and expanding employment opportunities.

Vivad se Vishwas Relief for MSMEs

For MSMEs that failed to execute contracts during the Covid period, the government and government undertakings would return 95% of the forfeited amount relating to the bid or performance security. This should help MSMEs that are struggling to make ends meet due to economic disruptions.

Digitization of Documentation

An entity DigiLocker will be set up for use by MSMEs. This will enable these businesses to securely store documents online, which can then be easily shared with various authorities, regulators, banks, and other business entities as needed.

Prioritizing MSME Payments

To assist MSMEs in receiving timely payments, the budget proposed deducting expenditures on payments made to MSMEs only after clearing all MSME related bills. This means that buyers cannot claim a concession unless they first pay MSMEs. The initiative is likely to compel buyers to pay off small businesses debts as soon as possible.

Revision of Presumptive Taxation

Micro-enterprises with a turnover of up to INR 2 Crore and professionals with a turnover of up to INR 50 Lakhs were previously eligible for the presumptive taxation scheme. The Union Budget 2023 increased the limits for taxpayers with less than 5% cash receipts to INR 3 Crore and INR 75 Lakhs, respectively. To assist MSMEs in receiving payments on time, the budget has also proposed allowing a deduction for expenditures incurred on payments only when the payment is made.

Evidently, the budget laid special emphasis on the welfare, development, and empowerment of SMEs through both financial and non-financial interventions. With the infusion of significant fresh capital towards India's small businesses, the government has earmarked SMEs as a clear prerogative for the next couple of years.

6.3

Additional *regulatory interventions* needed

SMEs are one of the main forces behind India's economic growth story. The SME sector, which includes the service industry, infrastructure, food processing, IT, among others has emerged during the past few decades as the Indian economy's most dynamic source of growth. Complementing the growth, the needs of these enterprises have also grown versatile over the years.

Due to its size, scope of operations, and accessibility to funding, the SMEs sector has been one of the most susceptible sectors during the epidemic. This has led SMEs to evaluate their financial situation and security immediately.

From a regulatory perspective, the government may step forward to offer soft loans with a longer repayment term and enhance credit limits to boost SMEs. SMEs must re-plan their total value proposition by enhancing product quality, bolstering distribution channels, and utilizing cutting-edge advertising techniques, among other things. To expand market outreach among buyers and providers, a robust digital ecosystem must be built.

Financial Interventions

Faster Disbursement - Requires policies for borrower friendly KYC checks and improvement in application process.

Modern Registration Solutions - Improvement in business registration, certifications, insurance and other licensing infrastructure affecting their credit worthiness.

Credit Bureau - issues such as lack of credit history and lack of financial resources can be resolved by setting up a credit bureau.

Access to Credit and Tax Incentives - Tax incentive such as tax cuts and exemptions, can be implemented to lesson the financial burden on SMEs and improve their finance accessibility.

Market Interventions

Push for Digital Awareness - Broaden the scope of scheme like "Made in india". Digital india and establish PPP to SMEs with access to digital technologies.

Building Digital Infrastructure and Skill Training - Development of digital infrastructure, such as broadband internet and mobile networks and improve their skills to help adopt new technologies.

SCM and Logistics Lnterventions - Initiatives such as transportation optimization inventory management and streamlined logistics processes can help to reduce cost and increase their competitiveness.

Business Development and Digital Marketplaces - Establish and promote digital environment that provide SMEs with a one stop sales arena to sell their products and services in domestic as well as international markets.

Formalization and Inclusion

Industry Interventions - Industry initiatives and regulatory changes to booster the growth of digital lending.

Financial Literacy - Educating SMEs on the benefits of practicing accounting, financial planning and other such concepts.

Awareness of Alternate Finance - Create awareness on benefits and risks of various lending options and promote high fidelity models via campaign and schemes.

Source(s): Redseer analysis on IDIs

There are multiple points where SMEs require support from regulators. Few of the necessary interventions essential to improve output and productivity of these SMEs are explained below:

Financial Interventions:

Micro, small, and medium enterprises are among the most important pillars of India's economy. However, despite being an instrumental cog in the wheels of economic growth and nation-building, the interest of SMEs has largely remained unaddressed. The segment's total productivity is hampered by the lack of institutional support for innovation. Below are the few gap areas which require special attention:

Faster Disbursement Time

Since many SMEs have narrow profit margins, they urgently need working capital to cover their ongoing expenses. However, the approval and disbursement times of traditional financial institutions are excessively long, rendering them inappropriate for the operating capital needs of SMEs. These protracted disbursement times deter potential SME borrowers from completing the process. Alternate lenders, however, take 1/10th of traditional banking system time to process the same application. This can be improved by creating a borrower friendly KYC policy.

