PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA19500

Project Name	MSME Growth Innovation and Inclusive Finance Project (P151544)
Region	SOUTH ASIA
Country	India
Sector(s)	SME Finance (100%)
Theme(s)	Micro, Small and Medium Enterprise support (80%), Other Financial Sector Development (20%)
Lending Instrument	Investment Project Financing
Project ID	P151544
Borrower(s)	Small Industries Development Bank of India
Implementing Agency	SIDBI
Environmental Category	F-Financial Intermediary Assessment
Date PID Prepared/Updated	31-Dec-2014
Date PID Approved/Disclosed	31-Dec-2014
Estimated Date of Appraisal Completion	02-Jan-2015
Estimated Date of Board Approval	24-Feb-2015
Decision	Authorized to proceed with appraisal

I. Project Context

Country Context

1. India has been amongst the world’s fastest growing economies in the last decade. In this period, India grew faster than 89 percent of the world’s nations. Real GDP expanded at an average annual rate of 8.3 percent between FY2003-04 and FY2011-12. Growth has been accompanied by an impressive reduction in poverty with about 140 million lifted out of absolute poverty between 2008 and 2011, and, while disparities remain, overall India’s growth has been inclusive.

2. A key driver of this growth has been the service sector, while the manufacturing and agriculture sector remain important due to their potential to absorb large segments of the labor force. The service sector now constitutes over 67 percent of GDP, up from 59 percent a decade ago - an increase that also highlights the transformational changes in the structure of the Indian economy with a marked shift towards this sector. Service sector growth has been broad based in terms of sub-sectors ranging from Information Technology (IT) and financial services to social sectors such as education and health services. The services sector has a broad geographic spread across India’s states. Several low income states (LIS)/Special Category states such as Madhya Pradesh, Tripura, Manipur, Chhattisgarh and Bihar outperform many other states in the growth rate of services sector.

This statistic also underscores the potential of this sector to contribute to furthering inclusive growth. The manufacturing and agriculture sectors, despite declining shares in GDP composition, remain important as labor intensive sectors and that functions as key sectors that absorb employment.

3. However, economic growth has slowed down in recent years. FY2013 and FY2014 have seen growth reduced to below 5 percent levels, though it has picked up sharply in the first quarter of the current fiscal year. The current account deficit has returned to the low pre-global crisis levels, as recovery in India's major export markets and a competitive exchange rate following last year's depreciation, helped stimulate exports.

4. For India to retain its high growth trajectory and meet its poverty reduction goals, it needs to address the recent economic slowdown and boost efforts to create jobs and foster entrepreneurship for its burgeoning population. The link between economic growth and poverty reduction has been well established and this has also been evident in India where most of the best performing states have reduced poverty faster than the national average. Reinvigorating economic growth is a key prerogative for Government of India (GoI).

5. A priority for India is to create 10-15 million jobs per year for the next decade to provide gainful employment to its growing young population. Rapid job creation, both in terms of formal employment as well as entrepreneurship, is key to generating the number of economic opportunities needed. The issue is not just the number of additional jobs (140 million by 2020), but also the type of jobs and the opportunities for young people to create their own jobs, start their own companies, and in turn, grow companies that will create more jobs. India needs more productive jobs, with growing labor earnings and the prospect of formalization; jobs that support upward mobility and take households into the ranks of an emerging middle class.

Sectoral and institutional Context

6. Central to this challenge of boosting growth and job creation is the micro, small and medium enterprises (MSME) sector, which contributes around 45 percent to manufacturing output and about 40 percent of exports (directly and indirectly). As such, entrepreneurship and business creation by MSMEs is crucial for large-scale employment generation and productivity growth. There is widespread recognition within India, as demonstrated by recent key government reports, that vibrant MSMEs are a key engine of economic growth, job creation and greater prosperity and that a vibrant entrepreneurial ecosystem fosters innovations and contributes to greater dynamism in the economy. MSMEs are also regarded as the crucible for the Government's "Make in India" vision formulated recently.

