BLENDED FINANCE – MSME SECTOR SUPPLEMENT

India's MSME Landscape

Micro, Small & Medium Enterprises (MSMEs) contribute significantly to the economic and social development of the country by fostering entrepreneurship and by generating employment opportunities. The relative importance of MSMEs can be gauged from the fact that the share of MSME GVA in total GVA (current prices) for 2019-20 was 33.08 per cent[1]. However, access to finance and cost of credit have been a concern for the sector[2].

The informal nature of MSMEs coupled with lack of documentation regarding their cash flows, credit histories and governance, leads to hesitation on part of formal financing institutions to optimally serve the sector with credit[3] . The addressable credit gap to the sector has grown at a CAGR of 37 percent to USD 397 billion. As a result, over 84 percent of total demand for credit for MSMEs is serviced through informal sources[4]

Total credit supply to Micro, Small and Medium Enterprises in India by source

Total supply of Debt to MSMEs (USD 1.1 trillion)

- **Formal sources (USD 168 Billion)**
  - Scheduled Commercial Banks (USD 139.6 Billion)
    - Public sector Banks (USD 85.7 Billion)
    - Private sector Banks (USD 49.2 Billion)
    - Foreign Banks (USD 4.76 Billion)
  - NBFC's (USD 23.8 Billion)
  - Other Banks (USD 23.8 Billion)
    - Regional Rural Banks RRBs (USD 1.75 Billion)
    - Urban Cooperative Banks UCBs (USD 1.75 Billion)
  - Government Institutions (USD 0.63 Billion)
    - Small Industries Developement Bank of India (SIDBI) (USD 0.16 Billion)
    - State Financial Corporation (SFCs) (USD 0.47 Billion)
- **Informal sources (USD 898 Billion)**

Source: Financing India's MSMEs: Estimation of debt requirement of MSMEs in India, SDG Investor Map Report for India, 2020

1 Economic Survey 2019-20

2 RBI Annual Report 2018-2019

3 PwC and FICCI (2019). A wider circle: Digital lending and the changing landscape of financial inclusion

4 Financing India's MSMEs: Estimation of debt requirement of MSMEs in India

Retail Financial Services NBFCs have created a strong business case for segments that are either inaccessible or unattractive for traditional banks and MSME lending continues to be a significant opportunity to meet the large unaddressed debt demand. They have played a critical role in furthering financial inclusion by helping create a credit linkage for borrowers in the unbanked and underbanked regions of the country. They help new to credit customers in creating credit history which over time helps these customers to access formal banking channels.

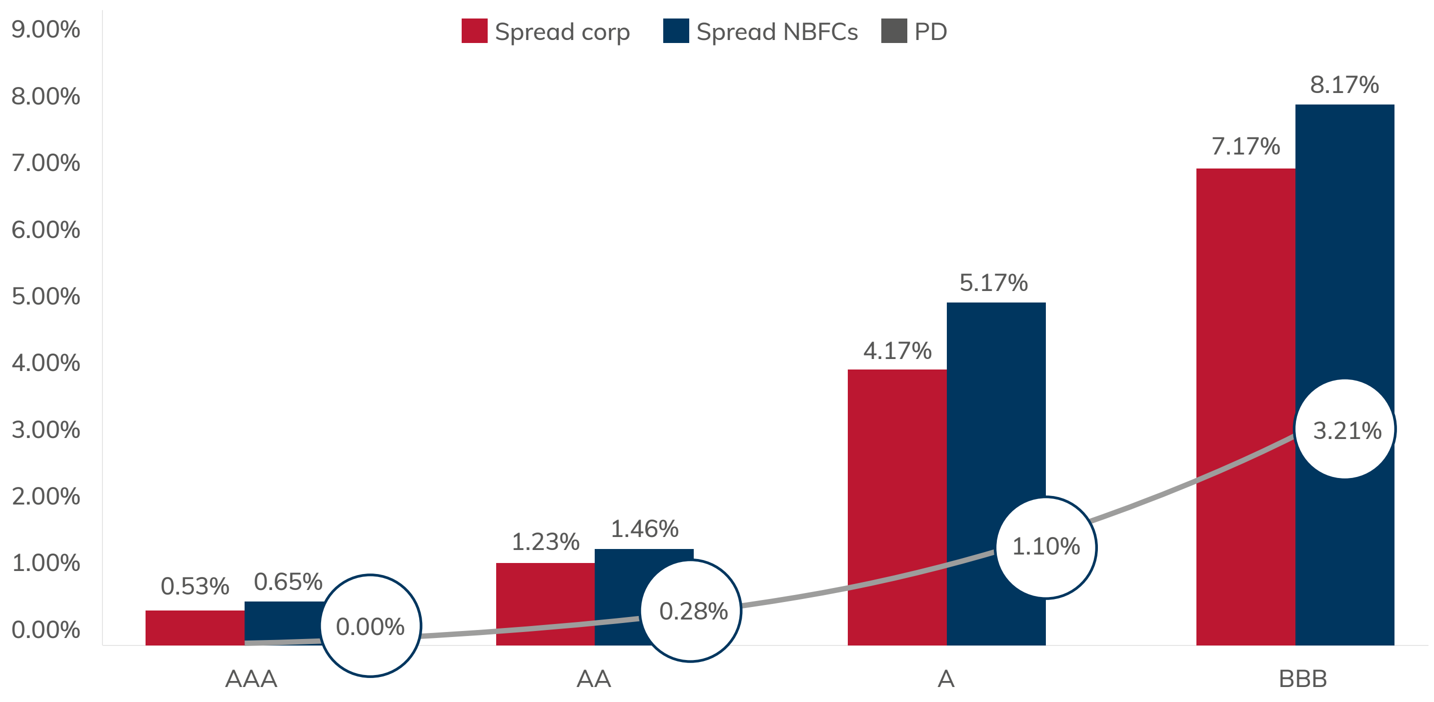
Need for Blended Finance to Support MSME focused NBFCs

