ICICI Bank
SME KNOWLEDGE Series

Creating Value for SME's

Concepts & Strategies in Indian context

Section – IX
Raising Finance:
Special Focus on Venture Capital

Executive Summary

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Small and Medium Enterprises (SME) Finance

The importance of SME sector is well-recognized world over owing to its significant contribution in achieving various socio-economic objectives, such as employment generation, contribution to national output and exports, fostering new entrepreneurship and to provide depth to the industrial base of the economy. India has a vibrant SME sector that plays an important role in sustaining economic growth, increasing trade, generating employment and creating new entrepreneurship in India.

Small and medium enterprises (SME) have not kept pace with the country's economic growth because of their inability to access finances, industry experts point out. According to Mr. David Emery, President, International Partnerships & Asia Pacific, Dun & Bradstreet, said: "Recent research at the World Bank has re-established that inability to access finance may be one of the reasons why we do not see a robust correlation between SME prevalence and economic growth. Therefore, the increasing strength of the financial system in the country will help Indian SMEs continue on their growth path. Another important aspect in this journey would be to ensure enhanced global visibility to these SME firms".

Lack of access to Finance has seriously affected the success of SMEs, impacting the sales of those enterprises. High cost of funds and lack of working capital finance reduces the expansion opportunities of these units. In addition, lack of training among bankers dealing with SMEs has impacted on the services provided to SMEs. There are also non-financial issues facing SMEs in India including lack of adequate infrastructure, international competition for exports and national regulations as well as social constraints (education), which inhibit the growth of SMEs.

Of all the elements that go into small business, Credit support is perhaps the most crucial for success. The best of plans can come to naught if adequate finance is not available at the right time. SMEs need credit support not only for running the enterprise & operational requirements but also for diversification, modernization/ upgradation of facilities, capacity, expansion etc. In respect of SMEs, the problem of credit becomes all the more critical whenever any episodic event occurs such as; a large order, rejection of consignment, inordinate delay in payment etc. In general, SMEs operate on tight budgets, often financed through owner's own contribution, loans from friends and relatives and some bank credit.

Finance being a major obstacle in SME development, needs to be examined and addressed at all levels. There are several reasons for low SME credit penetration, key among them being insufficient credit information on SMEs, low market credibility of SMEs (despite their intrinsic strengths) and constraints in analysis.

The basic financing needs of an SME can be met through Debt or Equity. The Debt can be raised through Banks and other financial institutions, whereas equity can be raised through the Private Equity or Venture capital. While the topic is a very extensive one, we would examine two aspects of the same – Raising Debt through Banking channels and Raising Finance through Venture Capital for Indian SMEs.

Assistance to SMEs by Banks

Fund based Bank Facilities:-
The Credit facilities provided from different banks for SMEs is listed herewith, which are fund based:

TERM LOANS: Term loan is an installment credit repayable over a period of time in monthly/quarterly/half yearly/yearly installments. Term loan is generally granted for creation of fixed assets required for long-term use by the unit. Term loans are further classified in three categories depending upon the period of repayment as under:

- Short term repayable in less than 3 years.
- Medium term loans repayable in a period ranging from 3 years to 7 years.
- Long term loans repayable in a period over 7 years.

CASH CREDIT FACILITY: a major part of working capital requirement of any unit would consist of maintenance of inventory of raw materials, semi finished goods, finished goods, stores and spares etc. In trading concern the requirement of funds will be to maintain adequate stocks in trade. Finance against such inventories by banks is generally granted in the shape of cash credit facility where drawings will be permitted against stocks of goods. It is a running account facility where deposits and withdrawals are permitted. Cash credit facility is of two types (depending upon the type of charge on goods taken as security by bank.)

- **Cash credit - Pledge:** when the possession of the goods is with the bank and drawings in the account are linked with actual movement of goods from/to the possession of the bank.

- **Cash credit- Hypothecation:** when the possession of the goods remains with the borrower and a floating charge over the stocks is created in favor of the bank.

OVERDRAFT FACILITY: Overdrawing permitted by the bank in current account is termed as an overdraft facility. Overdraft may be permitted without any security as 'clean overdraft' for temporary periods to enable the borrower to tide over some emergent financial difficulty. 'Secured overdraft' facility is against fixed deposits, NSC, and other securities.