7. However, the growth of the MSME sector has been constrained by lack of access to finance. Financial institutions have limited their exposure to the sector due to a higher risk perception, information asymmetry, high transaction costs and the lack of collateral. Lack of adequate finance is one of the biggest challenges inhibiting MSME growth. It is estimated that about 87 percent of MSMEs do not have any access to finance and are self-financed. Credit towards micro and small enterprises represent only around 13-15 percent of formal financial institutions portfolio. An IFC-Intellecap study showed a very large gap between demand and supply for credit for MSMEs. In addition to access to finance constraints, poor investment climate, lack of infrastructure and market linkages, and gaps in financial market infrastructure and legal framework are additional constraints.

While these are all important areas, these are the subject of parallel initiatives that seek to address them, and hence are not a focus of this project, which instead aims to complement such other efforts.

8. Addressing finance constraints for MSMEs is of utmost importance. Financial constraints hamper growth, competitiveness, response to shocks as well as employment and investment decisions at the firm level and thus affect the performance of the economy at large.

9. In responding to the challenge of enhancing the provision of financial services to MSMEs, an effort to adapt this response to India's evolving economic structure and focus on spurring key areas within the MSME sector that are particularly relevant for growth and employment, is critical. First, accelerating entrepreneurship finance is crucial for generating large-scale employment, but also providing solutions to myriad problems by supporting innovative solutions in sectors such as education, health, climate change, IT and financial inclusion. Recent studies have shown that young firms and startups play a critical role to job creation and productivity growth. Furthermore, India is seeing a vibrant growth of first time entrepreneurs (64 percent of startups), including the now globally relevant firms such as Infosys, Airtel, HCL, etc. Second, supporting the services sector which accounts for 67 percent of GDP and encompasses 71 percent of MSMEs would provide an impetus to growth and exports. Sectors such as education, health, entertainment, financial services, are the fastest growing sectors in the India economy, and are not only the drivers of economic growth, but also have the potential to significantly contribute to employment for future generations as India's economic composition continues to shift. Service sector's growth has also propelled growth in several low income states and has therefore contributed to promoting inclusive growth in the country. Third, supporting manufacturing growth is critical given that 75 percent of the MSMEs total output come from the top 10 industries in manufacturing. The manufacturing sector is a priority for GoI which is concerned by the share of MSME manufacturing in GDP dropping, just as the share of manufacturing to GDP has also been declining; GoI is targeting to increase the share of the manufacturing sector to 25 percent by 2022 from the current 16 percent. Further, enhanced provision of finance to India's manufacturing sector can help revive the sector whose performance is lagging behind compared to other countries, particularly China, and can contribute to maximizing the growing opportunities from the rapidly increasing labor costs in China.

10. Rationale: Limited financing to these three vital areas – early stage/start-ups, services and manufacturing – within the MSME sector has been a critical constraint. With regard to the first area, debt financing for early stage companies is virtually non-existent and MSMEs also lack mezzanine risk capital products. India's startup ecosystem is currently one of the fastest growing in the world. India has the potential to build about 2,500 highly scalable businesses that could generate revenues of Rs10 lakh crore (US$200 billion) in the next 10 years. To meet this potential, India needs to build a pipeline of over 10,000 startups. However, the rapid growth in the ecosystem and the demand for financing have not been matched by the supply of financing to early stage entrepreneurs. While India has seen substantive growth of venture capital (VC), the financial market to support the ecosystem has been undeveloped in debt options to startups. The lack of debt financing in the ecosystem has meant that firms grow slower and are less able to take advantage of economic opportunities due to lack of financing, and are often forced to turn to equity to finance working capital – which is both an expensive way of financing working capital and reduces entrepreneurial. One of the key findings of the Planning Commission report (Creating a Viable Entrepreneurial Ecosystem in India, Mitra Committee report, 2012) is the lack of debt financing instruments available to entrepreneurs, and estimates that around Rs3 lakh crores (or around US$50

billion) of capital would be needed over the next decade to build the pipeline of startups and entrepreneurial activity needed for India to meet its potential. The report states that half of the capital inflows needed for fostering early stage entrepreneurship is in form of debt instruments for working capital needs. In addition to the shortfall in early stage debt finance, MSMEs across various stages of growth lack mezzanine capital – which if provided is a valuable form of capital that can help strengthen balance sheets by providing longer term funding and leverage additional funding.