Modern Solutions for Registration

Older management systems, which mandate that small enterprises obtain licenses, insurance, certificates, etc., are one of SMEs issues. These rules prevent SMEs from getting capital in a timely manner. However, due to a lack of confidence and a lack of experience with technology, many small firms choose not to engage in online business transactions. Opportunities for SME are also hampered by regulatory loopholes that result in delays in getting licenses, insurance, and certificates. This calls for improvement in ease of registering business and requires awareness on getting necessary licenses to grow the business.

Collateral Free Loans

Collateral-free loans for SMEs in India can be difficult to obtain due to various challenges such as lack of credit history, limited financial resources, and a lack of collateral. Government schemes such as the PMMY, ECLGS and the Stand-up India scheme, which provide such loans have their own limitations. Establishing a credit bureau that tracks the credit history of SMEs can help to overcome the lack of credit history issues. This would allow lenders to assess the creditworthiness of SMEs based on their past credit performance. For example, they can use cash flow analysis, business analysis, and other financial metrics to assess the creditworthiness of SMEs.

Access To Finance and Tax Incentives

There are several strategies that governments and other organizations can implement to grow the contribution of SMEs to a nation's GDP. For SMEs to expand and flourish, they need to have access to reasonable and suitable financing options, such as business loans, grants, and investment possibilities. Tax incentives, such as tax cuts and exemptions, can be implemented to lessen the financial burden on SMEs and make it simpler for them to invest in development and expansion.

The disparity between SMEs who require financing and those who get it has an impact on India's financial inclusion. Many SME borrowers are excluded from the traditional lending environment due to smaller ticket sizes, SMEs geographical dispersion, and inadequate credit depth. In the end, such exclusion impedes access to universal credit and makes it more difficult to include all Indians in the financial services system.

Market Interventions:

Today, about 10-15% of SMEs are completely or partially using digital tools for their business processes. Many SMEs in India lack access to new and emerging technologies, such as automation, and artificial intelligence along with deficiency of digitization. This restricts their capacity to enhance their processes, boost their effectiveness, and maintain their competitiveness. Below are such areas which require intervention from the government and private players.

Pushing for Digital Awareness

SMEs in India often lack access to digital technologies, such as e-commerce, mobile payments, and digital marketing, which can limit their ability to improve their operations, reach new customers, and increase their productivity. The government can launch initiatives to encourage SMEs to adopt digital technologies and improve their digital capabilities. This can include providing funding, training, and other forms of support. For example, the government of India has launched the "Digital India" program, which aims to promote the use of digital technologies among SMEs. The government can work with private companies to establish public-private partnerships for better penetration.

Building Digital Infrastructure and Skill Training

Investing in the development of digital infrastructure, such as broadband internet and mobile networks, can help to improve the digital capabilities of SMEs and make it easier for them to become digital natives. Moreover, providing training and support for SMEs to improve their digital skills can help them to adopt modern technologies and increase their competitiveness. This can include training on how to use digital platforms and tools. The government can establish incubation and acceleration programs to help SMEs to develop and implement digital technologies and improve their digital marketing skills.

Supply Chain and Logistics Interventions

SMEs in India often struggle with poor infrastructure, which limit their ability to transport their goods and services to markets as well as their ability to access raw materials, equipment, and other inputs. Government and private sector interventions can include working with SMEs to identify and address bottlenecks in the supply chain and promoting clustering and networking among SMEs. This can include initiatives such as transportation optimization, inventory management, and streamlined logistics processes, use of digital platforms to manage inventory, use of GPS tracking systems for shipments, digital freight forwarders, and digital customs clearance systems.

Business Development and Digital Marketplaces

SME enterprises often struggle to access new markets, both domestic and international. To improve market accessibility various measures can be taken such as organizing trade fairs and exhibitions, export promotion programs, and e-commerce platforms. The government can implement export promotion programs to help SMEs enter new international markets and encourage SMEs to network and collaborate with each other, to share resources, knowledge, and best practices and increase their competitiveness in the market. Also, establishing and promoting digital environments that provide SMEs with an online marketplace to sell their products and services can help them to reach new customers and increase their revenues.