BILLS FINANCE: This facility is against bills of sales raised or book debts.

EXPORT FINANCE: Banks grant export credit on very liberal terms to meet all the financial requirements of exporters. The bank credit for exports can broadly be divided in two groups as under:

- Pre Shipment advances/packing credit advances are the financial assistance sanctioned to exporters to enable them to manufacture/procure goods meant for exports and arrange for their eventual shipment to foreign countries.
- Post shipment credits are the bills purchase/discount facility granted to exporters.

Non - Fund based Bank Facilities: -
Credit facilities, which do not involve actual deployment of funds by banks but help the obligations to obtain certain facilities from third parties, are termed as non-fund based facilities. These facilities include issuance of letter of credit, issuance of guarantees, which can be performance guarantee/financial guarantee.

Some Banks Offering Financial Assistance to SMEs

Bank	URL
Allahabad Bank	www.allahabadbank.com
Andhra Bank	www.andhrabank-india.com
Bank of India	www.bankofindia.com
Bank of Baroda	www.bankofbaroda.com
Bank of Maharashtra	www.maharashtrabank.com
Canara Bank	www.canbankindia.com
Central Bank of India	www.centralbankofindia.co.in
Corporation Bank	www.corpbank.com
Dena bank	www.denabank.com
ICICI Bank	www.icicibank.com
Indian Bank	www.indian-bank.com
Indian Overseas Bank	www.iob.com
IndusInd Bank Ltd.	www.indusind.com
The Jammu & Kashmir Bank Ltd.	www.jkbank.net
Punjab National Bank	www.pnbindia.com
Syndicate Bank	www.syndicatebank.com
State Bank of Travancore	www.statebankoftravancore.com
State Bank of India	www.sbi.co.in
State Bank of Bikaner & Jaipur	www.sbjbank.com
State Bank of Hyderabad	www.sbhyd.com
State Bank of Mysore	www.mysorebank.com
State Bank of Indore	www.indorebank.org
Small Industry Development Bank of India (SIDBI)	www.sidbi.com
Union Bank of India	www.unionbankofindia.co.in
United Bank of India	www.unitedbankofindia.com
UCO Bank	www.ucobank.com
Vijaya Bank	www.vijayabank.com

Some Initiatives to Improve access to SME Finance

ICICI Bank

Acknowledging the importance of SMEs, ICICI Bank, India's second largest bank, has a focused division examining the needs of the small and medium enterprises. The Bank provides SMEs with financial products and services which were earlier only available to large corporate houses. Banks have traditionally lent to SMEs against the security of fixed assets. This has resulted in the SMEs being under financed. Requirements of SMEs are different and lending to SMEs requires a slightly different approach. At ICICI Bank, Cluster Banking Approach is used to finance SMEs, which helps to get a better understanding of the SMEs and develop credit proxies to evaluate their business. For more information, please visit http://sme.icicibank.com.

Small Industry Developmental Bank of India (SIDBI)

Small Industries Development Bank of India (SIDBI) is the principal financial institution for the promotion, financing and development of industry in the SME sector in India. SIDBI is committed to developing a strong, vibrant and responsive SME sector. Alongside finance, SIDBI provides appropriate support in the form of promotional and developmental services. SIDBI provides quality services to both direct SMEs and institutional level clients. For more information, please visit http://www.sidbi.com.

SME Rating Agency of India Ltd (SMERA)

SME Rating Agency of India Ltd (SMERA), the dedicated rating agency for SME sector in India. SMERA has been set up by Small Industries Development Bank of India (SIDBI) in association with Dun & Bradstreet (D&B), Credit Information Bureau (India) Limited and leading public and private sector banks.

SMERA is also supported by several leading public and private sector banks, which are active in the SME space. The recognition and acceptance of SMERA’s ratings within the banking sector will help SMEs save time, effort and money while approaching different banks for credit. It will also simplify and quicken the process of lending to SMEs, while simultaneously reducing lending costs to the sector as a whole.

What is a SMERA Rating?