11. Second, the service sector lacks the ability to provide physical collateral and this lack of physical assets inherent in service sector activities, and in MSMEs in general, means that they face constraints in accessing bank financing. Indeed, most businesses in the services sector only create/ invest in light assets and operate from leased premises. Therefore, given the nature of these enterprises, they typically have softer collateral (e.g. fixtures, furnishings, equipment, etc.), with limited access to immovable collateral. All this makes access to formal finance challenging as financial institutions have yet to develop appropriate risk assessment frameworks to assess such enterprises. As a result traditional banking based on collateral lending does not cater well to these large, innovative and dynamic segments of the Indian economy. Thus, despite the contribution of the sector to GDP, its potential is not fully realized and many firms are unable to grow sufficiently. Financial depth (credit to GDP) for this sector is a mere 25 percent (RBI).

12. The introduction of customized products (for light assets and franchisee financing) with innovative financing mechanisms would support the growth of formal debt financing to the service sector and sector growth. Credit worthiness appraisal would be tailored with new borrowers' risk assessment approaches and drawing from multiple/alternative sources of information to address information asymmetry and assess credit risk.

13. Third, lack of finance to manufacturing MSMEs has contributed to constrained growth and limited competitiveness. The manufacturing sector is more capital intensive, has longer working capital cycles and has therefore higher working capital requirements than the services sector. It is estimated that with inefficient utilization of capital (and lower capital margins), working capital accounts for 70 percent of the total debt demand from the manufacturing sector. However, only 50 percent of the average demand of a manufacturing MSME is met in India, suggesting that many manufacturing MSMEs remain financially underserved. Manufacturing enterprises account for 73 percent of the MSME's viable and addressable debt gap (while services MSMEs make up 27 percent). The Inter-Ministerial Committee for Accelerating Manufacturing in MSME Sector emphasized the vicious cycle of credit issues, where lack of access to formal sources of finance leads to alternate and more costly sources of funds, resulting into low net cash inflow which increases the risk profile of the small units and reduces their credit worthiness. This, in turn, further exacerbates lack of access to formal sources of finance. Financing towards (or encouraging) sustainable improvements in the manufacturing MSME sector is one potential way to help strengthen the competitiveness of manufacturing MSMEs, for example through increased cost efficiency but also building competitive advantage beyond cost efficiency, deploying modern machineries, energy saving investments in plant and machinery/production processes, cleaner technologies in the manufacturing process that can increase productivity.

14. The GoI and the Small Industries Development Bank of India (SIDBI) have requested the project which will focus on the financial intermediation to the MSME sector, and complements other ongoing and parallel efforts by the GoI and industry to address the other constraints that

