

## What makes NBFC sector a better choice for raising funds for an MSME

### Article draft for the Economic Times; June 2019

It is well-acknowledged that Micro, Small, and Medium Enterprises (MSMEs) play an important role in the growth of the Indian economy and particularly, in equitable growth. According to data cited by SIDBI in its Financial Year (FY) 2018 annual report, MSMEs have contributed approximately 29% to Gross Domestic Product (GDP) in FY 2017. In a recent survey by the Confederation of Indian Industry (CII), MSMEs have reportedly created additional jobs of 13.5 to 14.9 million per annum over the last four years<sup>1</sup>. Despite these positive growth-indicators however, there remains a substantial underserved market – of the 6.34 Crore MSMEs in the country, only about 8% are served by formal credit channels<sup>2</sup>. ICRA has estimated the unmet credit demand from the sector in FY 2017 at INR 25 trillion<sup>3</sup>.

An interesting trend is that while credit growth to specific MSME segments has increased year on year,<sup>4</sup> and aggregate MSME lending as a proportion of GDP has increased over a 5-year period<sup>5</sup>, the market share of Public Sector Bank (PSB)-lending to MSMEs has shrunk over a 5-year period with other private lenders gaining market share<sup>6</sup>.

Providing reliable access to formal credit to MSMEs has long been challenging due to (a) inadequate formal data for credit assessment in case of informal, micro SMEs, (b) the lack of tailor-made products that match customer needs with lender preferences, (c) long turn-around times for granting loans, and (d) the requirement of collateral, guarantees, etc. required by most traditional lenders. Regulatory restrictions on banks on-lending for unsecured lending also constrains the flow of credit.

Over the last decade, Northern Arc Capital has worked with multiple NBFCs lending to MSMEs. Our market insights show, that over the last decade, NBFCs have been significant credit providers to MSMEs especially at the lower end. Well-established regional players with in-depth knowledge of micro markets and low-cost distribution serve MSMEs beyond the Tier I cities, focussing on tailored credit underwriting. These NBFCs have attracted both equity and debt capital, given the promise in the sector also leading to co-lending partnerships with banks.

These NBFCs serve MSMEs through (i) differentiated credit underwriting that takes into account multiple sources of data (formal and informal) in the absence of credit ratings/formal data, seasonality of cashflows, industry and cluster risks, as well as a 360 degree view of the borrower, (ii) designing product offerings that are best suited to their target segment (for example, flexible collateral structures, customised products tailored to their working capital cycles), (iii) risk-pricing exposures, and (iv) reduced turn-around times from credit appraisal to disbursement through standardised processes and use of technology .

The NBFCs' difference in approach to underwriting MSME credit has been made possible by their focus or specialisation in MSME-lending by sector, geography, client segment, or a

---

<sup>1</sup><https://www.cii.in/PressreleasesDetail.aspx?enc=FMXV5OWa+OnDs4xBuYxXHeYY8ZR0LoFE0bUqTG84ZKZWkactkBCAcDx2yH/i1/6ZB2j9e79AKiiDA1FUzgrtoQ==>

<sup>2</sup> SIDBI Annual Report FY 2018

<sup>3</sup> <https://www.indiatoday.in/pti-feed/story/msme-credit-to-grow-at-12-14percent-over-next-5-yrs-icra-1192814-2018-03-19>

<sup>4</sup> MSME Pulse – March 2019, by TransUnion CIBIL and SIDBI

<sup>5</sup> MSME Pulse – March 2019, by TransUnion CIBIL and SIDBI

<sup>6</sup> MSME Pulse – March 2019, by TransUnion CIBIL and SIDBI



combination of these features and their calibrated operations and distribution designed to best serve their clients.

Lending models that cater to the MSME segment can be broadly classified under three heads – (i) lenders to informal / small businesses, (ii) lenders focussed on asset financing, and (iii) lenders focussed on secured lending. Northern Arc works with many specialised NBFCs offering credit to identified client constituents– ranging from micro enterprise loans, loans against property, unsecured business loans, school finance, and supply chain financing.

In addition to the steady growth of specialised lenders described above, technology-enabled lending (Fintech) has emerged as a major trend in recent times. Fintech lenders have capitalized on emerging sources of digital data as well as surrogates to evaluate credit-worthiness of borrowers and have combined this with technology-enabled analytics for more efficient underwriting. Given the complementary strengths, we are also seeing the evolution of partnership models between NBFCs leveraging their distribution strength and superior customer understanding with larger NBFCs and banks who are able to efficiently aggregate and further distribute the risk.

These innovative approaches help in creating greater outreach and in more reliable, efficient access to credit to borrowers who may otherwise be excluded from the formal system.

In addition to the emergence and growth of differentiated lending models and evolving co-lending partnerships, the MSME segment is poised to receive a shot in the arm through increasing banking system and policy interventions – a much needed stimulus for not only the growth of the MSME sector but also for the ideal of sustainable and inclusive growth.