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IMC
Chamber of Commerce and Industry

Catalysing MSME entrepreneurship in India

Capital, technology and public policy

Whitepaper

June 2017

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Foreword - KPMG in India

Small businesses in India are characterised by heterogeneity, fragmentation and their proclivity to operate in what is called the 'informal economy'. The story of small businesses in India is the one characterised by paradoxes: large-scale employment with the least job security, responsible for a large number of policy initiatives, subsidies and a host of protectionist measures. Yet, they are unable to grow in comparison to their peers globally, and importantly, while they are celebrated for their entrepreneurial spirit and energy, they have poor access to new technology and capital. Another paradox is despite the abundance of studies and dialogue available on the subject, there is very little access to credible data or a comprehensive database, as a large number of such businesses operate in the shadow of the formal economy, are funded by friends, relatives, money lenders or informal institutions, who do not maintain proper accounts, often buy and sell in cash, employ casual workers, or rely on family labour.

Among other things, demonetisation drive in November 2016 brought a sharp focus on the contributions as well as constraints of micro and small businesses. Largely operating in the cash based economy, many businesses found it hard to keep afloat, when a bulk of the currency in circulation at the time was withdrawn abruptly. This impacted consumers and business owners, but also financial institutions that had exposure to these businesses, resulting in poor portfolio performance and low growth. With the implementation of the Goods and Services Tax (GST) and the continued policy push on increasing the taxpayer base through 'formalisation' of the economy, it will be interesting to follow the journey in the coming years and hope that the sector is able to finally resolve the paradoxes and reward entrepreneurship, which would have far-reaching benefits in a nation with a large young population and low rate of job creation in the formal economy.

In this paper, we briefly examine the role of public policy, capital and technology and post that after 70 years of independence, 45years of bank nationalisation and priority sector lending norms, 60 years of Khadi and Village Industries Commission (KVIC), more than 30 years of microfinance and cumulatively, centuries of effort, how the needle may move in the next few years. And that may be because of the fundamental shift in the nature of technology. Digital technologies and the super computing power in the hands of consumers as well as service providers by way of mobile phones today, and possibly wearables or Virtual Reality gadgets tomorrow, combined with other innovations such as 3D printing and advances in robotics, will change the nature of workplaces in as fundamental a way as electricity, steam engine, motorcar or personal computers have done in the past.

It is reasonable to believe that all these innovations and developments will create ecosystems that are, huge, well-oiled networks of communities, making discovery enjoyable rather than a painstaking business proposition. These technological advances can empower the individual disproportionately as compared to corporations. While corporations, slow and deliberate, will adapt these changes to enhance their processes and effectiveness, individuals will find it much easier to build from ground up, at a scale that works for them. They will be able to access knowledge, network, policy benefits and most importantly, capital. Much of this is already visible in economies such as China, where aggregators and service providers such as Alibaba or Tencent built digital platforms that closed information gaps for many small businesses and empowered them to blossom.

But we also believe that this is unlikely to happen by serendipity. It will require hard work by way of digital infrastructure, policy readiness to embrace change while protecting consumers as well as some basic 'plumbing' as far as existing policies towards small and micro businesses on demand and supply side are concerned. There are enough examples today of supply-side players that are using digital technology to disrupt traditional lending and investment in small businesses, making it possible not only to reach small and micro businesses (something their more traditional counterparts, Non-Banking Financial Companies (NBFCs) did with much success), but to also build data on their borrowers' businesses that has the potential to power non-linear growth for both, the borrower and lender. And there are many examples across the country, in cities and villages, small and large centres of the country of entrepreneurs who are solving problems for local communities or for an identifiable global community.

Many micro and small businesses are run by women entrepreneurs and the new technology has significant positive impact on this group, by breaking away from the shackles of property as collateral or working space. A woman entrepreneur in Patna or Indore making high-end sarees and selling them using social networking websites to customers across the world is not uncommon. At the lower end, there are many who will have the opportunity to use the same technology to enhance their products, connect with buyers, source material, and improve the bottom-line. Many lenders, including banks, NBFCs, digital lenders are already looking at this segment to lend to them. Venture capital funds as well as private equity players are keenly watching the space to handhold and grow these so-called 'startups'. In addition, there are new-age lenders that are creating leading products and delivery channels for these businesses at various stages of their lifecycles.

The creation and strengthening of the ecosystem of small businesses has many positive externalities on skilling, employment, wealth creation and overall nation-building. It is a cause worth pausing and thinking about. We have tried to bring together an analysis of some of the factors that can help in establishing and achieving some of these critical goals. We have also spoken to many participants in this ecosystem and have shared their insights. We hope you find this report useful.

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Foreword - IMC

Micro, Small and Medium Enterprises (MSMEs) in India have experienced several highs and lows in the past few years, but have been flourishing despite a challenging environment. The sector, which is the backbone of our economy, has to take cognisance of the changing Indian economic scenario. The Indian economy is likely to emerge as one of the leading economies in the world, poised to become a USD5 trillion economy by 2025. Thus a major impetus is to be made to strengthen the sector as this has been a significant contributor in generating employment (across skill sets) and contributing to the nation's economy. The current government has thus launched many initiatives and taken steps to reorient the sector for an enhanced level of economic activity. Some financial, technical initiatives and support have been given to rejuvenate the sector. These include re-implementation of Public Procurement Policy, MUDRA Yojana, Make in India, Startup India, and Skill India. These initiatives are aimed at empowering the sector so that growth increases by 12-15 per cent per annum and its share in GDP increases to 25 per cent by 2025. The announcement to implement GST Bill in 2017 is a landmark decision that will help eradicate indirect taxes, create more transparency in tax process and contribute to business growth in unconventional sectors as well.

The current year 2017 is also expected to see a lot of interesting developments. It is expected that the entire business models of this sector could undergo a change due to the advent of advanced technologies, which is opening new vistas across sectors especially giving rise to the B2B business ventures. These developments could play a decisive role in bringing synergies in entire business chains to established brands and small shop owners.

The adoption of smartphones and its related applications will thus bring about a union of e-commerce and m-commerce (mobile commerce) and help the sector achieve operational efficiency, transparency, quicker realisations, faster settlement of business obligations and a transformed customer experience.

The sector will do better if the timely availability of credit at an appropriate cost is delivered. As the banks are now transmitting the reduced rates to the economy, there is hope the sector will make full utilisation of the reduced rates. The introduction of e-processes by fintech companies and other initiatives will help improve the system and processes, and reduce delays. The issue of delay (which adds to the cost of the funds in loan processing, sanction and release) could be eliminated through these 'state of the art' electronic platforms where applications to fulfillment of credit could happen online. This would be facilitated with the help of seamless availability of key information on credit worthiness and also release funds online. All of this is done cost effectively.

There is also a change in the mindset in which the MSMEs are being looked at now. It is but essential that the new wave economy of the Government of India through its Make in India and other formats, offers a unique scope to this sector to strengthen its contribution to the nation's development through building communities of thought leaders to dedicate for growth, bring experts and practitioners to share perspectives, share ideas and knowledge by the experts – who are part of domestic as well as foreign trade, develop innovative ideas, develop skill based knowledge workers who can develop products to compete in the global markets, develop spirit of entrepreneurship. India, incidentally, is in the top 5 league of the most entrepreneurially charged economies.

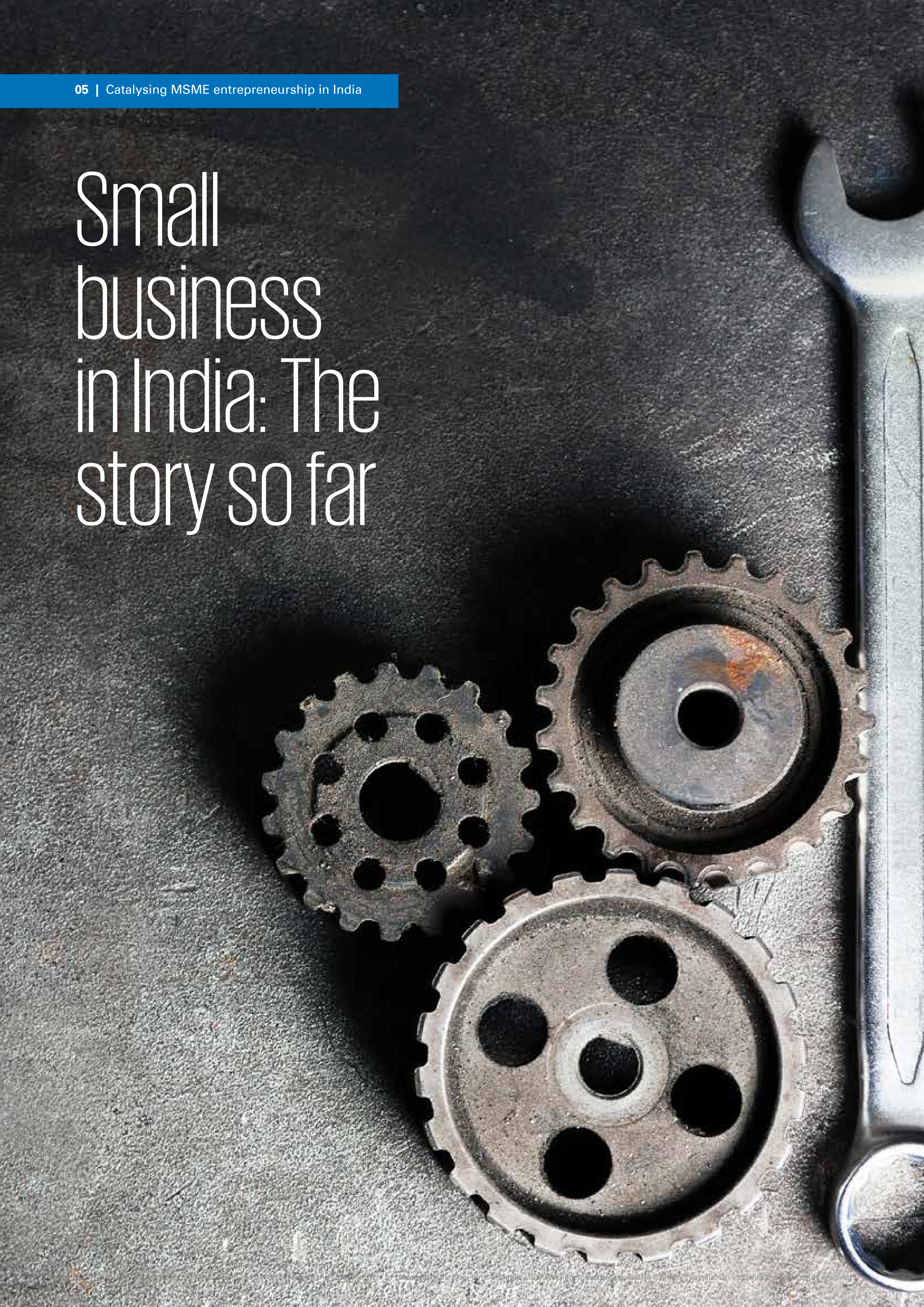
The year 2017 will further witness strengthening of current policies and introduction of new initiatives to improve the business environment for MSMEs. Implementation of the GST Bill is expected to benefit MSMEs not only with simpler tax structure but also with aspects such as improved technology adoption in order to comply with GST system. The 'One Nation, One tax' approach will make India an open market helping MSMEs explore new markets with no or low entry barriers and experience business expansion. Therefore, the upcoming GST Bill is expected to revolutionise the Indian tax system and offer the MSME sector an equal footing as compared to their bigger, more established counterparts.