SMERA Rating is an independent third-party comprehensive assessment of the overall condition of the SME, conducted by SME Rating Agency of India Limited. It takes into account the financial condition and several qualitative factors that have bearing on credit worthiness of the SME. For more information, please visit http://www.smera.in

SMERA Rating consists of 2 parts, a Composite Appraisal/Condition indicator and a Size indicator. SMERA Rating categorizes SMEs based on size, so as to enable fair evaluation of each SME amongst its peers. An SME unit having a SMERA Rating would be able to enhance its market standing amongst trading partners and prospective customers.

Exim Bank of India

Exim Bank of India provides a suite of services to its SME clients which include providing business leads, handholding during the process of winning an export contract and thus assisting the generation of export business on success fee basis, countries/ sector information dissemination, capacity building in niche areas such as quality, safety, export marketing, etc. and financial advisory services such as loan syndication, etc. Exim bank offers a specialised scheme called **Debt Restructuring Scheme for Small and Medium Enterprises**.

Venture Capital

Venture capital is a type of private equity capital typically provided by professional, institutionally-backed outside investors to new, growth businesses. Generally made as cash in exchange for shares in the investee company, venture capital investments are usually high risk, but offer the potential for above-average returns.

A **venture capitalist** (VC) is a person who makes such investments. A **venture capital fund** is a pooled investment vehicle (often a partnership) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans.

Structure of the funds

Most venture capital funds have a fixed life of 10 years, with the possibility of a few years of extensions to allow for private companies still seeking liquidity. The investing cycle for most funds is generally three to five years, after which the focus is managing and making follow-on investments in an existing portfolio. This model was pioneered by successful funds in Silicon Valley through the 1980s to invest in technological trends broadly but only during their period of ascendance, and to cut exposure to management and marketing risks of any individual firm or its product.

Venture capital is generally suitable for all entrepreneurs. Venture capitalists are typically very selective in deciding what to invest in; as a rule of thumb, a fund may invest in as few as one in four hundred opportunities presented to it. Funds are most interested in ventures with exceptionally high growth potential, as only such opportunities are likely capable of providing the financial returns and successful exit event within the required timeframe (typically 3-7 years) that venture capitalists expect.

This need for high returns makes venture funding an expensive capital source for companies, and most suitable for businesses having large up-front capital requirements which cannot be financed by cheaper alternatives such as debt. That is most commonly the case for intangible assets such as software, and other intellectual property, whose value is unproven. In turn this explains why venture capital is most prevalent in the fast-growing technology and life sciences or biotechnology fields.

If a company does have the qualities venture capitalists seek such as a solid business plan, a good management team, investment and passion from the founders, a good potential to exit the investment before the end of their funding cycle, and target minimum returns in excess of 40% per year, it will find it easier to raise venture capital.

Other Alternatives to venture funds

Because of the strict requirements venture capitalists have for potential investments, many entrepreneurs seek initial funding from angel investors, who may be more willing to invest in highly speculative opportunities, or may have a prior relationship with the entrepreneur. Furthermore, many venture capital firms will only seriously evaluate an investment in a start-up otherwise unknown to them if the company can prove at least some of its claims about the technology and/or market potential for its product or services. To achieve this, or even just to avoid the dilutive effects of receiving funding before such claims are proven, many start-ups seek to self-finance until they reach a point where they can credibly approach outside capital providers such as VCs or angels. This practice is called "bootstrapping".

Venture Capital in India

This is the only route to fund knowledge-based industries, where true partnership between ideas, enterprise, capital and experience can be harnessed. It has been the reason for US dominance in technology and innovation, which could be ours now. VCs are a very recent phenomenon in India. Success and growth of VC industry is vital for achieving our goals in the knowledge industries.