While the performance of the Retail Financial Services NBFC sector has been robust, access to debt capital markets remains a challenge for this segment. Indian debt capital markets are shallow and are skewed towards larger and higher rated NBFCs.

The mid-market segment comprises of more than 250[5] NBFCs in the A/BBB rated segment which carry an investment grade rating but are overly reliant on bank financing as the access to capital markets remains low. This space has historically seen very low default rates and the current spreads over risk free more than compensates for the incremental risk. However, most investors perceive this segment to be risky, a conclusion which is not supported by the actual underlying data.

As per CRISIL Rating transition studies NBFCs as a sector has the lowest default rate amongst all the sectors with only four defaults over the past two decades. Interestingly these defaults have been by NBFCs which had been initially rated AAA. There have been no defaults by NBFCs in sub-AAA rated segment in past two decades.

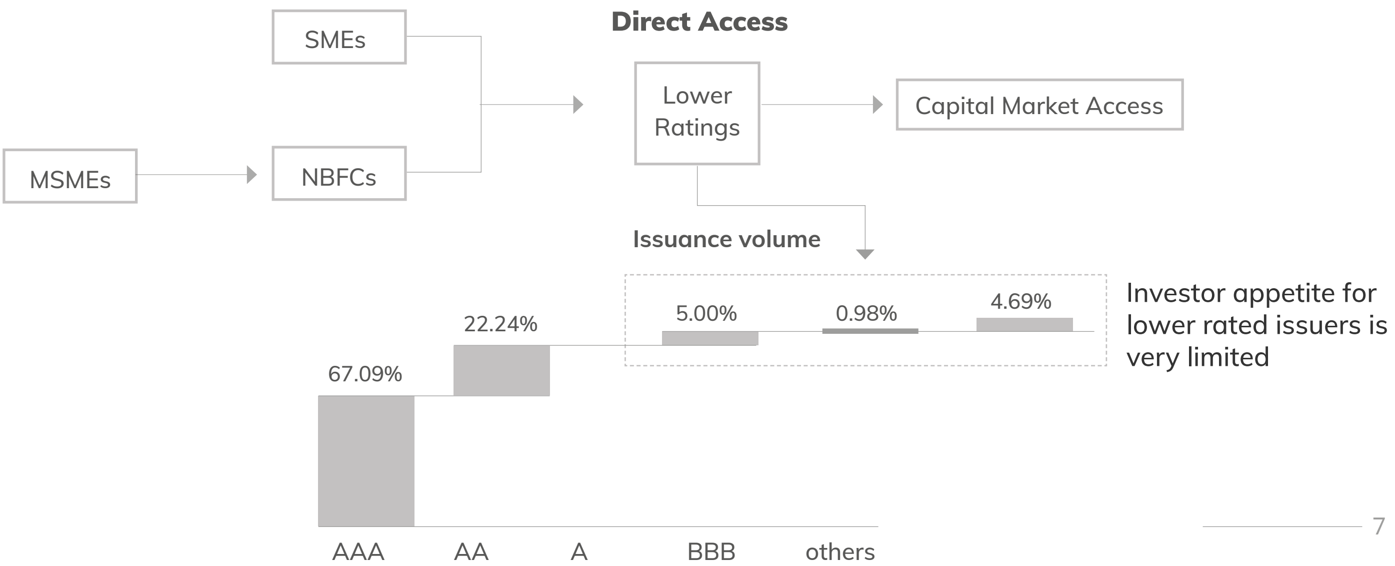
Return vs Risk (Spread over Gsec)