The year 2017 is going to be a year of progressive changes in the Indian MSME sector based on the above-mentioned trends. Several policy interventions along with technology and innovation will continue to play a pivotal role in creating a business-friendly atmosphere for the MSMEs.

Deepak Premnarayen
President - IMC Chamber of Commerce and Industry

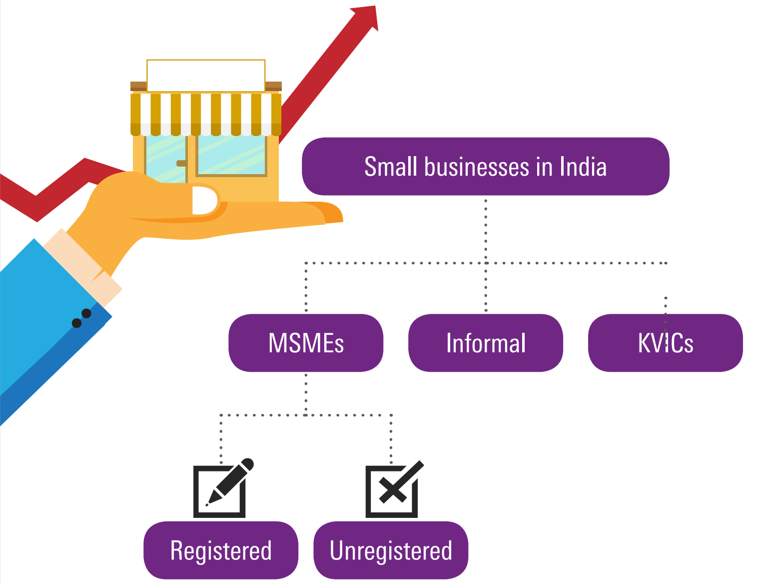
Vishwavir Ahuja
Chairman - Finance and Banking Committee, IMC Chamber of Commerce and Industry

Small business in India: The story so far



The micro and small businesses in India are characterised by heterogeneity and fragmentation, and a number of them are informal.

Much before the term, Micro, Small and Medium Enterprises (MSME) caught on and within the broad contours of the 'export substitution' policy paradigm, India had defined Small Scale Industry (SSI) in order to target resources towards this segment of industries, rightly considering it to be the engine of growth. An SSI in the 1950s was defined as an industry with investment of up to INR5 lakh in fixed assets and employment of 50/100 people with or without power. By the 1960s, the employment criteria was dropped and the investment ceiling thereafter was constantly increased. The MSMED Act in 2006 used 'micro and small' instead of 'small scale industries' and added a definition of 'medium'. Further, the definitions are based on the investment criteria and differentiated on the basis of manufacturing and services.[01]



Size of the enterprise	Micro	Small	Medium
Manufacturing (Investment in machinery)	Upto INR25 lakh	Above INR25 lakh upto INR5 crore	Above INR5 crore upto INR10 crore
Service (Investment in Equipment)	Upto INR10 lakh	Above INR10 lakh upto INR2 crore	Above INR2 crore up to INR5 crore

Globally also, there is no universal definition of MSME. The definition of micro and small enterprises differ from country to country. The definition reflects the business environment and socio-cultural aspects of a country. Most countries have a flexible and industry-wise definition. Some countries have more than one definition, mostly due to a different definition by law to provide for schemes, and a different definition used by the national statistical institute of that country for statistical purposes. In research done by the IFC, out of 120 economies analysed, 26 economies had more than one definition.

For example, in Brazil, according to the general law of SMEs, a micro business is defined in terms of gross yearly revenue of up to USD73,584. A small business is defined as having gross yearly revenue of between USD240,000 – USD73,584,648. On the other hand, the Brazilian Institute of Geography and Statistics, uses the number of people employed as the threshold, where 0 to 9 is micro and 10 to 49 is a small business.[02]

In the U.S.A., small businesses are differentiated on the basis of their industry type. For a manufacturing business to be a small business, the average employment over the last 12 months is used as a criteria. Whereas for a service enterprise, annual average gross receipts over a period not less than three years is used to determine if it is a small business. For businesses other than service and manufacturing, 'small business' status is given on the basis of data over a period not less than three years. For example, a commonly used threshold is the average annual receipts of below USD7 million for most retail trade and most services, while for manufacturing, the employee threshold varying from 500 employees to 1500 employees is used. Thus, 'small business' in the US might look big when compared with another country.

In the European Union (EU), micro enterprises are defined as those having less than 10 employees, with annual turnover and a balance sheet total of less than EUR2 million. Small enterprises are defined as those having less than 50 employees, with an annual turnover and balance sheet total of EUR10 million.[03] Thus in the EU, a combination of the employee criterion along with a financial criteria is used. These ceilings are revised periodically. Even though both the U.S.A. and EU are economically developed in comparison to other countries, their threshold limits have stark differences.

In countries such as South Africa and China, definitions are based on the employee criteria combined with financial criteria such as annual turnover, total assets, etc. but these thresholds are different for different industries or sectors.

The World Bank recognises a MSME when it meets two out of the three criteria[04] mentioned below:

Size of the Company	Employee	Asset	Duration of exemption
Micro	< 10	≤ USD10,000	≤ USD10,000
Small	< 50	≤ USD3 million	≤ USD3 million
Medium	< 300	≤ USD15 million	≤ USD15 million

01. MSMED Act 2006
02. Micro Small and Medium enterprises, IFC World Bank Report, June 2010
03. The New SME Definition, Enterprise and Industry Publications, EU SME Center, 4 June 2013
04. Micro Small and Medium enterprises, IFC World Bank Report, June 2010

The MSMED Act[05] in India does not make it obligatory for a micro enterprise to register and thus there is no official, accurate database of all such businesses. According to a report presented in the Rajya Sabha on the MSME amendment bill proposed, the ministry admitted to targeting mostly those MSMEs who had registered. The registered MSMEs form a very miniscule part of the total business and hence schemes for MSMEs have not been implemented to reach the target. Further, even though registrations are not mandatory, according to the Factories Act of 1948, enterprises with 10/20 or more workers with/without power must be registered. Thus, there exists an inconsistency in the law[06].

Also, the monetary threshold prescribed in 2006 might not be valid today. Prior to 2015 the definition based on investment criteria was not indexed to inflation. The MSMED (Amendment) Bill, 2015 (the Bill) proposes that the threshold be changed every five years in order to account for inflation and changing market dynamics[07]. The Bill seeks to periodically change the investment limit through government notifications. The bill also seeks to bring under the ambit of the MSMED Act, village enterprises previously covered under the KVIC Act.

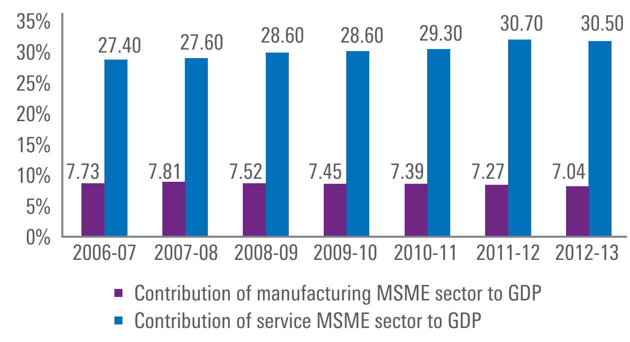
There are various thresholds to determine the size of an enterprise in Indian law. The thresholds are based on the type of law. For example, The Employees Provident Fund Scheme requires a business with 20 or more employees working in any of the industries listed in the scheme to register with the Employee Provident Fund Organisation. Likewise, the Employees State Insurance Scheme also uses the number of employees as a threshold.

According to the Companies Act, 2013, a small company is a company whose paid up capital does not exceed INR50 lakh and turnover doesn't exceed INR2 crore[08] as per the last profit and loss account. A small company cannot include a public company, a holding company or a company set up by a special Act. Thus, in this definition various criteria are used.

Lenders typically use the size of the balance sheet and policymakers tend to use the number of employed persons to classify companies. The challenge observed in the latter is that if obligations of paying staff benefits is placed upon enterprises, they typically begin to use manpower agencies that help them hire more people without fulfilling obligations of paying employee benefits. In the event of no standard definitions and rules, these conflicting definitions and practices pose complexities for effective transmission of policy benefits as well as for lending to these enterprises through formal financial institutions.

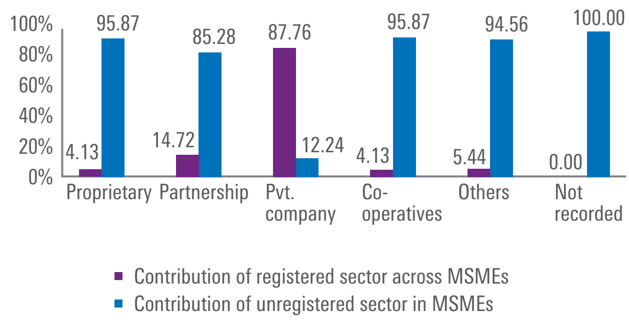
MSME landscape in India

Contribution of MSME sector to the country's GDP



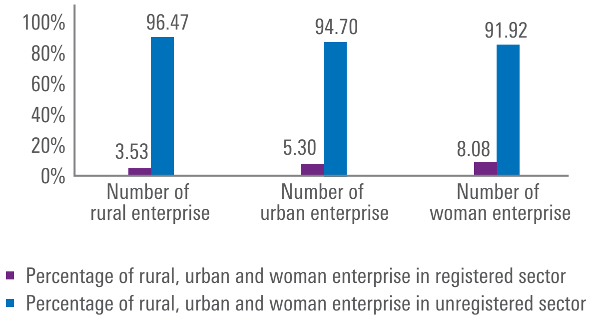
Source: 1. Fourth All India Census of MSME 2006-07,
2. National Account Statistics (2014), CSO, MoSPI and
3. Annual Survey of Industries, CSO, MoSPI.