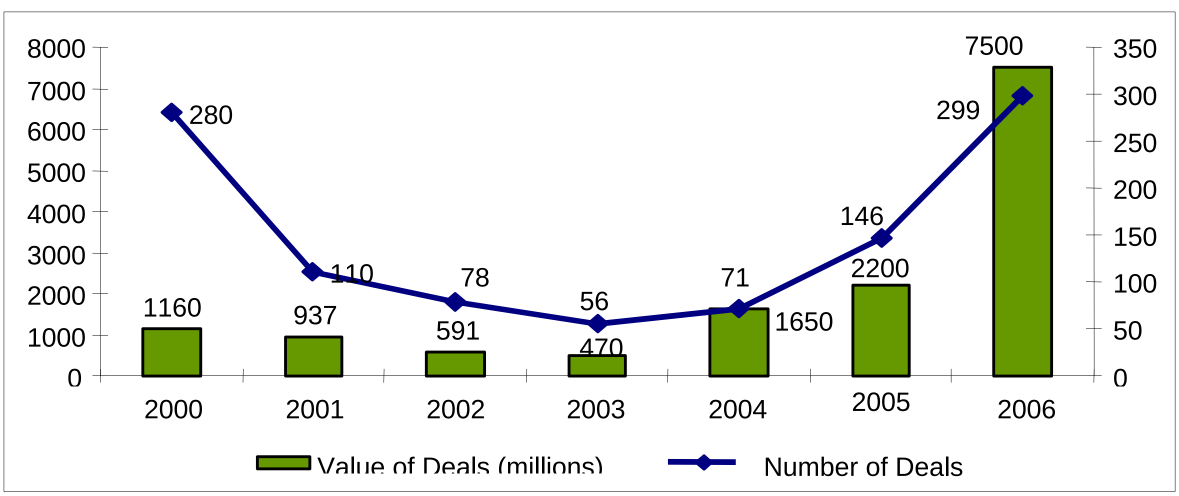
Venture capital (VC) is perhaps the only source of funding for innovation, particularly in knowledge-based industries. Worldwide, it is the engine of growth for innovation-driven start-ups across all sectors. The US and Israel are prime examples of how a robust VC ecosystem, backed by a supportive legislative framework, has made them world leaders.

India is poised to gain a substantial interest in VC Funding activity, as over 90% of the funds raised by domestic VCs come from overseas institutions and individuals. This year the amount of foreign exchange flowing in through this route will be close to USD 7 billion, more than any other form of FDI into India.

The initial attractions of VC funds were the knowledge-based industries. Companies in this sector had been mostly global, and therefore less affected by domestic issues. They had been growing rapidly and have been moving beyond cost arbitrage to higher value offerings. The factors that have worked for them are the high quality of human capital in India, the high levels of entrepreneurship and lower costs. The setting up by many MNCs of their R&D centres in India has led to the fostering of innovation and several entrepreneurial spin offs. There are now many emerging centres of innovation – IT, Biotech, Wireless, semi conductors, pharma etc. With the firm growth of economy in India, there is now the opportunity to build strong technology companies serving both the global and domestic markets.

The VC / PE in India has been growing at a phenomenal rate. It was approx. USD 1 bn in 2004, over USD 2 bn in 2005 and was estimated to be almost USD 3.5 bn in the first 6 months of 2006.

Growth of PE/VC in India 2000 – 2006 (US$ millions)