[5]Source: Care Research
[6]Source: FIMMDA, CRISIL, Spread for A and BBB - Vivriti estimates
Note:
- Current spread is as on 1st August 2022
- Default rates as per CRISIL Ratings Annual Default and Ratings Transition Study - FY 2021

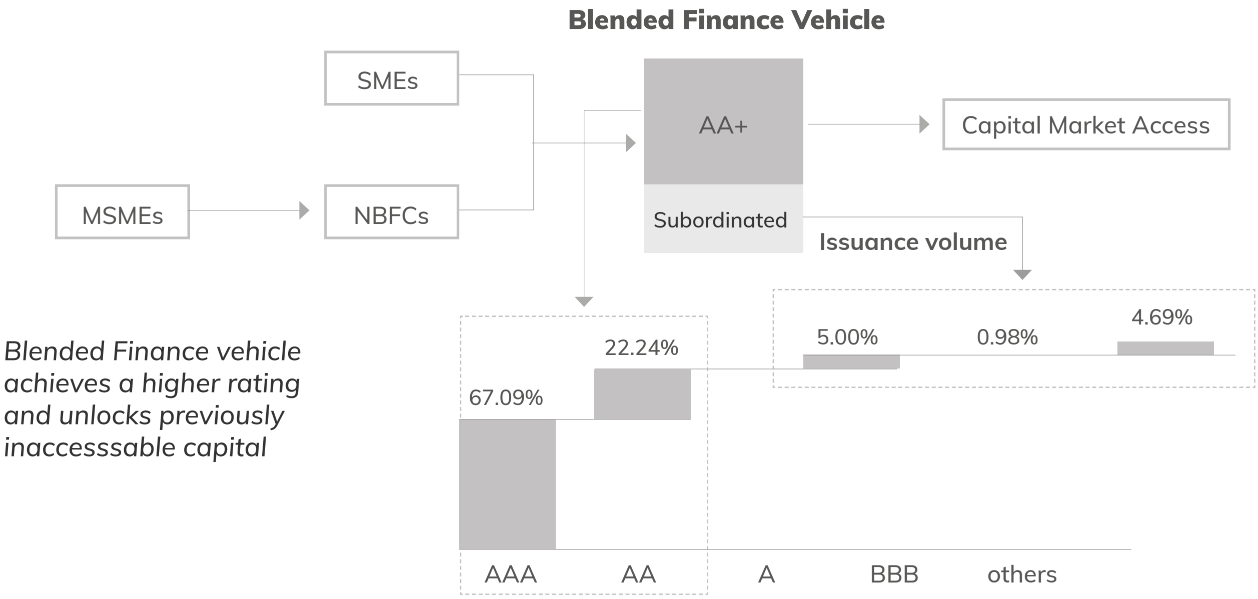
The Spreads in the ‘A’ and ‘BBB’ rated entities are relatively higher than AAA / AA peers without a commensurate increase in credit risk. Additionally spreads on bonds issued by NBFCs are higher than similarly rated bond issued by corporates.

Access to capital markets depends on high rating



This dichotomy in the perceived and actual risk needs to be broken and calls for an intervention through blended finance structure.