Unregistered businesses constitute a large majority of the MSME business



Source: Fourth All India Census of MSME, 2006-07
*: For activities excluded in Sample Survey of Fourth All India Census of MSME, Unregistered sector (Retail/Wholesale Trade Establishment, Legal Services, Educational Services, Social Services, Hotels & Restaurants, Transport, Storage & Warehousing (except Cold Storage) data were taken from Economic Census-2005, Central Statistics Office of Ministry of Statistics and Programme Implementation

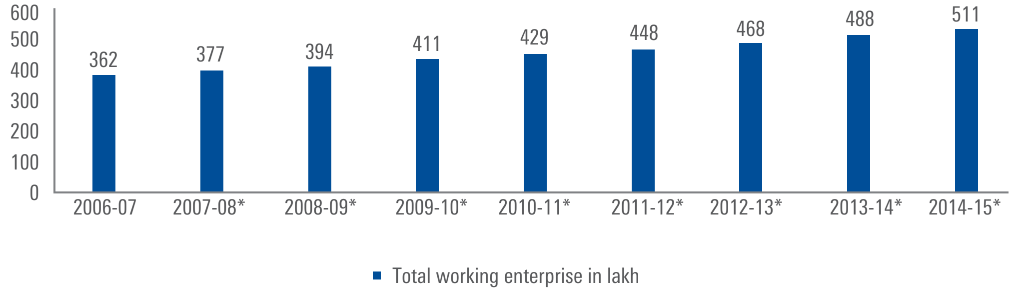
Socio-demographics of the registered MSME sector



Source: Fourth All India Census of MSME, 2006-07
*: For activities excluded in Sample Survey of fourth All India Census of MSME, Unregistered sector (Retail/Wholesale Trade Establishment, Legal Services, Educational Services, Social Services, Hotels & Restaurants, Transport, Storage & Warehousing (except Cold Storage) data were taken from Economic Census-2005, Central Statistics Office of Ministry of Statistics and Programme Implementation

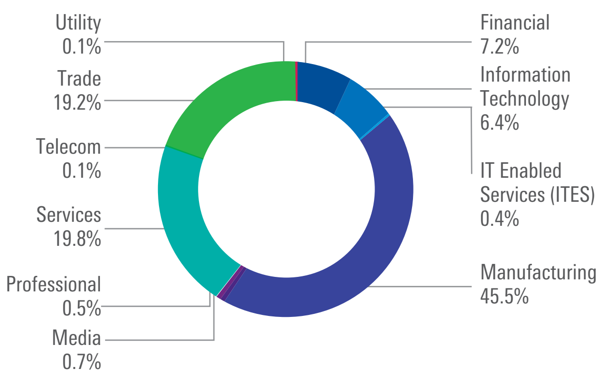
05. MSMED Act 2006
06. World Employment Social Outlook, International Labor Organization, 12 January 2017
07. GST council approves GST Bill, Press Information Bureau , Ministry of India,
08. Ministry of corporate affairs, Companies Act, 13 June 2011

Employment in the MSME sector



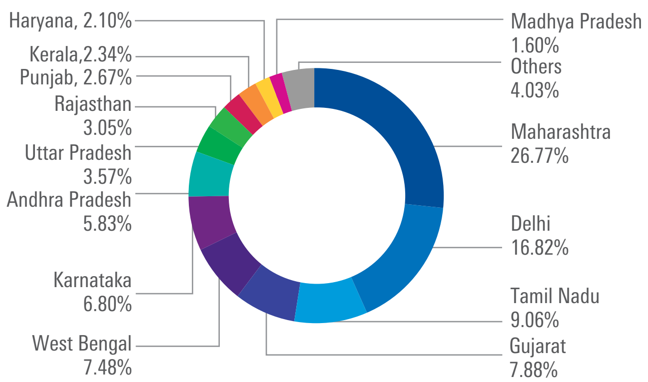
Source: Fourth All India Census of MSME, 2006-07
*: Projected Numbers, as the Fifth All India Census is not yet released

Sector-wise division of MSME companies

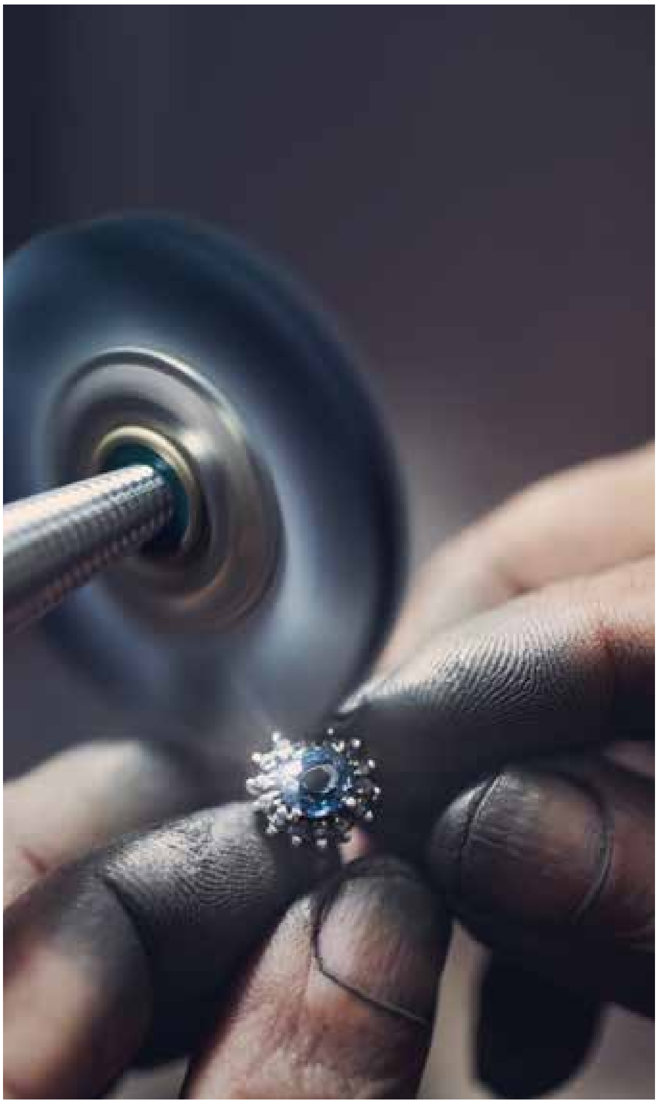


Source: Companies which are part of Dun & Bradstreet database, where the below information is available- company size considered: <=INR300 crore/Employees <=750
Sectors: Across, Cities: Pan India

State-wise division of MSME companies



Source: Companies which are part of Dun & Bradstreet database, where the below information is available- company size considered: <=INR300 crore/Employees <=750 , Sectors: Across, Cities: Pan India



Understanding the capital lifecycle of MSMEs

As evident from the previous section, despite the difficulty of enumeration, documentation and challenges of formal data, it is reasonable to believe that small businesses play an extremely important role in our economy. This is despite poor access to equity or debt capital and highly unequal access to skills and technology. On the other hand, capital providers (both debt and equity), technology solution providers such as aggregators, start-ups, and software service providers as well as a government keen to show higher growth and employment are all looking for winners amongst these small businesses who can be appropriately funded to become large businesses. After all, every large business was once a small business.

Understanding the capital lifecycle of the small business as they grow through family loans, personal equity, working capital loans, collateral financing, overdrafts, short-term and long-term loans and impediments to access such as difficulty in providing collateral, lengthy processing time for loan application, lack of knowledge of available schemes and procedural complications is useful to find the right solutions. (Singh and Wasdani[09], Asian Development Bank Institute).

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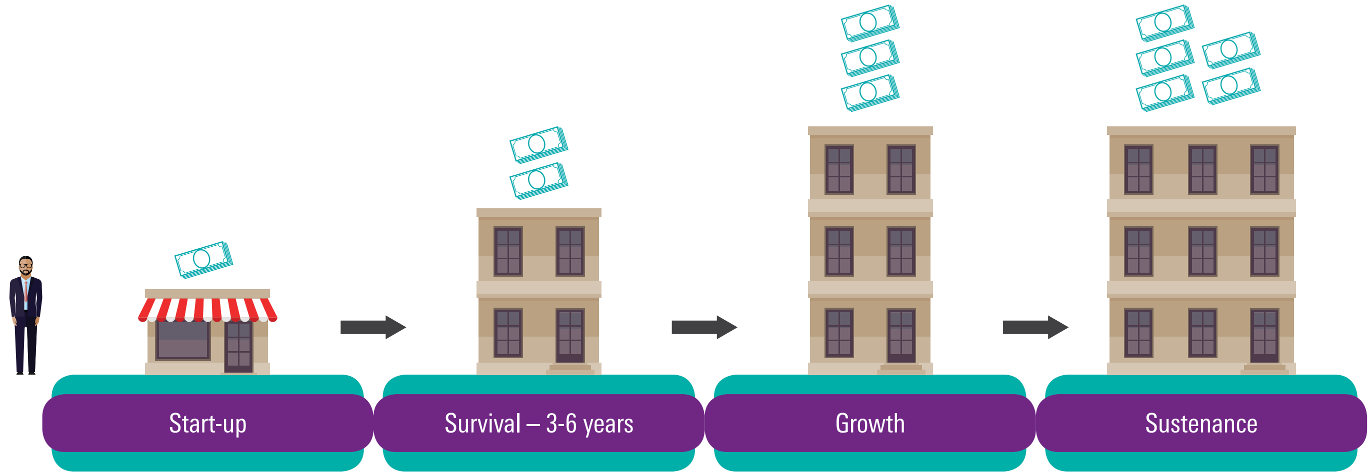
09. Finance for Micro, Small and Medium Enterprises in India, IIM Bangalore Publications, 1st September 2016

Traditional sources of finance across the lifecycle

Lifecycle stages



Start-up

- First 3 years
- Establishing a business in a marketplace
- Funds mostly used for financing working capital
- Quasi-equity when personal assets are used as collateral to borrow

Sources of finance

Quasi-equity

- Personal funds and savings
- Money borrowed from friends, family wealth
- Public banks, money lenders

Survival – 3-6 years

- Enterprise is trying to breakeven with regard to initial investment
- Purpose for financing are working capital, short-term loans, overdrafts

Sources of finance

Debt and equity

- Public banks
- Moneylenders
- Personal funds
- Private banks

Growth

- Enterprise has survived and will try to expand into new markets
- Enterprise may have documents in place to borrow from formal sources
- Enterprise may re-plough profits to finance expansion

Sources of finance

Debt and equity

- Public banks, private banks
- Personal savings, family wealth
- Moneylenders
- Co-operative banks, SIDBI

Sustenance

- Little change or no change in growth of the enterprise
- Need for short-term and long-term loans

Sources of finance

Debt and equity

- Public, private, co-operative banks
- Personal savings

Current regulatory framework and policies

As a measure of ease of doing business, the Government of India had introduced a presumptive taxation scheme under Section 44AD of the Income-tax Act, 1961 (the Act). As per the said provisions, an individual, Hindu Undivided Family and a Partnership business (excluding Limited Liability Partnership) shall be chargeable to tax on the basis of deemed business income. The deemed business income is worked out as 8 per cent of the total turnover/gross receipts of the assesse of the respective financial year. Further, no deduction for any expenditure (which is otherwise eligible for deduction while computing the total income) is allowed as deduction while computing the deemed total income. This Section is applicable only in cases where the total turnover/ gross receipts of previous year does not exceed an amount of INR2 crore.