SMEs in India frequently deal with a complicated and onerous regulatory environment, which makes it difficult for them to launch and expand their offerings. Regulations can be made simpler by the government, which can also lower compliance costs and increase corporate efficiency. Addressing all these challenges will require a combination of government and private sector interventions, tailored to the specific conditions, and needs of the SMEs.

Formalization and Inclusion of Alternate Finance:

Alternate finance for SME loans, can help fill the credit gap faced by India's SME sector by providing access to capital for businesses that may not qualify for traditional bank loans. These options can also provide more flexible terms and lower interest rates. Additionally, many alternate finance platforms use advanced technology and data analysis to assess creditworthiness, which can help to increase the efficiency and accessibility of lending for SMEs. Inclusion of alternate finance models in mainstream financing is critical for SMEs growth and development. Additionally, it is required to improve financial literacy amongst these enterprises and increase awareness of non-traditional lending channels.

From a perspective of formalization and inclusion, the future of alternate finance in India looks promising. The Indian government has been taking steps to promote the growth of alternative lending models, such as revenue-based financing, through regulatory changes and industry initiatives.

- The Reserve Bank of India (RBI) has been working on a framework for regulation of digital lending platforms which includes the revenue-based financing model. This is expected to bring more transparency, fair practices, and better user protection in the sector.
- The RBI is facilitating digital onboarding of businesses by simplifying the KYC requirements. The future can become brighter once platforms like OCEN are introduced by the authorities.

There is a need to improve financial literacy among SMEs and increase awareness related to financial planning and use of alternate funding options for short-term borrowing needs to boost growth and development. These have been explained below in detail:

Informational Efforts

The government should start informational campaigns to spread knowledge about different lending options among India's online businesses, such as revenue-based financing. To inform SMEs on the advantages, risk, and accessibility of these models, these efforts may include seminars, workshops, and webinars.

Collaboration with Trade Associations

The government might work with trade associations to connect with digital SMEs and inform them of alternative loan options. Industry groups can offer education and tools to aid SMEs in comprehending and using these models.

Support for Digital Platforms

The government can support the development and growth of digital platforms that connect digitized SMEs with alternate finance options. This can help increase access to these models for SMEs and make it easier for them to find lenders.

Including Alternate Lending Models in Government Programmes

By incorporating alternative lending models, such as revenue-based financing, into their programmes for SME finance and development, the government can encourage digital SMEs to become more aware of and use these models.

By implementing these measures, the government can help increase awareness of alternative lending models among digitized SMEs in India and make it easier for them to access the funding they need to grow and thrive.

Alternate finance has shown to be a highly effective way to help SMEs with their problems and give them access to credit at low interest rates. Moreover, seeing the trends it is expected that alternate finance channels will boost capital supply fulfilling the working capital requirements of these digitized SMEs.

Overall, the future of alternate finance models-based financing in India looks positive, with the government and industry working together to promote its growth and make it more accessible to borrowers. However, as with any new financial model, it is important to be aware of the risks and make sure that the borrowers and lenders are aware of their rights and responsibilities.

6.4

Global precedents – regulatory practices

Around the world, SMEs are regarded as a high impact sector of the economy. Consequently, governments of various countries have engineered schemes to boost and develop this burgeoning sector. Most remarkable interventions come from the Asia-pacific region are from Hong Kong and Singapore that have come up with targeted interventions for digitized businesses.

Hong Kong:

- According to the Global Entrepreneurship Monitor (GEM) study, responsive government administration and streamlined procedures are two factors that encourage entrepreneurship in a country.

- In this context, Invest Hong Kong is a company established by the government to provide current information on firms in Hong Kong. The establishment of a department with the sole purpose of disseminating information on the type of funding and other financial assistance provided by the government for the growth and successful operation of these enterprises as

Funding

Favourable regulations on job creations

Favourable regulations on import/export

Reduced tax

- There is also a group that assists investors in establishing successful businesses in cities and specialises in identifying and connecting potential investors with suitable business partners. With such approaches, the government's efforts to create a favourable environment for entrepreneur enterprises will undoubtedly be successful.

Singapore:

The government launched 5-year nationwide projects that are focused on science and technology in the late 1990s to address the country's poor over-reliance on foreign capital and lack of indigenous entrepreneurship and innovation.