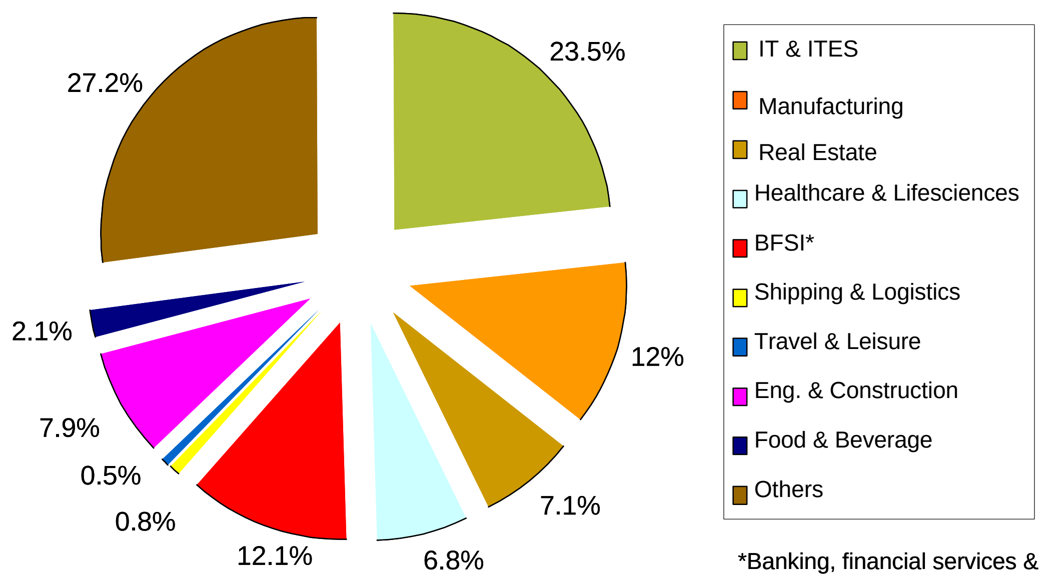


Source: TSJ Venture Intelligence India

2006 – PE/VC Trends

- US$7.5bn invested in 2006 across 299 deals.
- IT & ITES retained its status as the favorite industry among PE investors, followed by manufacturing and real estate.
- Largest PE deal was $900M LBO of Flextronics by Kohlberg Kravis Roberts (KKR).
- M&A and IPO activity continued to remain strong
- In 2005 alone:
    - PE Firms obtained exit routes for 43 companies
    - 17 PE-backed firms issued IPO's (raised $950M)

2006 PE/VC Investments by industry - Total US$7.5Bn



*Banking, financial services & insurance

Source: TSJ Venture Intelligence India

Top Cities attracting PE Investments (2006)

City	No. of Deals	Value (US$M)
Mumbai	69	1,780
Delhi/NCR*	41	395
Bangalore	40	1,525
Chennai	22	354
Hyderabad	17	492
Pune	10	1,114

Source: TSJ Venture Intelligence India

* National Capital Region (NCR)

Some SMEs focussed Indian Based Venture Capital Companies

ICICI Venture Funds Management Company Limited

ICICI Venture is today one of the largest and most successful private equity firms in India with funds under management in excess of USD 2 billion. Its investment focus areas span across private equity, buyouts, real estate and mezzanine financing. It has several "firsts" to its credit in the Indian Private Equity industry.

ICICI Venture, over the years has built an enviable portfolio of companies across sectors including pharmaceuticals, Information Technology, media, manufacturing, logistics, textiles, real estate etc thereby building sustainable value.

ICICI Venture is a subsidiary of ICICI Bank, the largest private sector financial group in India.
For more details please visit: http://www.iciciventure.com

IFCI Venture Capital Funds Ltd. (IVCF)

IFCI Venture Capital Funds Ltd. (IVCF) was originally set up by IFCI as a Society by the name of Risk Capital Foundation (RCF) in 1975 to provide institutional support to first generation professionals and technocrats setting up their own ventures in the medium scale sector, under the Risk Capital Scheme. In 1988, RCF was converted into a company, Risk Capital and Technology Finance Corporation Ltd. (RCTC). In Feb 2000, when it introduced the Technology Finance and Development Scheme for financing development and commercialization of indigenous technology, its name was changed to IFCI Venture Capital Funds Ltd (IVCF).
For more details please visit: www.ifciltd.com

IL & FS Group

IL&FS was incorporated in 1987, and commenced operations in May 1988 as a subsidiary of Central Bank of India (CBI), one of the largest nationalized banks in the country. The initial shareholders were the Unit Trust of India (UTI) and the Housing Development Finance Corporation Limited (HDFC). Thus, from its inception, IL&FS inherited the experience and expertise of these institutions. For more details please visit: www.ilfsindia.com

Gujarat Venture Finance Limited (GVFL)

Started in July 1990, at the initiative of the World Bank, GVFL Ltd. is regarded as a pioneer of Venture Capital in India. Over the past ten years, GVFL Ltd. has provided financial and managerial support to over 57 companies with a high growth potential.

GVFL Ltd invests all over India and across industries. It has created a niche for itself in small and medium scale companies. Investment and monitoring such companies require considerable effort and involvement as compared to large projects.
For more details please visit: www.gvfl.com

SIDBI Venture Capital Limited (SVCL)

SIDBI Venture Capital Limited (SVCL) is a wholly owned subsidiary of SIDBI, incorporated in July 1999 to act as an umbrella organisation to oversee the Venture Capital operation of SIDBI. SVCL mission is to catalyze entrepreneurship by providing capital and other strategic inputs for building businesses around growth opportunities and maximize returns on investment. SVCL will manage the various Venture Capital Funds launched/ being launched by SIDBI.
For more details please visit: http://www.sidbiventure.co.in

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