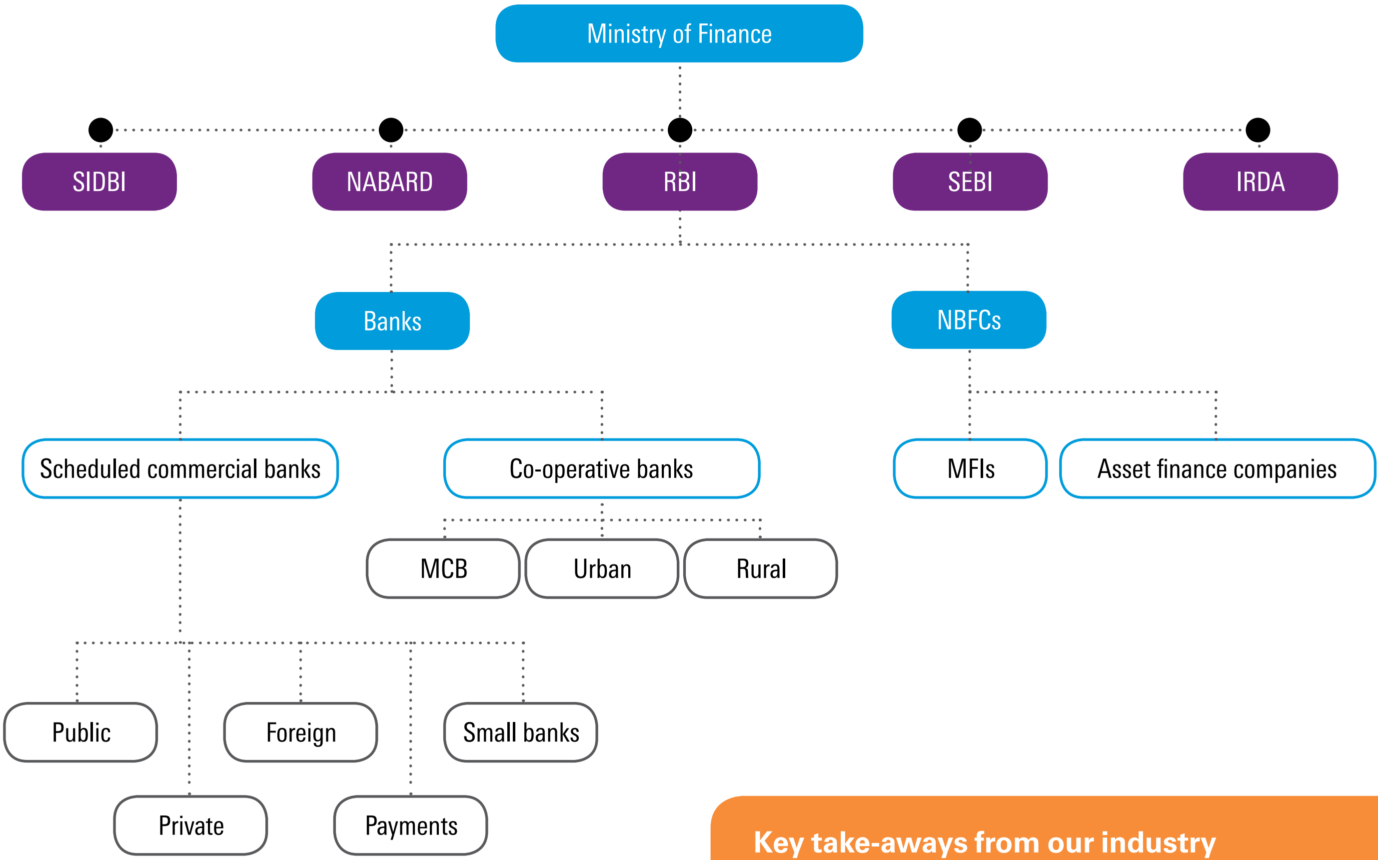
Recently, the Finance Act of 2017 has further amended this Section to provide that the deemed income shall be computed at 6 per cent instead of 8 per cent in respect of the total turnover/gross receipts which is received in non-cash mode (viz. an account payee Cheque, an account payee bank draft or use of electronic clearing system through a bank account).

The applicable Income Tax Return form (ITR) in case of presumptive taxation scheme is ITR 4 which is a 9 pager form as against the ITR 3 (prescribed for assesse not falling under the above presumptive taxation scheme) which is detailed and long. Apart from the above:

- The Finance Act, 2017 has prescribed lower corporate tax rate of 25 per cent for domestic companies whose total turnover/gross receipts for the financial year 2015-16, is upto INR50 crore.
- Section 115BA of the Act provides for 25 per cent corporate tax rate for new eligible manufacturing companies without claiming specified deductions, allowances.

100 per cent deduction of profit derived by eligible start-ups from eligible business (viz. business involving innovation, development, deployment or commercialization of new products, process or service driven by technology or intellectual property) for a period of 3 consecutive years out of initial 7 years.

Regulatory framework



Key take-aways from our industry discussion: Regulations

Financial Institution's perspective:

Given the dynamic environment in which MSMEs operate, there exists high red tapeism. Current regulatory processes need to be inclusive of these companies. Some amendments have been made on the regulation front but they still favour the unicorns in the start-up world or prefer a particular sector.

Regulations for banks and NBFCs requires them to primarily look at financial metrics and positive cash flows before investing which limits the capacity of these lenders to invest in promising businesses which require heavy upfront working capital investment.

MSME's perspective:

Regulations are complicated and not standardised across states. Taxation rate is high, competition with big brands causes high capital need especially during the formative years and it is very difficult to get quality people as well.

Current regulatory policies

Various policies have been instituted in order to increase and deepen access to financial services. Both direct and indirect tools have been mandated by the government, RBI and institutions such as NABARD and SIDBI.

Direct interventions entail imposition of policies on financial service providers that provide certain kinds of service to a target population in order to include them in the formal credit system.

An example of this is Priority Sector Lending (PSL) which has its origins in the late 1960s. The Reserve Bank of India (RBI) has instituted PSL wherein banks have to lend 40 per cent of Adjusted Net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposure (CEOBSE), whichever is higher, towards a few specified sectors such as Micro, Small and Medium enterprise, agriculture, renewable energy, etc.[10]

Other key aspects of PSL norms with respect to MSME are as under:

Within the overall limit of 40 per cent of PSL norms, there is a sub-target of 7.5 per cent of ANBC or CEOBSE for lending to micro enterprises.[10]

Only following MSME shall qualify for PSL lending norms:

Manufacturing enterprises

MSMEs engaged in the manufacture or production of goods to any industry specified in the first schedule to the Industries (Development and Regulation) Act, 1951 and as notified by the government from time to time.

Service enterprise

Bank loans up to INR5 crore per unit to micro and small enterprises and INR10 crore to medium enterprises engaged in providing or rendering of services and defined in terms of investment in equipment under MSMED Act, 2006.[11]

Other finance viz. factoring transactions, khadi and village industries, loan by banks to MFIs for on-lending to MSME, are also included in PSL norms under finance to MSMEs.

Also, to ensure that MSMEs do not remain small and medium units merely to remain eligible for priority sector status, the MSME units will continue to enjoy the PSL status up to three years after they grow out of the MSME category concerned.

Where banks are unable to meet the PSL target, to the extent of shortfall in the achievement of target, they have to invest in the Rural Infrastructure Development Fund (RIDF) established with NABARD and other funds with NABARD/ NHB/SIDBI/MUDRA Ltd.

Further, the RBI has allowed banks to trade in PSL certificates. Since the sectors under PSL have a broad coverage, some banks have been driving credit to the bankable within the sectors.

In late 1992, the Self Help Group (SHG) Bank Linkage programme[10] was launched in order to extend the outreach of the formal banking system to the poor who formed SHG to pool savings and borrow among themselves. The programme reduced transaction costs for both the borrower and lender and encouraged the formation of SHGs with the help of NGOs. But the spread of the programme has been uneven, mostly restricted to those areas in the reach of NGOs. Banks have been advised to meet the credit requirements of SHG members. This was also envisaged in the Union Budget for the year 2008-09 wherein it was stated as under:
"Banks will be encouraged to embrace the concept of 'total financial inclusion'. The government will request all scheduled commercial banks to follow the example set by some public sector banks and meet the entire credit requirements of SHG members, namely, (a) income generation activities, (b) social needs like housing, education, marriage, etc. and (c) debt swapping." (Verbatim quote from budget 2008-09)[12]

The RBI, in 2005, formulated guidelines for banks to provide general credit cards to extend credit facilities to non-farm entrepreneurs through the General Credit Card Scheme.[13]

The Government of India has also been active in setting up policies for financial inclusion. Regional rural banks were established in 1975 in order to cater to a rural based population. The Swarnajayanti Gram Swarojgar Yojna (SGSY) launched in 1999 has been instrumental in forming SHGs in rural areas. The credit guarantee fund scheme for small and micro enterprise was setup in the year 2000 to provide collateral free credit to make funds available to this sector.[14] The RBI also granted in-principle approval to 10 entities for the setting up of a small finance bank in India.The objectives of setting up of small finance banks will be for furthering financial inclusion by (i) provision of savings vehicles primarily to unserved and underserved sections of the population, and (ii) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high-technology, low-cost operations.

The Micro Units Development and Refinance Agency Bank (MUDRA) has been set up for the development of micro units and to refinance Micro Financing Institutions (MFIs) and fund to non-corporate small businesses and aid, support micro businesses/entrepreneurship. MUDRA will have a corpus of INR20,000 crore to refinance both non-profit and for-profit MFIs and will also regulate MFIs.[14]

10. Priority Sector Lending- Targets and Classifications, Reserve Bank of India, 23rd April 2015
11. MSMED Act, 2006
12. Union Budget Report 2008-09
13. Revised General Credit Card Scheme,RBI, 2 December 2013
14. Micro Units Development and Refinance Agency Bank, 01 March 2015

In order to transform the entire ecosystem of public services through the use of information technology, the Government of India has launched the Digital India programme in 2015 with the vision to transform India into a digitally empowered society and knowledge economy. Other indirect policy interventions include subsidies. A subsidy is an instrument of fiscal policy and it means that the government pays partly for goods or services of private consumption.

For example, the Technology Upgradation Fund Scheme (TUFS) for the textile industry caters to textiles and the jute industry. It facilitates induction of state-of-the-art technology by the textile units. It includes benefits such as 5 per cent interest reimbursement of the normal interest charged by the lending agency on Rupee Term Loan, or 5 per cent exchange fluctuation (interest and repayment) from the base rate on Full Container Load, or 15 per cent credit linked capital subsidy for SSI sector, or 20 per cent credit linked capital subsidy for power loom sector, or 5 per cent interest reimbursement plus 10 per cent capital subsidy for specified processing machinery.[16]

15. Micro Units Development and Refinance Agency Bank, 01 March 2015
16. Narendra Modi launches mudra bank for small firms with 20,000 crore corpus, Economic Times, 9 April 2015

Key challenges faced by the players in the ecosystem

Financial resources are the basic requirement of MSMEs and most of them lack strong financial backing. MSMEs tap into various sources for funds and banks still form the largest lending source. Access to capital at the right time throughout the growth stage of an MSME is essential and is still a major stumbling block.

When it comes to MSME lending, the major deterrents for financial institutes are high transaction costs, low ticket sizes and high risks involved. Large financial institutions often need collaterals such as inventory or infrastructure which many of these businesses lack at the inception stage. They need to see an encouraging turnover and cash flows from these MSMEs to alleviate the fear of delinquency. Early stage micro and small businesses cannot showcase assets such as plant and machinery, consistent cash flows in their books, which in turn impacts their ability to provide collateral as security to the banks. Overall, poor financial performance and improper books of accounts of these micro and small enterprises keep the banks at bay.

The track record of the promoters and their overall rapport with lenders is also an influencing factor for the banks. In the past, lack of financial discipline in the promoters have deeply impacted the loan ticket size. Lending institutions including banks have their own credit evaluation criteria. Low credit worthiness and non-abidance to bureau norms of these MSMEs are some other impediments.

Low credit limit and high interest rates offered by banks and NBFCs becomes a limiting factor for MSMEs to avail loans. Additionally, a complex and time-consuming loan disbursal process of banks and NBFCs makes it cumbersome for MSMEs as they need processes to be fast during their growth stage to meet rapid demands.

Heavy investment businesses such as retail and manufacturing spend a lot of their initial capital on raw material, labour costs, and in setting up factory. Business owners feel that banks and NBFCs should be considerate of the sectors and industry to which the businesses are aligned.

Key take-aways from our industry discussion: Access to capital

MSME's perspective:

Banks, with the complexities involved in their loan process, seem to benefit the larger players more than MSMEs. Definitions of collateral and security requirements are very ambiguous and the process lacks transparency.

Loan approval process is a long-drawn process. Many market situations require an efficient process that is much quicker than the one in practice today.

