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Start-up financing – a large untapped opportunity for Banks

The Reserve Bank of India (RBI), in its recent circular dated 4th September 2020[1] has brought startups under the purview of Priority Sector Lending (PSL). As per the current regulations, an entity is considered a startup if it has been in existence for not more than a period of 10 years from the date of incorporation and if its annual turnover has not exceeded INR 100 crores in any preceding financial year[2].

Priority Sector Lending refers to lending to specific segments that have traditionally been unable to receive timely and adequate access to debt capital. These sectors, such as agriculture, micro and small and medium enterprises (MSMEs)[3], renewable energy etc., are quintessential for an economy's overall growth. The Government and the RBI, in an effort to ensure timely credit flow, have mandated banks to lend a minimum of 40% of their Adjusted Net Bank Credit[4] to these segments. This has helped entities operating in these segments raise adequate debt at affordable pricing.

The revised guidelines provide for PSL classification for loans up-to INR 50 crores extended to the following categories of startups:

a. engaged in agriculture and allied services
b. entities that conform to the definition of MSME and
c. others – provided they meet the startup definition criteria

Current debt landscape for startups

Primary sources of debt for the startup ecosystem has been:

a. Venture debt
b. Invoice discounting by Fin-techs
c. NBFCs
d. Banks

Venture debt has been an important financing avenue for startups in India. Venture debt comes with warrants (i.e. the right to subscribe to a company's shares at a later point), which gives investors a possible equity upside along with the fixed income returns in the form of interest. Venture debt is typically availed by borrowers along with/ close to an equity capital raise. This allows startup founders to retain ownership in the company (viz. diluting more by raising additional equity). Loans typically have a tenor ranging between 18-36 months with a monthly amortizing structure.
In a pandemic struck world, with equity investors getting selective, credit flow from this channel could slow place; albeit temporarily.

Invoice discounting is a source of short-term working capital financing for startups. This is done by unlocking the capital tied up in unpaid invoices. This has enabled startups manage their working capital and has helped them free up equity capital. These offerings however attract high rates, making them less alluring in the long term.

Banks and large NBFCs financing have eluded startups as these companies do not fit the traditional underwriting framework. Key reasons include limited business vintage, first generation entrepreneurs as promoters with limited personal assets, absence of collateral, lack of profitability track record and external credit rating. Further long-term finance has been a challenge for asset light companies (absence of hard assets such as land, building and heavy machinery) despite strong cash flows. That said, some of the larger NBFCs and Banks have selectively taken short term exposures on some of the bigger startups in the recent past. This is through their Cash Credit (CC) and Bill Discounting (BD) offerings. CC products however require startups to lock in their high cost equity capital in fixed deposits as margins. This is a deterrent for companies in a growth/cash burn phase. Further, banks are open to discounting bills of only higher rated anchors/parties, leaving startups scouting for additional working capital funding channels.

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What does this mean for Banks?

Lending to emerging businesses requires a tweak in the diligence process of banks with a nuanced understanding of every business model, its unit economics and its path to profitability. Typically, startups incur losses in their formative years as they front load costs to build a strong team and a technology enabled system to bolster revenue growth backed by equity capital. Thus, this necessitates banks to adopt a slice and dice approach to understand margin profiles better. It also requires close monitoring on a periodic basis viz. the annual exposure review done by banks. Banks would need to build dedicated teams with the required expertise to assess and monitor these businesses closely.

A sizeable opportunity for Banks

Venture Capital (VC) investment in India has grown at a robust pace with USD 32 billion[5] being infused into 3,500+ companies over the last 5 years. India focused VC funds continue to garner strong interest. This provides an enormous opportunity for banks to cater to emerging businesses with strong corporate governance structure and unit economics. These startups also have a sound reporting framework which provides transparency and comfort with respect to internal controls and corporate governance. A bank's strong control over a borrower's operating cashflows bodes well for them as they can structure and monitor their exposures effectively.
Apart from building a good quality loan book, banks can offer cash management and other associated services to build its liability book. Catching these companies' young gives them exclusive access and ensures long term stickiness. Also, as these companies scale up, banks would be favorably placed to cater to their growing requirements on the asset as well as on the liability side.

Northern Arc's experience of working with emerging companies

Over the last decade, Northern Arc Capital has lent to high quality small and mid-sized financial institutions (who on-lend to individual retail customers) and has helped them tap the debt capital market. We have been the first lender to most of the emerging financial institutions and have subsequently enabled financing for them from other NBFCs, Banks, Mutual Funds, Development Financial Institutions (DFIs) etc.; thus, being that inextricable link between our client partners and mainstream capital market investors. We revolutionized the way our smaller client partners could access capital markets through innovative product structures such as the multi-originator securitization (MOSEC®), pooled bond issuance and persistent securitization (PerSec™).

We have developed a strong underwriting practice in the niche sectors that we operate in. Our philosophy has always been to become thought leaders in the sectors that we work in. We have balanced our sector led approach by diversifying into six sectors over the last decade. We currently operate in Microfinance, Vehicle Finance, Affordable Housing Finance, Agri Finance, Business Loans and the Mid-Market Corporates space.

The Mid-Market Corporate Lending vertical was started four years back with a mission to enable finance to underbanked corporates and to expand our coverage beyond financial institutions. We have evaluated 100+ early stage companies with unique business models since then. This is across sectors such as Education, Food & Agri, Healthcare, Consumers, Logistics, Clean Energy and IT/ITeS. The team has built a strong understanding of these sectors and business models. Our underwriting approach for this segment has been similar to that of financial institutions viz. lending to high growth businesses backed by strong promoters, sound corporate governance and strong process controls. This has been ably supported by our robust underwriting framework, risk models to assess portfolio performance and risk monitoring practices. Our underwriting approach has been cashflow based wherein we have been able to tailor our debt offering through innovative products such that debt repayments can match the cashflows from the business. Over the last 4 years, we have executed over 50+ transactions and have enabled financing to the tune of INR 800 crores with participation from capital markets as well. A good asset quality is a testament to our underwriting capabilities.

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Given Northern Arc Capital's experience in underwriting emerging businesses, we see ourselves playing a valuable role in helping banks provide financial access to startups. This would also help us further our mission of enabling finance for our client partners by serving as a bridge between them and the debt capital market investors.

[1] https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=50310

[2]Startup definition is as per Ministry of Commerce, Government of India. Note: we have used startups and emerging business interchangeably

[3] An enterprise shall be classified as a micro, small or medium enterprise based on the following criteria: -

i) micro enterprise, where the investment in plant and machinery or equipment does not exceed INR 1 crore and turnover does not exceed INR 5 crores

ii) small enterprise, where the investment in plant and machinery or equipment does not exceed INR 10 crores and turnover does not exceed INR 50 crores and

iii) a medium enterprise, where the investment in plant and machinery or equipment does not exceed INR 50 crores and turnover does not exceed INR 250 crores

[4]Adjusted Net Bank Credit (ANBC) is arrived as follows:

1 Net Bank Credit = Total loans & advances less inter group transactions - bills rediscounted with RBI and other approved financial institutions

2 ANBC = Net Bank Credit + (investments in non-SLR categories under Held to Maturity + other investments eligible to be treated as priority sector)

[5] https://www.bain.com/globalassets/noindex/2020/bain-report_india_venture_capital_report.pdf