The government established the Techno-Partnership Innovation Fund to foster high technological advancement, primarily to encourage investment in entrepreneurship and innovative firms.

Singapore became one of the top financial centers thanks to its very advantageous environment and flexible tax laws. For instance, it is known that Singapore's government significantly reduced the burden that taxes place on international corporations, and this one action allowed both individual investors and foreign enterprises to benefit from a 5-year tax exemption.

In fact, this strategy encouraged transnational corporations to start research and development (R&D) departments and more entrepreneurship ventures with sufficient finance, which fueled the creation of new business lines and enhanced productivity in the nation, boosting the expansion of their industrial activities.

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07

Key *Takeaways*

Takeaway	Details
'Digitized' is the way forward	Consequent to the pandemic, SMEs have experienced the benefits of a wider audience, reduced costs and higher efficiencies. Therefore, digitization is no longer just for prospering businesses, but also for emerging enterprises. This trend is likely to continue for the near future and many digitized businesses will enter the market in the next 5 years.
SMEs struggle to raise capital	There are 3 key challenges SMEs face while raising funds, that must be solved for: ◦ Lack of collateral to offer against loans. ◦ Elevated risk perception amongst traditional lenders. ◦ Pedantic lending procedures resulting in delayed loan disbursements.
USD 200 Bn+ credit demand	Digitized businesses collectively have a potential credit demand of ~USD 220 Bn. However about ~USD 165 Bn is serviceable when adjusted for sick enterprises and commercially unviable businesses.
~30% of demand is addressed	During FY'22. about USD 53 Bn was infused into the market across different lending channels, that accounts for ~30% of the overall addressable demand.

Credit capital deficit	There is a capital deficit of ~USD 112 Bn, that is presently limiting businesses from growing and innovating new and more efficient ways of working. SMEs are forced to opt for informal lending channels and recycle their revenues, which further inhibits their ability to build scalable and investable businesses.
Small enterprises are impacted severely	Small businesses account for ~90% of the credit demand and still struggle the most to raise capital, mainly because of their poor business metrics, limited assets, and uncertain growth projections. This gap is likely to widen substantially over the next 5 years, if the existing economic and regulatory climate prevails.
New age lending solutions such as Revenue-Based Finance (RBF) are the silver lining	Alternate finance has emerged as a saving grace for SMEs that have opted into lending models such as RBF, trade receivable financing etc. The models offer high degree of flexibility, collateral-free lending and are completely aligned to business growth, making them attractive propositions for SMEs.
Share of alternate finance is likely to double	At present, ~5% of the lending market is contributed by alternate finance channels. This grew substantially during the pandemic and is likely to double over the next 5 years to reach ~11% owing to a higher market awareness and understanding, SME first approach and high flexibility of repayments.
Revenue-Based Finance (RBF) is now more relevant than ever	Being data-driven, revenue-based, and flexible has made RBF one of the most robust and popular forms of alternative funding. With a typical flat fee structure between 6-12%, and loan amount suited to the working capital needs of diverse businesses, SMEs can benefit from ready, unbiased access to capital at competitive costs.

Glossary

Terms	Definitions
Digitized SME	Digitized SMEs are those that have completely or partially adopted digital tools for procurement, discovery, logistics, payments, bookkeeping, inventory, communication among other business processes. (~30% revenues through online channels).
Micro business	Any enterprise with annual turnover of < INR 50 Lakhs.
Small business	Any enterprise with an annual turnover of INR 50 Lakhs-10 Crores.
Medium businesses	Any enterprise with an annual turnover of INR 10 - 150 Crores.
E-commerce (D2C + DNB)	New-age brands that build, market, sell and ship a product directly to the consumer either through e- marketplaces, or their own brand.com, thus, avoiding the traditional retail distribution models.
SaaS	SaaS includes e-commerce enablers, ERP, CRM, HRM, IT/ITeS, mobile applications such as gaming, music, entertainment apps etc.
Food	Food includes restaurant aggregators, cloud kitchens, cafeteria management, QSR among others.