Working capital requirements are bloated in retail as brand building activities and marketing activities are money guzzlers. It is difficult to secure the right amount of working capital loans initially especially from banks.

The MSME credit crunch - Gap in demand and supply

The issue of lack of adequate flow of credit to the MSME sector is a long-standing one, thus creating a huge credit gap for companies in this segment. As of 2014-15, almost 92 per cent of MSMEs had no finance, 5 per cent had finance from institutional sources, and 3 per cent had credit from non-institutional sources.[17]

Among MSMEs, the 'micro' segment forms the largest part of the debt gap, with most entities operating in the service sector, thus lacking collaterals required for credit, as well as limited promoter experience. In case of banks, the percentage of MSME credit to the total priority sector credit has also remained very low, hovering between 1-2 per cent in the 2008-2013 period.[17]

For the 'small' segment of MSMEs, the credit gap is mainly attributed to the gap in working capital financing, with funds from banks not meeting their requirements. Banks tend to keep conservative working capital funding limits because of lack of transparency and asymmetry of information in financial statements by these enterprises.

The 'medium' segment of MSMEs is relatively well-funded when compared to the micro and small segments, and also absorbs equity in many cases, in addition to debt. The debt gap in the medium segment enterprises is mainly due to lack of sufficient working capital financing and lack of financing for service enterprises in this segment.

17. Issues of MSMEs in India, Research Gate Publications, 10 May 2016

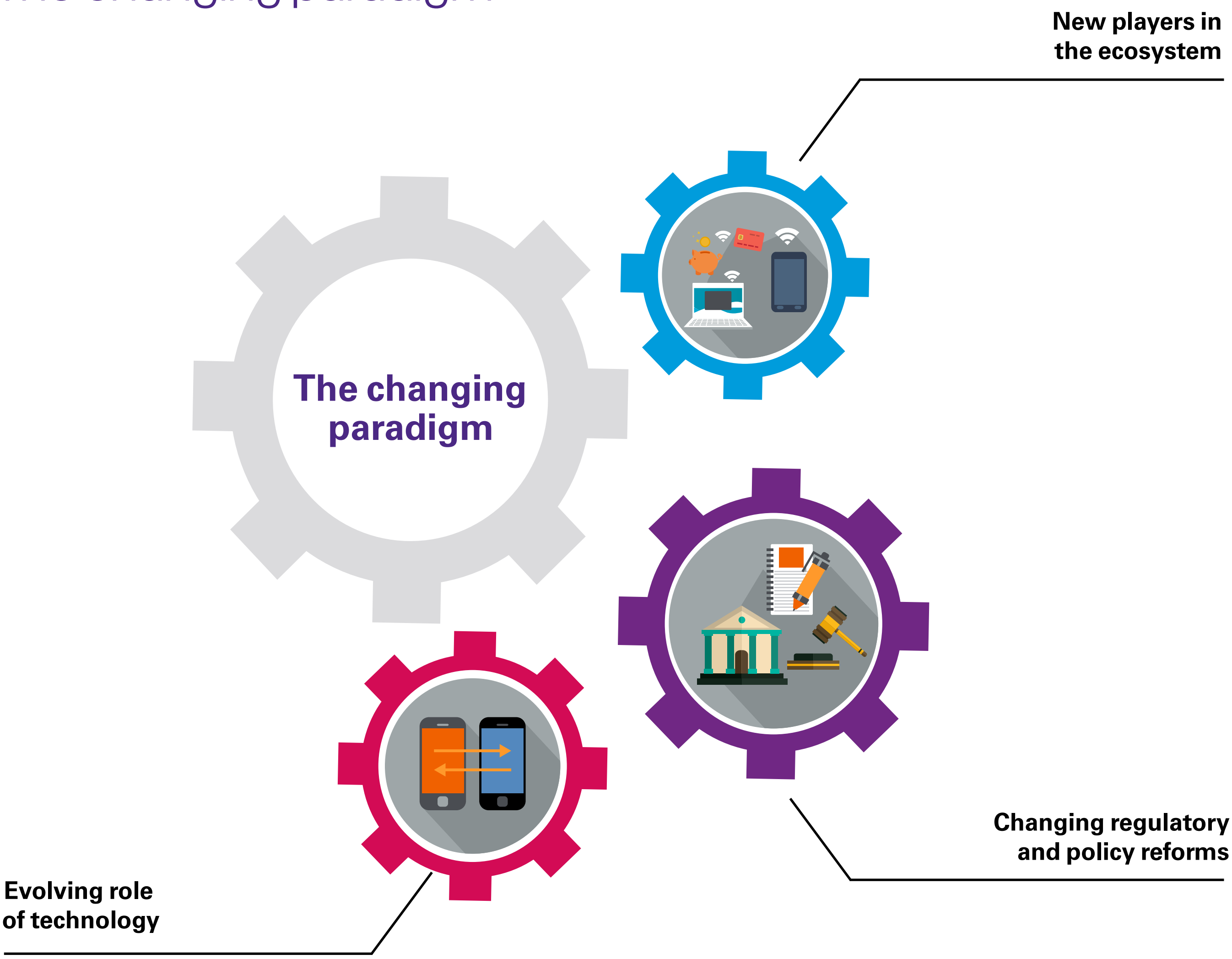
The changing paradigm

The last few years have seen changes in paradigm affecting the MSME financing ecosystem. Technology is seen as having a major impact with growing internet and mobile penetration, rise of ecommerce and new age fintech companies creating innovative models impacting the way business is being done on both financiers side as well as for MSMEs.

As banking gets unbundled, new models and sources of capital are being opened up for new businesses. There is an emergence and growth of a new class of alternative financiers – fintech companies, crowdfunding, peer-to-peer lending, new age digital NBFCs, (alternate lending platforms) etc.

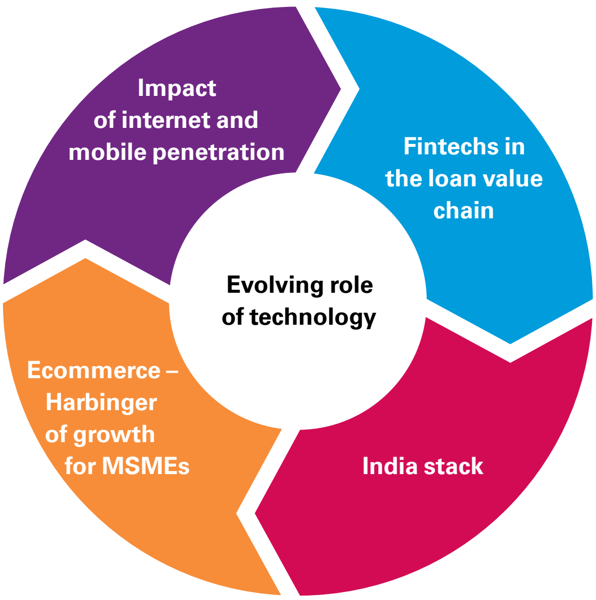
Policy and regulatory reforms are also undergoing a change and steps are being taken to factor-in impact of the above trends. However, these are at a nascent stage.

The changing paradigm



The evolving role of technology

Technology is having a positive impact on the MSME sector. This section takes a look at the impact of technology on this sector.



Impact of internet and mobile penetration

With over 430 million internet users,[01] 380 million mobile internet users[02] and disruptive schemes by new entrants like Jio, the opportunity is ripe for India and its millions of MSME businesses to ride the wave and reap benefits of the ever increasing internet and mobile penetration. The rise of the internet has touched multiple aspects of MSME commerce, essentially bringing businesses online.

01. Number of Internet users could in India could cross 450 million by June, Live Mint, 02 March 2017
02. India to have over 500 million mobile internet users by 2017, The Economic Times, 21 Nov 2016

Online MSME communities

These are internet based communities of MSMEs which work to bring suppliers, manufacturers and service providers on a single platform for better interaction, creating a social media website like experience for them. Services such as CoreLogs have created thriving online communities where MSMEs share business requirements.[03]

Raw material sourcing

Online B2B platforms such as Power2SME and industry buying are being used by a large number of MSMEs to source products and raw materials online, with the benefit of transaction and price transparency. These portals also provide line of credit and working capital loans to MSMEs through tie-up with banks.[04]

Social media and online marketing

Given the ubiquity of social media platforms, a presence on social media helps companies not only in better branding, but also help understand customer needs through reviews and comments. Online marketing and sponsored posts on platforms such as social networking websites help companies reach out to the maximum number of customers, with an ability to monitor and fine-tune their campaigns based on online analytics provided by these platforms.

With the focus being largely on growing their revenues, owners of MSME businesses typically operate on restricted budgets and limited resources. As a result, affordability, return on investment and costs are the key considerations when it comes to marketing. Start-ups have started to acknowledge and embrace digital marketing with a mobile-first approach, investments in omni-channel and content marketing.

Moving away from a ‘one size fits all’ approach to highly defined personalisation, content marketing is helping small businesses with better lead nurturing which in turn has a big impact on better conversion rates and increased order value.

The dynamic pace of change in customer behaviour naturally translates into a high rate of adoption for the ’mobile first approach’- be it website, e-mail or social media. These mobile strategies assist MSMEs reach new customers, leverage location-based services, engage with existing ones at a more personal level and collect intelligent customer data.

Omni-channel offers opportunities to MSME retailers by helping them create superior customer experience, vast customer data and insights and improved sales productivity.

The Internet of Things (IoT) and Artificial Intelligence (AI)

Industrial applications of IoT are expected to greatly change the way MSMEs are conducting their businesses, such as using sensors to physically track stores, stock, staff and managing the overall premises remotely. The impact is expected to be seen in the coming years, wherein IoT connected devices are likely to make businesses more efficient, reduce cost and aid in better decision-making.

Similarly, AI applications such as ‘chatbots’ are being deployed on websites and mobile applications. Marketing communications are converting into human machine conversations as actual conversations are being taken over by bots. AI brings marketers the potential to automate mechanical tasks such as product recommendations and customer complaints.

Productivity applications

Companies such as Zoho, provide a host of online collaboration, productivity and business applications especially suited to the needs of MSMEs such as customer relationship management and email. Enterprise software maker SAP plans of setting up 30 centres across 13 cities to help small and medium businesses become compliant with GST. SAP as an application service provider for GST, has taken measures like ‘GST in a Box’ and has setup an online resource centre along with several other measures.

Online business registration

To enable MSMEs to register themselves faster online and avoid cumbersome paperwork, the Government of India notified of the Udyog Aadhaar[05] scheme to ensure easy registration and wide coverage of MSMEs in availing benefits of schemes targeted towards them by state/central governments. Over 30 lakh enterprises[05] across the country have received Udyog Adhaar numbers through this initiative.

