INDOSTAR
CAPITAL FINANCE

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Uplifting Financial Ecosystem for SMEs

Small and medium Enterprises sector is the backbone of any developing economy as it provides employment to millions of people and is the central nervous system to manufacturing growth of the country. As per CARE rating estimates, there are 45 million SME units in India out of which only 7% are registered while 93% are unregistered. Besides, according to the report, SMEs account for 45% for the manufacturing, contributes 8-9% in India's GDP and accounts for 40% of the exports.

Vast Gap in Lending

To meet the future growth and fulfil existing demand, SMEs are in need for growth capital to expand their operations. SME lenders require funding for two reasons primarily – i) Capex ii) Working capital.

As per IFC estimates, SMEs require total funding of $650 billion, $ 520 Billion as debt while $130 Billion as equity. * In all 93% of the SMEs depend upon on self-finance or unorganized sector. Despite the lending push from the Government, there is still a significant gap between the requirement of funds and the availability of funds. IFC has estimated that the total debt gap is $ 380 billion while the total equity gap is $ 38 billion (source CARE).

Challenges

Traditionally organised lending has always been controlled by Banks, Financial institutions, NBFCs. These players have more data intelligence on the customer and their credit worthiness, and also, regulatory provisions prevented competition in the market.

SME funding has been marred by multiple challenges. Due to opaque financials and organisation structure of SMEs, lenders complain of high acquisition and operations cost along with higher default risk. Whereas SME borrowers face the challenge of snail pace of processing by financial institutions & lack of understanding of their business needs.

Solution

Most of the traditional lenders have used digitisation as a process to build efficiency in their accounting process and providing customers with a better interface. However what is the need of the hour is to completely integrate the ecosystem from back end process to the front end. This can help in the following ways:

a) **Cost effective & fast lending facilities** – Taking benefit of technology to build infrastructure for cost-effective & swift availability of SME finance

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b) **Customised products for SMEs** – Providing products such as factoring, trade finance, cash management services, project finance, bank guarantee, or letter of credit tailed made for client's needs.

Evolving digitization of SMEs financing

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markets, are working on multiple models of lending which can reduce time and cost of lending. Such on-line solution is a win-win for both lenders and the SME since with this SME's can have cheaper access of funds and for lenders cost of acquisition is reduced. Many of these solutions are targeting SMEs and with the help of technology delivering a new class of products that is more accessible and available. Moreover, they can be scaled rapidly. These products are trying to work on following attributes:

a) **Robust customer acquisition-** Traditional acquisition methods had been a highly costly affair, mainly due to generalised communications to the market, huge salary costs of trained team of acquisition managers, the cost of processing non-credit worthy customers etc. Borrowers often feel shy of going to banks due to fear of rejection by credit teams.

   With better technology and data scrubbing, lenders are making more customised marketing campaigns to focused groups, and new marketplace enablers are providing institutions capability to take the loan acquisition process online, saving a lot of costs of offline process thereby. Many lenders have started a process, where initial loan processing happen online and lenders collect KYC & documents, once credit appraisal is done. With the introduction of Aadhaar card, eKYC is looking possible in the near future, which this can ease the loan process exponentially.

b) **Managing Risks-** Since, lending to SMEs can bring a lot of stress to lender's balance sheet Banks and NBFCs are not keen in pushing SME strategy. This has provided perfect case for growth of online P2P (Peer to peer lending) lending platforms. These platforms use complex algorithm based

approach, to understand the borrowers and matching them to the right lenders & investors. These platforms primarily act as an intermediary between the borrower and lending/ investor and do all the work from sourcing to appraisal with minimum charge and fees. In developed countries like the US in last one year, $6 billion of loans was disbursed using such platforms. For such platforms, a lender can be a traditional bank, NBFC, small banks, private bank or PE etc.

c) **Credit appraisal-** Historically lenders had been using Credit scores only as thecriteria apart from financial disclosures by SME, for credit appraisals. The biggest challenges of poor SME credit offtake is poor financial disclosures by SME & less credit history as they had been dependent on unorganised sector due to fear of rejection or long time-consuming process. This could be because of less financial literacy with the promoters and founders and also pressure to maintain low administrative costs.

Integrating traditional credit appraisal approach with data analytics tool (based on internal or external data), lenders can build a lot of intelligence, to take a better view of borrowers. There could be a lot of ecosystem around an SME which can authenticate their credit worthiness. It could range credit rating of their Customers, banking habits with their Bank, analysis of their credit history, industry growth, and social matrix. Many banks and NBFCs have started offering pre-approved programmes to customers based on data intelligence. Under Pre-approved programs, lender offers a particular type of loan to its customers based on data intelligence, where a borrower is not required to prove his or her credibility.

Some of the recent P2P start-ups-popularly called fin-tech(Short for of financial technology) have started accessing the credit rating of the borrower from their social networks – What kind of social interactions they have on the social network, People they network, habits etc..

Digitisation

Banks and Institutions have started or under the process of investing in the digitisation of lending process for better financial inclusion. The development of SMEs is significant to the Indian growth story since more than 55% SMEs are located in rural India providing employment to millions. The entry of new fin-tech start-ups in SME financing is creating competition in this space and food for thought, for the banking industry

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