Travel	Includes online travel agents, flight aggregators and tour operators.
Edtech	Includes digital learning platforms for students and employees.
Other Platforms	Others include e-pharma, online travel agents, cleantech, edtech among others.
3rd party investors	Includes alternate finance channels such as family offices, angel investors, trust's capital, private financers etc.
Working capital	Short-term borrowing needs of SMEs required for a quarter of operations in a year.
Alternate finance / financing/ funding	This includes new age financing models such as RBF, trade receivable-based funding, Invoice discounting, among others.
Microfinance Institutions	Financial companies that provide small loans to people who do not have any access to banking facilities.
PSU	Public sector banks
RBF	Revenue-Based Financing

Appendix

Demand side Methodology

Investment Segmentation	Turnover Estimations	Total Turnover	Working Capital	Total Credit Demand
- Ecommerce - SaaS - Food - Travel - Edtech - Others	Expert interactions to arrive at average turnovers for each sector Differentiated by small and medium enterprises	Number of enterprises multiplied by average sector turnover was used to arrive at sector wise turnover	Working capital requirements for each sector was confirmed through sector experts	Working capital as a percentage of turnover for each sector was calculated Yearly working capital requirement for each sector was summed up to achieve total digitized SME credit demand

Note: Only working capital estimates have been considered since they account for most of the credit demand of such enterprises

- The 7.7 Mn SMEs have further been bifurcated into micro, small and medium businesses; of which, small and medium businesses were selected as the focus area of the study because micro businesses do not qualify for credit.
- There are about 2.7 Mn small and 27 thousand medium digitized enterprises in India whose credit demand has been calculated based on their annual turnover and working capital requirements.
- Further, these small, and medium enterprises have been categorized as:
  - E-commerce
  - Software as a Service (SaaS)
  - Food and food related technology (Food)
  - Travel (online travel agents, tour operators and flight aggregators)
  - Edtech (e-learning platforms for both students and employees)
  - Others (e-pharma, cleantech, and trading firms amongst others)

- Turnover for each sector has been arrived at through in-depth interactions with brands from each of the above sectors. These values are different for small and medium businesses as under:

Average annual turnovers (steady state)

Sectors	Small Enterprises (USD MN)	Medium Enterprises (USD Mn)
E-commerce	0.6	6
SaaS	0.7	9
Food	0.4	5
Travel	0.6	6
Edtech	0.6	6
Others	0.6	6

- Working capital for these enterprises have been validated for each sector, replicating a business at steady state.

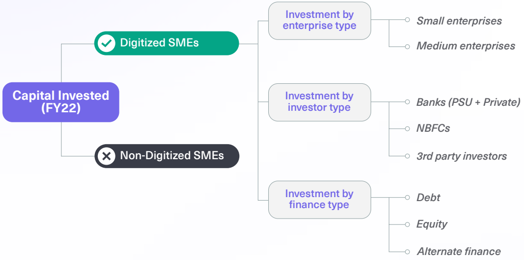
The requirement for working capital has been estimated separately for small and medium businesses as under:

Average Working capital requirements as a percentage of turnover

Sectors	Small Enterprises	Medium Enterprises
E-commerce	14%	14%
SaaS	10%	10%
Food	9%	9%
Travel	12%	12%
Edtech	11%	11%
Others	9%	9%

- Total credit demand is calculated on the basis of working capital requirements multiplied by the number of enterprises in each sector. The need for financing of capital expenditures / long term borrowings have been excluded.

Supply Side Methodology



Note: Non-digitized SMEs are excluded from the analysis

- The supply side context has been built on a bifurcation of the formal lending space that accounts for ~60% of the overall SME lending in India, split into small and medium businesses.

- This formal sector lending was divided into funding towards digitized SMEs that made up ~40% of the overall capital invested in FY22 and further classified by investor type as:

Sector wise split of capital invested in FY22

Sectors	% Split
PSU	30%
Private Banks	42%
NBFCs (includes Fintech)	25%
3rd party investors (family offices, HNIs, Angel Investors etc.)	4%

- This invested capital was also further classified by investment type into debt, equity, and alternate finance segments to understand market preferred modes of funding.

- The capital was also classified between the selected sectors viz e-commerce, SaaS, food, and others to estimate the amount of capital invested within each of these verticals as under:

Sector wise split of capital invested in FY22

Sectors	Small Enterprises (USD MN)	Medium Enterprises (USD Mn)
E-commerce	55%	55%
SaaS	17%	17%
Food	4%	4%
Travel	4%	4%
Edtech	6%	6%
Others	15%	15%

- The cumulative total is referred to as total capital invested in digitized SMEs.

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