Key take-aways from our industry discussion: Importance of technology

Financial Institution’s perspective:

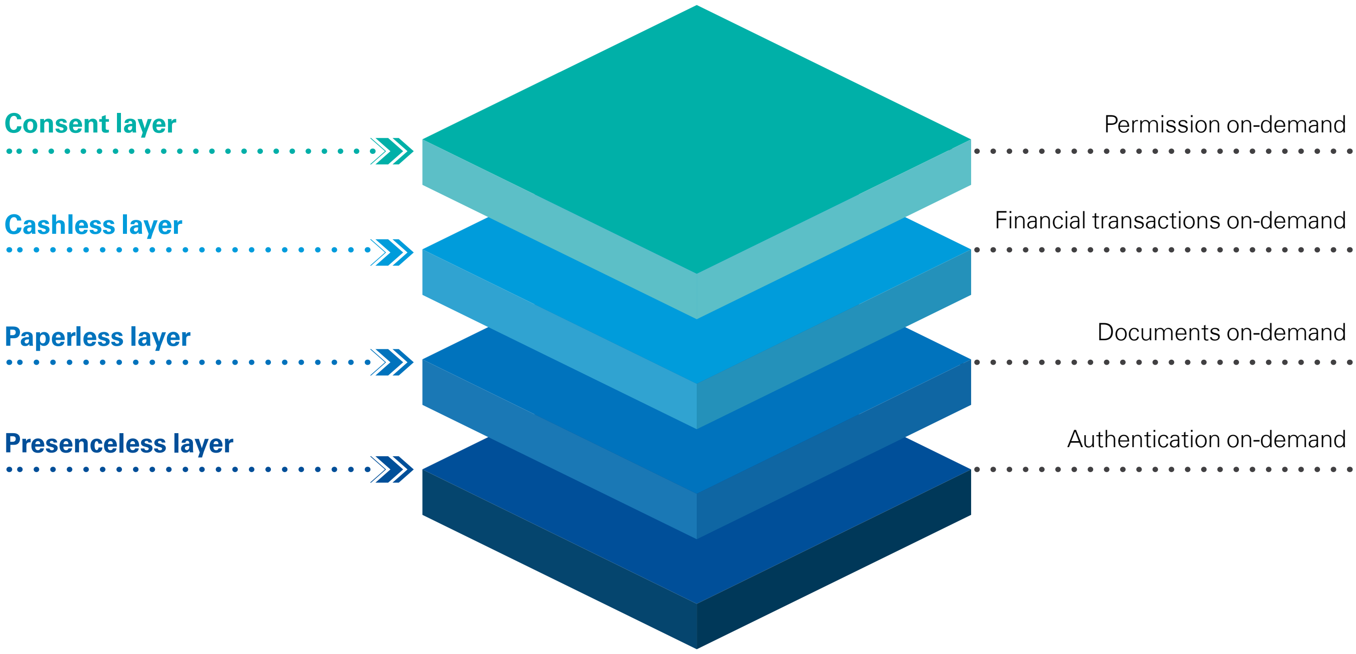
There is scope for innovation and cutting edge technology adoption especially in the education and healthcare sector based MSMEs in our country. A very long tail of addressable market in tier 2/3 cities is not benefitting from these MSMEs as a result.

Lack of credible data is unable to compensate for the lack of collateral to assess credit worthiness of the MSME.

Adoption of technologies around automation will help the companies produce accurate data. GST coming in will help ease out a lot of hassles around running businesses across different states.

03. How SMEs are benefitting from the Internet, MeriNews, 27 April 2017
04. Heres-why-b2b-e-comm-cos-are-becoming-preferred-choice-for-smes-to-procure-goods, Economic Times, 28 October 2016d
05. MSMEs urged to get Udyog Aadhar, The Hindu, 04 May 2016

India stack



India Stack is a set of APIs or Application Program Interface, which helps various stakeholders of the society access an open digital infrastructure. By doing so, the government along with businesses and customers can move towards a more digital economy. An API is a set of codes that facilitates interaction between software programs. This digital infrastructure aims to make India more efficient by reducing paperwork and 'paper' altogether and eliminating middlemen that currently exist in the payments system. India Stack provides four different layers.

1

Presenceless layer

An organisation such as a bank that needs identity confirmation of an individual can ask for biometric information such as the individual's iris scan or fingerprint and can verify it from the government's database. Thus, the individual does not have to be physically present for identification. The individual can also have a digital signature called e-sign.

2

Paperless layer

Information and documents move with the identity of the individual. A government repository of documents such as driver's license, mark sheets, etc. are stored in the 'Digi Locker'. The identity and address of the subscriber are verified electronically through Aadhaar authentication and this is called Aadhaar e-KYC.

3

Cashless layer

The Unified Payment Interface (UPI) was set up by the National Payments Corporation of India which enables digital payments at reduced costs. Transaction history of individuals or organisations can aid to determine their creditworthiness. Thus it becomes easy for borrowers to borrow, lenders can avail the credit history when consent to access is given by the potential borrower, and funds can be disbursed quickly.

4

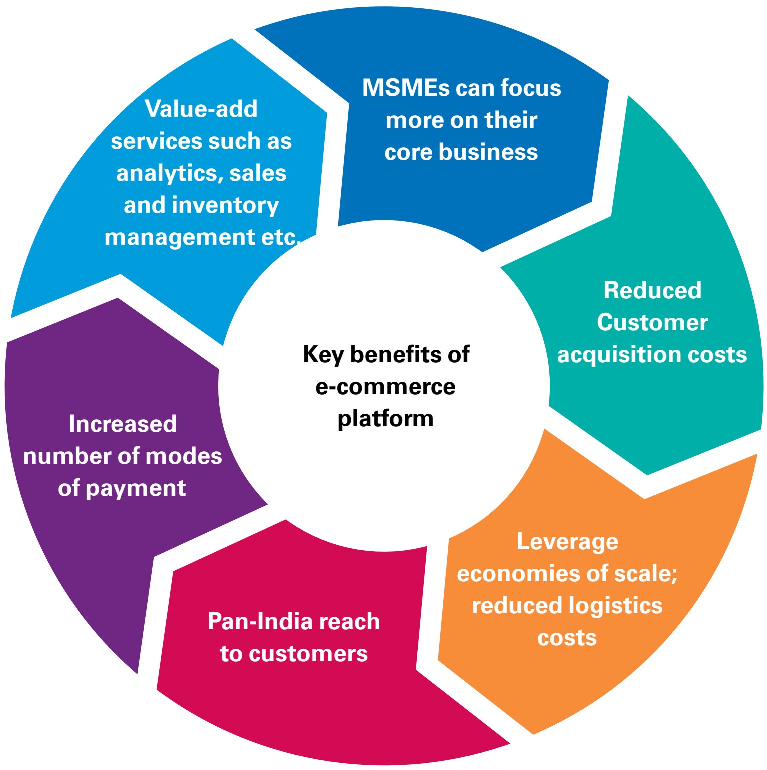
Consent layer

The individual who uses his Aadhaar card for various purposes on this platform along with various documents has the ultimate authority over who can access his/her data.

India Stack aims to help micro and small businesses in a number of ways. A proprietor can borrow easily, as his identity is easily verified and documents are available on the Digi Locker, thus reducing the time spent in getting the loan. 'Transaction costs' are greatly reduced, as hardware such as a mobile or laptop gives an individual access to India Stack. This way, they do not spend time away from their business, which probably is small and employs only a few people. The proprietor can borrow and pay back in digital cash. He/she leaves a digital footprint that if given consent to a lender helps them access information on the proprietor's credit worthiness. Since it is an open infrastructure, there is equality of access, regardless of whether a business is small or big. Getting a business on this platform, eliminates the possibility of corruption or being charged a high interest rate as the platform is a competitive marketplace.

As an example, Rang De is moving away from its cash disbursal model to a digital model leveraging bank accounts created under Pradhan Mantri Jan Dhan Yojna (PMJDY) scheme and Aadhaar, eKYC and UPI, which come under India Stack. They aim to target women in the underserved communities under their project 'Swabhimaan'. Under this program, borrowers will be able to customise their loans and also receive funds and repay them using UPI. Rural Indians will also have a credit score linked to their name which will help them tap funds in a much easier way in the future.

Ecommerce – Harbinger of growth for MSMEs



In less than a decade, ecommerce has established itself as a household name. Increasing telecom penetration in the form of high-speed internet and smart mobile phones, financial instruments for online payment, along with conventional growth indicators, such as rise in disposable incomes and education, have all contributed to the scale and rapid growth of ecommerce.

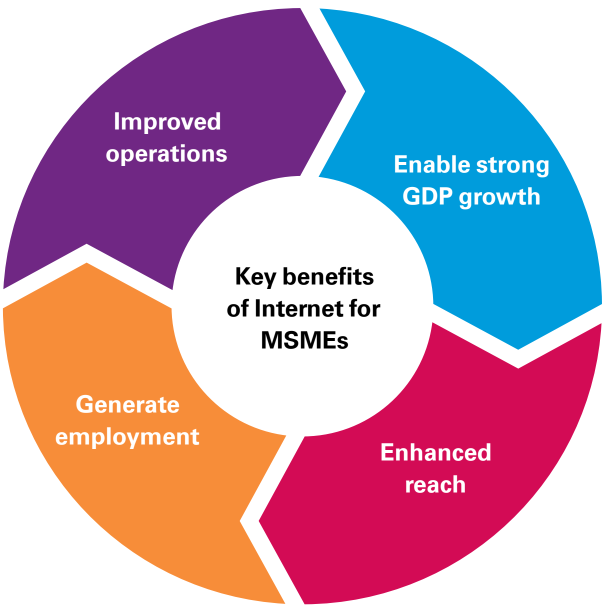
The customers' perspective is well known – convenience and cost are the key drivers of ecommerce adoption. The seller's perspective, however, is quite different. Ecommerce companies have been fairly vocal about their positive impact on MSMEs and their contribution towards their growth and expansion, including promotional campaigns highlighting the same. These are well placed, and ecommerce has indeed given most MSMEs an additional channel for customer acquisition and sales.

Key benefits of an e-commerce platform to MSMEs

Following efforts can help MSMEs reap the potential benefits that an ecommerce platform presents:

- By taking over activities, such as order management, logistics and complaints handling, ecommerce companies enable MSMEs to focus on their core business, i.e. manufacturing (or trading)
- On their own, an MSME may not be able to reach customers beyond the immediate geography and their expansion will be constrained by their ability to set up offline presence (offices or sales outlets). Ecommerce gives them a pan India reach from their base location
- Customer acquisition costs for MSMEs are trimmed as they get access to a captive customer of the platform, as well as a potential customer with every new customer added by the platform
- An MSME may not be in a position to accept some modes of payment (credit card, wallet, bank transfers, etc.), but the ecommerce company ensures that this is not a bottleneck for any sale
- Leveraging economies of scale, e-commerce companies are able to offer better costs for forward, last mile and reverse logistics from the third party service providers.

Many e-commerce companies also provide Value Added Services (VAS), such as analytics on customer preferences, sales and inventory management, among other relevant data points and insights and so on. These would also include channels for liquidating old/outdated inventory, sale of used goods through appropriate ecommerce websites, and support for invoicing and packaging, among others.



Adopting digital technologies to influence growth

As per the ‘Impact of internet and digitisation on SMBs in India’, study by KPMG in India and Google India (January 2017), the influence of digital technologies adoption is interpreted as follows:

Enable strong GDP growth

Rising internet penetration and greater uptake of digital by SMBs could help increase their contribution to India’s GDP by 10 percentage points (46 to 48 per cent by 2020)

Improved operations

Digital SMBs grow revenues/profits up to twice as fast as offline counterparts

Enhanced reach

About 51 per cent digital SMBs cater to customers beyond their city as against 29 per cent offline

Generate employment

Engaged SMBs employ five times more employees compared to offline ecommerce companies, which may not be able to survive by themselves. There is an entire ecosystem of companies that is vital to the sustenance of their operations. Many of these companies are start-ups, and their mere existence is by the virtue of their growth and proliferation.

Multiple start-ups in the space of last mile logistics, cataloguing, analytics, technology, financial technology (fintech), including payment gateways, online only sellers, aggregators, liquidation/refurbishing agencies and many others, have sprung up in response to the fast growing ecommerce industry.