inhibit MSMEs' growth and employment potential. The proposed project also complements other World Bank engagements with the GoI for the MSME sector and builds on previous successful financial sector engagements with SIDBI (2004 and 2009). As discussed above, access to finance is one of the main constraints faced by entrepreneurs (including startups) in the MSME segment. By focusing on specific areas/sub-sectors, the project will help develop appropriately designed products, mechanisms and initiatives that address the key constraints that inhibit finance for early stage, service and manufacturing MSMEs. Assistance will be provided through SIDBI directly (particularly relevant for early stage financing, service sector financing and manufacturing sector financing linked to better management practices), all areas where interest from other lenders is lacking, as well as through other eligible participating financial institutions (PFIs, refinancing) which are interested. By demonstration, the project will catalyze private sector financing, leveraging SIDBI's role as the apex development bank for MSMEs. Capacity building of the intermediaries in the targeted areas of the project would also contribute to sustainability of the effort and enhanced outcomes. The proposed project also supports SIDBI's transition to new focus areas in line with its strategic business plan and therefore contributes to strengthening India's apex development bank for this sector. The proposed project supports enhancing the capacity of SIDBI to deliver and develop financial products to MSMEs in the areas of early stage debt finance, and service and manufacturing sector finance. The project also supports SIDBI transition to new focus areas, including creating markets for new financial products and services for first generation entrepreneurs and new models for service sector financing. It supports SIDBI transition as a 'market making' financial institution in line with its recently formulated strategic business plan. It uses innovative financing products for the first time as SIDBI moves towards emerging areas in services, risk capital and early stage firms; which would strengthen the MSME eco-system. The project aims to use innovative channels to address issues around information asymmetry and credit risk by leveraging information from multiple sources (e.g. angel investor networks for early stage debt financing, or franchisers for service sector financing, and credit bureaus), which will be supported by the parallel technical assistance which is designed to support implementation, enhance project quality and overall, to facilitate long term sustainable development beyond the term of the project.

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II. Proposed Development Objectives

The project development objective is to improve access to finance of MSMEs in manufacturing and service sectors from early to growth stage, including through innovative financial products.

III. Project Description

Component Name

Component 1: Spurring Early Stage and Risk Capital Financing

Comments (optional)

15. Component 1 will support pioneering early stage debt financing (including angel and early stage venture debt) and also support risk capital financing to MSMEs.

Component Name

Component 2: Supporting Service Sector Financing Models

Comments (optional)

16. This component will support products offered by PFIs and SIDBI which are better tailored for the services sector. These include SIDBI's recently introduced products, which are a small part of SIDBI's balance sheet at present but represent products that have the potential to grow. Among them is the introduction and scale up of innovative models of financing with customized appraisal

parameters that rely on business viability and cash flow assessment (rather than typical models that rely on collateral as a primary criterion for eligibility). The project will seek to focus on products such as asset light models, and franchisee financing.

Component Name

Component 3: Supporting Finance to Manufacturing MSMEs

Comments (optional)

17. This activity will seek to support various manufacturing sector financing products, including the introduction of new financial products and/or financing mechanisms for the manufacturing sector. The project will also support sustainable improvements in manufacturing MSMEs, through promotion of better management practices that will support their competitiveness in India but also globally.

IV. Financing *(in USD Million)*

Total Project Cost:	550.00	Total Bank Financing:	500.00
Financing Gap:	0.00		

For Loans/Credits/Others	**Amount**
Borrower	50.00
International Bank for Reconstruction and Development	500.00
Total	550.00

V. Implementation

18. SIDBI is the borrower and the implementing agency for this proposed project. SIDBI is the apex institution for MSMEs in India and has a long standing experience in designing financing products and services for MSMEs. It plays a key public policy role in India's MSME sector and therefore benefits from strong support and trust from the Government of India (GoI), reflected in the responsibilities bestowed by GoI on SIDBI, including for implementation of key programs for the MSME sector.

19. The project is expected to extend the loans to MSME manufacturing sector through SIDBI as the financial intermediary. While all the industries considered for sub-loans shall have to comply with environmental regulations, there is a need to address environmental risks from a financial institution perspective. In this regard, the project will follow Environmental and Social Risk Management Framework (ESMF) to as an instrument to minimize the risks.

VI. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01	x	
Natural Habitats OP/BP 4.04		x
Forests OP/BP 4.36		x
Pest Management OP 4.09		x
Physical Cultural Resources OP/BP 4.11		x
Indigenous Peoples OP/BP 4.10		x
Involuntary Resettlement OP/BP 4.12		x
Safety of Dams OP/BP 4.37		x

Projects on International Waterways OP/BP 7.50		×
Projects in Disputed Areas OP/BP 7.60		×

Comments (optional)

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