Access to capital markets depends on high rating



As can be seen from the above data, large amount of capital which is currently invested in AAA/ AA rated companies can be unlocked for A/BBB rated companies with the use of blended finance structures. **Hence, blended finance can play a big role in deepening the debt capital markets in India and is a highly scalable proposition.**

[7]Source: CRISIL Yearbook on the Indian Debt Market 2021, Vivriti Estimates

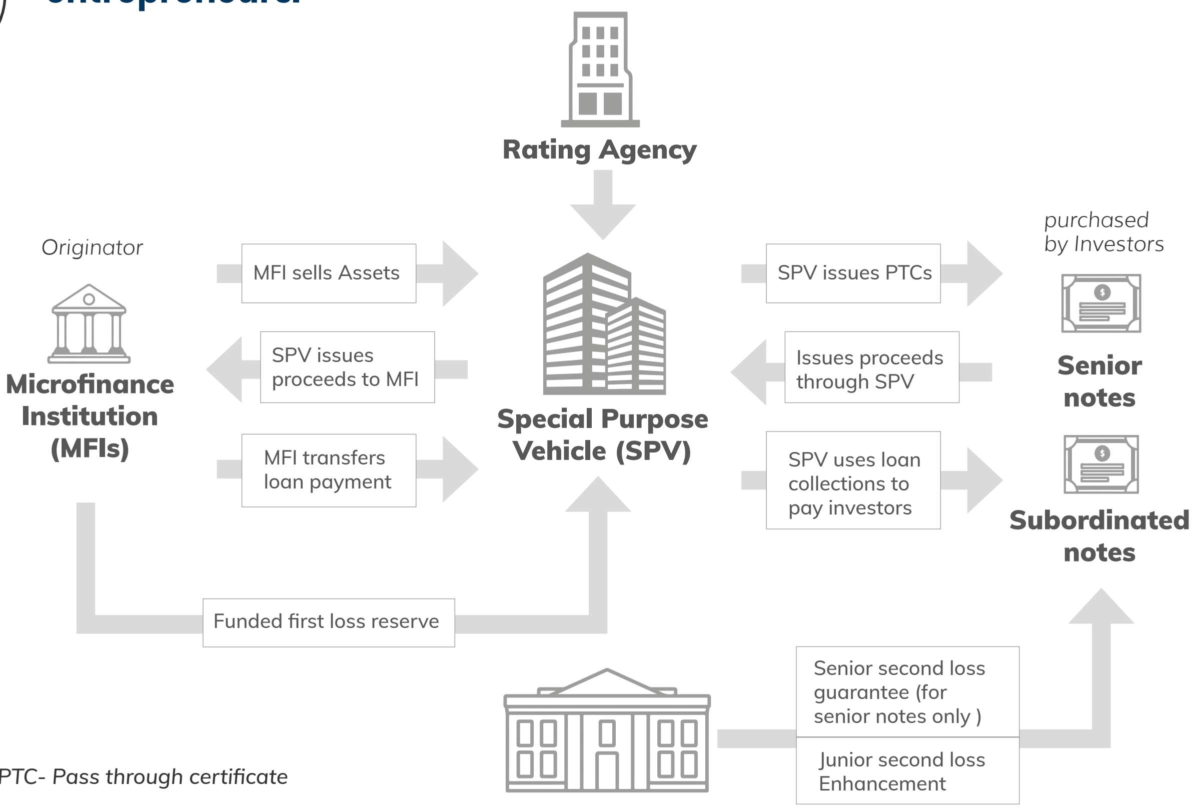
Summary of Blended Finance transactions in the MSME NBFC Sector

Given below are some of the notable blended finance transactions in the NBFC Sector.

US$50Mn Loan Guaranty Program with USAID, and DFC for women empowerment

The United States Agency for International Development (USAID) and the U.S. International Development Finance Corporation (DFC) have jointly sponsored a US$50 million loan portfolio guarantee to Kotak Mahindra Bank (KMBL) to support increased access to finance for women borrowers, and micro, small and medium enterprises (MSMEs) across India. The program is supported by Vivriti Capital (Holding Company of Vivriti Group), which will provide a US $1 million first loss guarantee.

ADB's Risk Participation and Guarantee Program for supporting micro entrepreneurs.



*PTC- Pass through certificate

ADB's Risk Participation and Guarantee Program is a credit enhancement and a risk-allocation tool, designed to address a market gap and promote local currency lending to micro-finance institutions. ADB partners with micro-finance institutions, to increase their access to local currency funding and address the financial needs of millions of people, at the base of the pyramid across the region. Given its risk-sharing structure, the program encourages private sector participation on market-determined terms. Vivriti Capital and other lenders have relied on this program to direct funding to smaller MFIs who have limited access to capital markets.