The scalability of e-commerce companies is more or less constrained by the support they get from the overall sector and conversely, their growth closely mirrors the growth of the sector as a whole.

While the sector is under the scanner for its apparent lack of focus on profitability and aspects of channel conflict driven by differential pricing in some categories, its overall impact on MSMEs and start-ups in the ecosystem is significant – not only by virtue of direct impact, but also because of the positive atmosphere of entrepreneurship and innovation.

Fintechs in the loan value chain

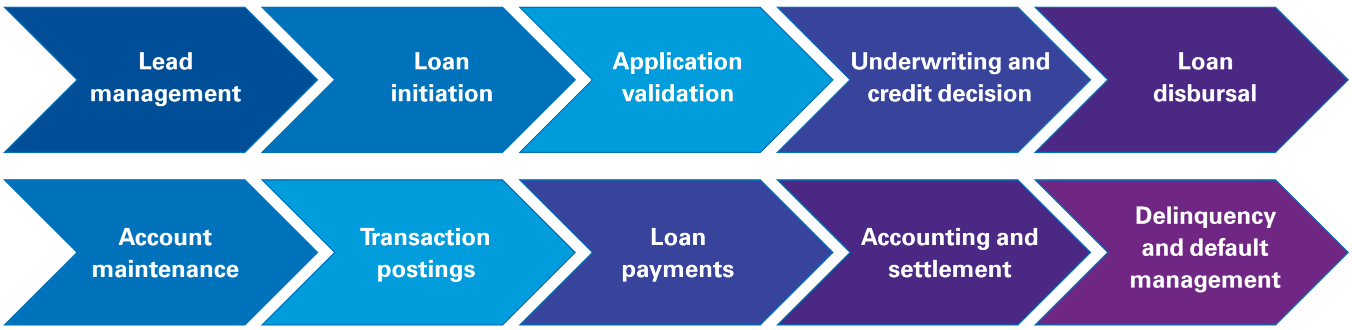
Over the last three years, fintech in India has seen rapid growth, and is expected to grow at the same pace going ahead. The ecosystem for fintech in India has also received a boost through government and regulatory initiatives, and startups in the segment have new opportunities to leverage them and launch innovative and competitive products. Banks and regulators are hard-pressed to revisit their operating model and policies respectively to create a conducive environment of collaboration and dynamism amidst the participants in the fintech ecosystem.

Fintechs have created innovative solutions across the lending space in creating alternate capital sources as well as in the loan value chain. Innovative fintech solutions are found across loan origination, loan management and loan collection.

These new breed of fintech lenders have emerged to address the gap of micro and small businesses' needs for financing and propensity of the mainstream lenders to address these funding needs. These fintech disruptors are gaining from the fact that micro and small businesses are turning online to search for alternate sources of financing. Ease of access to funding sources is something the new age MSMEs are looking for, and the fintech firms have hit the right chord by addressing this need.

Leading organisations are moving towards digitalising their loan processing platform to integrate/augment their core lending business processes and strategy with fintech solutions. Fintech solutions based on cloud, alternate scoring models, big data and blockchain, can drastically change the way banks function by introducing agility, a connected operating model and reduced cost structure. Besides streamlining the processes, fintechs can aid banks to adopt a very customer-obsessed approach. A collaboration between fintech organisations and banks is a win–win situation as both parties can gain from strengths on both sides to co-create value. The biggest value the banks see with this collaboration is the speed-to-market and convenience which is the need of the hour for the MSMEs. The opportunity to test solutions quickly and cost-effectively is why banks find partnerships with fintech start-ups highly lucrative. For instance, banks and NBFCs have started seeing value in alternate credit scoring methods and have become much more forthcoming in adopting them. Measures like these can pave the way for an ecosystem which will be inclusive of MSMEs. Banks in emerging economies of Asia, Middle East and Africa, and South America are witnessing a rapid adoption of fintech based solutions.

Loan value chain



Veridu is a London based fintech start-up, which provides instant identity verification for streamlined onboarding, reduced fraud, and know your customer requirements. It uses deep machine learning and data extraction algorithms to do identity verifications.

CreditVidya is a B2B technology platform, helping lenders make critical underwriting and credit decisions based on credit scores assigned to new-to-credit and thin file customers, through leveraging non-traditional data sources. These non-traditional data sources include behavioral (pending payments or categories of purchases), social networks, transactional (through recharges or e-commerce spends). All this information is received from the borrower's smartphone or e-mails based on their permission.

IGSN- provides workflow management solutions for the loan disbursal process. It has recently ventured into other products such as CRM and loan management system.

A concept that is still being explored in India by players like KredX, is invoice discounting. KredX is an invoice discounting platform that helps match businesses which need working capital funding to investors interested in low risk, high return lending. Micro and small businesses are often in a dilemma because their customers do not make payments on time and as a result their account receivables increase. This forces such businesses to borrow money at high interest rates to meet their working capital requirements. Even obtaining the funds at high rates also becomes difficult for them because of the unavailability of security of collaterals. KredX has tried to bridge this very gap by digitising the invoices and using them to hand out credit. Buyers can purchase these invoices and give small business owners capital in a short span of two days. While still in a nascent state, this method of converting invoices into assets has proven to be successful in Singapore (ApexPeak) and China (Qupital), and has the potential for growth in India as well.

Credit Sense, is a Brisbane based, Australian start-up which facilitates automatic bank statement retrieval and helps ensure that assessment of transaction histories are consistent, compliant and efficient.

Players like Zoho and Profitbooks are equipping MSMEs with software and technology platforms while companies like StoreKey and Catalyst Lab aggregate the demand of wholesale and retail sale for small merchants, thereby, improving their market power and competitiveness.

Blockchain for lending

Supply chain finance is used to finance various parties in a supply chain, using short-term credit to balance working capital between a buyer and a seller, thus reducing the aggregate supply chain cost. MSMEs are often seen as providers of raw materials and input for other, larger global value chains, which makes this proposition all the more useful. Supply chain finance solutions leveraging blockchain are an emerging area in the industry today, which enable all the stakeholders in the supply chain finance solution to work with a single ledger shared among them.

A supplier and manufacturer, along with every other participant, will solely update their parts of the transaction, enabling efficiency, re-affirming trust and transparency on a distributed ledger record that is immutable.

Indian banks are working on blockchain applications in various areas of the transactions journey and financial processes, to bring simpler and more efficient financing options for traders (import/export/domestic) including the paper-intensive processes of trade finance and supply chain financing segments.

A leading bank has successfully completed a broad trade finance blockchain transaction with a client. It claims to be the first Indian lending institution to complete proof of concept of a trade finance transaction (end-to-end) successfully for a client. This solution implementation has reduced the turnaround time in trade finance approvals from 30 days to a few hours, thus helping exporters improve efficiency in operations. With the help of blockchain technology, the bank has been able to reduce the time taken for a Letter of Credit (LC) from 20 to 30 days to only a few hours. The time involved in completing the process deprives exporters in the value chain from utilising their sale proceeds efficiently[06].

Another leading bank is working on the development of a supply chain finance solution in collaboration with leading technology software provider. They have additionally indicated the formation of an association to develop blockchain solutions in domains such as import/export finance, KYC, loans, regulatory auditing, etc.

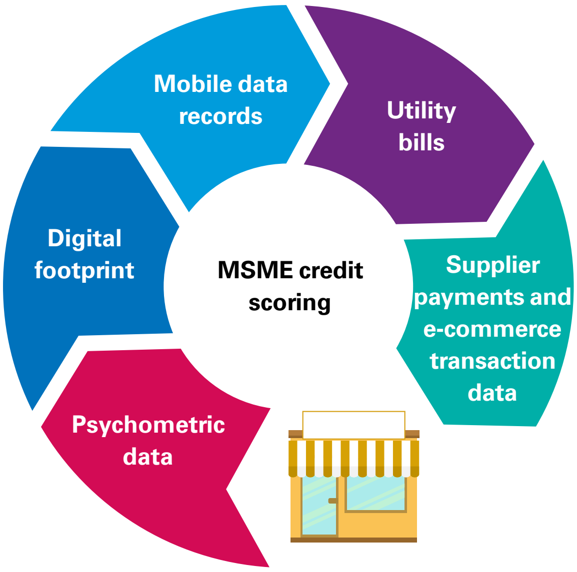
Another Indian bank has completely digitised vendor financing for its client by implementing a multi-nodal blockchain transaction. Cateina Technologies, a fintech startup is behind this implementation that has been done on a smart contract based on Blockchain. They have used the Hyperledger Fabric supported by a leading technology software provider and integrated it with their own systems to allow this client to digitise the discounting and fund disbursal process. This is based on the security and efficiency that blockchain provides. MSMEs are the key vendors for the client, who have largely benefitted from the vendor payout solutions' digitisation action. Blockchain's shared public ledger has brought transparency to all the stakeholders involved. The bill discounting process cycle has been reduced from four days to almost real-time.

This Indian bank also aims to enhance the digital experience of its corporate clients, partners and developers who collaborate with them on an API banking platform[07], which is an integrated blockchain solution by leveraging cloud based cognitive services.

06. Kotak Mahindra Bank cuts turnaround time for trade finance, Financial Express, 17th May 2017

07. How Yes Bank is Using Blockchain Technology to Help Companies Fully Digitize their Systems, ndtv.com, 10 January 2017

Alternative means of credit scoring



Given the lack of quality data to perform the credit scoring process, new lending techniques based on alternative data have emerged as a substitute to the traditional models of scoring. This is being leveraged by fintechs. The major sources of alternative data include:

Online

This includes a digital footprint based on data from social networking and ecommerce sites such as Amazon and Facebook. They are useful in establishing income, stability and professional network size. Other clickstream data, such as web addresses visited before online loan application, the nature of affiliate network driving the traffic, etc. can be a useful source of predicting repayment behaviour.

Mobile

Mobile data generally comprises Call Detail Records (CDR) and Transaction Detail Records (TDR). These records can be used in estimating the network size and financial stability of an entity.

Supplier payments and ecommerce transaction data

History of payments to suppliers can be used as an estimate of the willingness to pay, as well as of revenue and working capital.

Utility bill payments

Payments of mobile/telephone and electricity bills can be used as indicators of willingness to pay.

Psychometric data

Collected during application time using surveys and questionnaires, psychometric data has emerged as an effective indicator of an individual's character and willingness to pay. In-person administration of questionnaire, however, involves higher cost in data collection, but with a potential of robust predictive power.