Vivriti Samarth Bond Fund

Vivriti Samarth Bond Fund (VSBF) is a US$35Mn blended finance vehicle to provide liquidity support to enterprises during COVID-19. The fund invests in lower rated (A/BBB) retail financial services NBFCs which lack access to capital markets. The fund is divided into two tranches. The senior tranche comprises 80% of fund size and the junior tranche comprises 20% of fund size. The senior tranche has a priority in payment of cashflows and has been rated CRISIL AA+(SO) for capital protection.

Philanthropic investors like The Michael and Susan Dell Foundation have provided catalytic capital in the junior tranche. This has allowed institutional investors like Banks, Insurance companies and corporates to participate in the highly rated senior tranche. These investors would find it difficult to directly invest in A/BBB rated entities. Thus, by employing blended finance VSBF has been able to direct commercial capital to impact related investments and helped create a capital market footprint for lower rated issuers.

Promising Lenders Fund

Promising Lenders Fund (PLF) is a 3-year Blended Finance Vehicle structured as an alternate investment fund (AIF). The Fund utilizes a layered capital structure with 75% Senior Tranche, 17.5% mezzanine tranche and 7.5% subordinate tranche. This structure allows investors with different risk-return preferences to co-exist in the same fund.

The senior tranche is being anchored by an Indian DFI with a mandate to develop India's MSME sector. Fund invests Rs 15-22 Crores per transaction in capital market instruments like Non-Convertible Debentures issued by smaller NBFCs and other lenders that extend last-mile finance to MSMEs, micro-entrepreneurs and low-income households. The tenure of instruments will range from 2-3 years. This helps the NBFCs to develop a capital market footprint in addition to directing capital to areas where is it most needed. The Fund senior tranche has been rated AA+ (SO) for capital protection and the Mezzanine Tranche has been rated BBB- (SO) for capital protection by CRISIL.

Knowledge Partner: Vivriti Asset Management

Vivriti Asset Management (part of Vivriti Group) is a fund manager to fixed-income funds that invest in enterprises, backed by fundamental research and sectoral view. Vivriti Capital has created India's largest tech-enabled marketplace for enterprise debt, counting 400+ institutional participants, and having mobilized over US$ 3.5 Bn over the past 3 years.

Glossary

Returnable Grants: An innovative financial instrument that aims to leverage the best of grant capital structured in the form of a loan. Through this mechanism, the borrower receives a zero-interest loan with only a moral obligation to repay. Once returned, the grant capital forms part of a revolving fund that can then be re-disbursed, thereby creating enormous leverage on the initial grant capital. This type of financing appeals to developmental funders and philanthropic donors as they can regularly receive the reflows and deploy the funds across other programs or priorities.

Guarantee: In this instrument, the guarantor agrees to pay part of the entire value of the loan to the lender as a risk-mitigation measure in the event of non-payment or loss of value. This instrument aids in shifting the risk-return profile of the investment and reduces the cost of capital, making the investments commercially viable. A partial credit guarantee can attract private investors by improving an investment's creditworthiness by limiting the downside losses reducing the required return for that level of risk for other investors.

Interest Subvention: In this instrument, based on the social impact that is achieved by the business enterprise, the interest component on loan gets paid fully or partially by a developmental funder or a donor to promote the achievement of social goals. Interest subvention instrument acts as a great incentive for the business enterprises to expand their portfolio of products/services while creating social impact and not compromising on their commercial viability.

Portfolio Level Social Success Note (SSN): An altered version of a traditional SSN wherein multiple social enterprises with a proven business model are covered under an umbrella of low-cost loans offered by the same financial institution. Each of the social enterprises which form part of the portfolio have to achieve quantifiable and measurable impact indicators basis which the quantum of outcome payments are linked. If the social enterprises within the portfolio achieve the predetermined impact indicators and outcomes, the outcome payer (donor/ philanthropic funder) offers the risk investor (financial institution) an added incentive depending on the outcomes which have been achieved.

Development Impact Bonds (DIBs): Results-based contracts in which one or more private investors provide working capital for social programs, implemented by service providers (e.g., Social Enterprises), and one or more outcome funders (e.g., public sector agencies, donors, etc.) pays back the investors their principal plus a return if, and only if, these programmes succeed in delivering results. In a DIB the outcome payer is typically a private donor or a development agency.