In India, Janalakshmi Financial Services Limited (JFS), an MFI, partnered with Entrepreneurial Finance Lab (EFL) to incorporate alternative data for credit scoring and reaching out to the unbanked, and helping clients move from joint liability customers (group loans) to individual loans. The EFL incorporated psychometric assessment into JFS's existing processes, thus providing the ability to accurately differentiate the credit risk in the borrowing population. The psychometric assessment by EFL examines attributes such as autonomy, optimism, self-confidence, opportunism and acumen.[08]

Key take-aways from our industry discussion: Credit scoring

Borrower's perspective regarding the necessity to change the existing credit scoring process:

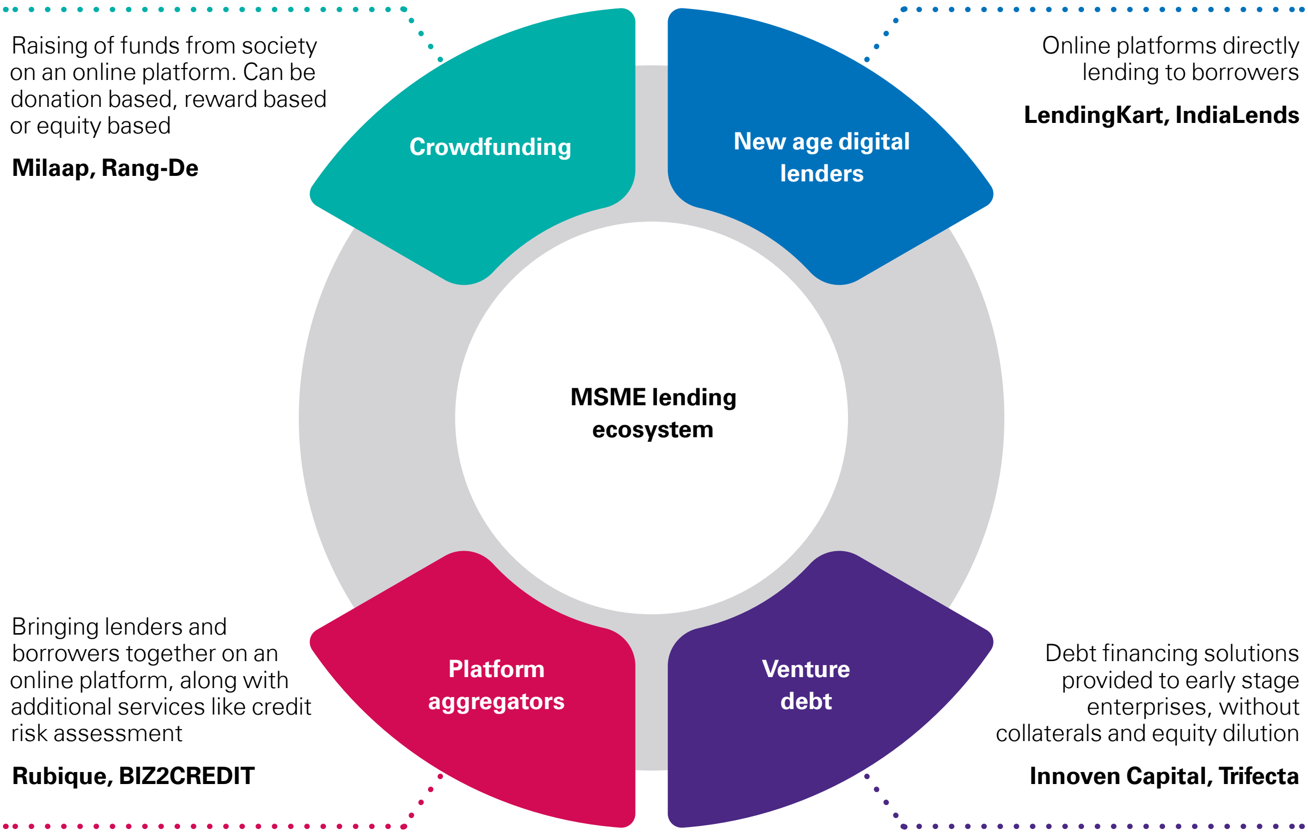
There is a need to revamp the existing credit scoring system to bring empathy into the equation. Lenders should for example, factor in the stage at which an MSME is in its growth lifecycle and the market forces that surround it as well.

The credit rating process should be seamless. There is a need to change the mechanism around the credit scoring process. If a MSME has secured a loan from a Public sector bank after going through a laborious assessment process, the credit score should automatically be generated and shared with all existing financial institutions.

08. EFL uses psychometric test to stop loan defaulters, Yourstory, 15 January 2014

New players in the lending ecosystem

For a sector that consistently contributes to India's industrial output and has had a higher growth rate compared to the country's GDP, MSMEs have not been supported adequately by financing and lending players in the ecosystem. Loans to this segment generally have a small ticket size, high transaction charges, and have a perception of high risk due to poor or no credit rating and inexperience of promoters/entrepreneurs as well as a lack of collaterals. New innovative models of financing are coming up that are addressing some of these gaps.



Platform aggregators

Digital aggregator platforms have come into creation as they help bring the borrower and lender together on a single platform, thereby, creating value for all players in the process.

Rubique offers solutions directly integrating with systems at financial institutions, thus allowing for online sanctions and real-time approvals. Rubique's online platform allows for analytics on several customer data points to assess their creditworthiness, ensuring predictability and providing them with several eligible offers to choose from. Rubique not only provides a marketplace for customers to choose from eligible offers, but also a full range of fulfillment support similar to other lenders. By 25 February 2017, Rubique had catalysed INR1,000 crore[09] in disbursement and processed over 1 lakh applications.

BIZ2CREDIT has a marketplace model, bringing lenders and fund seeking borrowers on the same platform to provide loans for small businesses, equipment, working capital loans and line of credit.

smelending.com[10] is a unique technology-based platform solution which connects three key parties – dealers, their principal supplier and lending institutions like banks and NBFCs. Over 24,000 dealers currently benefit from smelending services with over INR500 crore of loans annually across 150,000+ loan transactions.

New age digital lenders

There is also an emergence of new age digital lenders using technology as a backbone for creating innovative lending solutions.

Lendingkart is a start-up in the working capital lending area. It has developed technology based tools leveraging big data analytics, helping lenders evaluate the borrower's credit worthiness, and provides other value added services. Lendingkart Finance Limited, is a NBFC lending to MSMEs in India, with an aim of transforming MSME lending by making the lending processes convenient, thus providing easy credit access. LendingKart leverages analytics to analyse thousands of data points from various data sources to judge the creditworthiness of borrowers.

Some USPs[11] include:

- LendingKart provides a 100 per cent online application process, taking just 15 minutes to complete, with minimal documentation requirements (only VAT returns and bank statements for vendors on e-commerce platforms)
- There is no requirement for net-worth details or collaterals
- Loans are disbursed within three days, at fair interest rates.

Lendingkart Finance does not incorporate a vendor's historical records (income tax returns and financials), unlike NBFCs and banks to evaluate the credit risk associated with a potential client. It focuses only on a client's business growth and cash flows in the current year.

IndiaLends[12] builds risk profiles of a customer using its proprietary algorithms for underwriting, which incorporates parameters like utility bill payments, bank transactions, etc. It is not just helping such clients get easier access to credit, but also in building a credit score profile to help them negotiate larger funds at better rates in the future. The repayment performance of customers now goes into building their CIBIL score, for loans they borrow through Indialends. Earlier, there was no provision for reporting of loan performance to a credit bureau and consequent improvement in credit scores, when clients borrowed funds through money lenders. This lending model also leverages technology to improve loan approval and disbursal time. IndiaLends processed 8,000 loan applications and disbursed INR30 million in 2016.

ArthImpact[13] is a digital lending platform, that provides loans from INR2,000 up to INR1 lakh to bring the benefits of 'India Stack and Jan Dhan' to households and small businesses in India with an income bracket of INR1 lakh to INR5 lakh per annum. ArthImpact ensures a turnaround time of 30 seconds[14] provided the applicant has a bank account and Aadhaar card along with one or two additional identification documents.

Capital Float[15,16] is the trade name of Zen Lefin Pvt. Ltd., an NBFC registered with the RBI, which underwrites unsecured business loans to start-ups, manufacturers and ecommerce merchants. As an MSME lending platform, Capital Float disbursed INR1,000 crore in loans to about 7,000 borrowers within 10 months ending January 2017, and expects to disburse INR5,000 crore to finance 20,000 borrowers, including 10,000 kirana stores in the next 12 months with about 60 per cent of its total borrowers coming from outside metro cities. Loans to ecommerce sellers and MSMEs constitutes 33 per cent of the book of Capital Float. The average loan amount extended to a merchant is INR10 lakh, at an interest rate of 16 to19 per cent, for a tenure between 60 days and three years. Loans to small retail shops, however, are capped at INR50000.

FlexiLoans[17], is a platform for online lending, which leverages credit and technology algorithms to provide solutions for loan recovery and credit appraisals, for loans starting from INR10,000. It assigns an internal rating to the entity based on their cash flow statements and makes an assessment of their repayment capacity. Once all the documentation is in place, the loan is approved within 48 hours. FlexiLoans.com is also working with various ecommerce players such as Flipkart and ShopClues to access data, reviews and ratings on small and medium-sized business owners who can be potential borrowers. It has even teamed up with a finance company, banks and point-of-sale machine manufacturing companies to reach out to maximum number of MSMEs who need small business loans. FlexiLoans.com plans to expand its reach from 70 to 200 cities in the next 18 months and more than double loan disbursals to around INR500 crore.

09. Rubique facilitates disbursements of Rs 1000 crores loans, Business Standard, 7 March 2017
10. Introductory Video of Smelending.com, Innovative Payment Solutions, 20 Nov 2016
11. SBI sanctions credit facilities of 3.1 Mn $ to New Age Lending Platform, INC 42, 10 May 2017
12. IndiaLends formula for fintech disruption Tailored rates, Quicker Loans using Risk Analytics
13. One touch fintech – Arth Impact starts on tap digital lending, BW disrupt, 08 March 2017
14. Manish Khera begins new entrepreneurial venture for digital lending,, Business Line, 5 December 206
15. Capital float disburses Rs, 1000 cores as SME loans in last 1 year, SMEstreet, 22 February 2017
16. CapitalFloat to disburse rs 5000 crores in SME loans in FY 18, Live Mint , 21 February 2017
17. Offering flexi loans to those new in the credit system. Flexiloans.com, 17 May 2017

Venture debt

The genesis of a new form of asset class called 'venture debt' emerged in the Silicon Valley in the early 80s. As the startup wave rose in India, China and Singapore, venture debt companies started moving to these geographies in early 2008. Startups acknowledge that this form of lending can augment their equity capital and result in a more efficient capital structure. Venture debts were traditionally known to organisations via the venture capital (VC) networks and hence were limited in their reach. However, in recent times, the concept of venture debt has garnered considerable media coverage, spreading large scale awareness in the Indian startup space that is not dependent on VCs alone.

Innoven Capital and Trifecta are leading venture debt firms for Indian focused startups. Last year Innoven Capital has disbursed close to USD85 million in 53 transactions across 45 companies[18]. It looks to invest USD100 million in the next fiscal year.[19] Trifecta invested USD26 million in the last one year focused primarily on technology sector companies.[20]

As a rule of thumb, a venture debt investment round is typically 10 to 15 per cent of the equity investment round. For a start-up to go for a venture debt round, it is mandatory for it to have raised equity funding. Venture debts also consider factors such as maturity of the sector, time of getting in the market, product differentiation and relationship with investors before lending to a startup. While sourcing for venture debts is not as dependent on VCs as a few years ago, a strong relationship with a VC, though, is key asset.

Venture debt companies fill in the financing need of the MSMEs at a stage where the exposure for a traditional bank or NBFC is not conducive. Interestingly, we are seeing banks and venture debt firms join forces to work on collaborative models of MSME financing making it lucrative for both parties.

Crowdfunding

Crowdfunding is raising of funds from society on online or on other social platforms. A business, start-up or non-profit might raise money on a crowdfunding platform to carry out a project that is often beneficial to society, innovative, etc. Contributions are made mainly in small amounts and by a large number of people.

Crowdfunding can be donation based, where the purpose of donation is a social issue, where the contributor expects nothing in return and contributes for the betterment of a member of the society or for the cause. Similarly, crowdfunding can be reward based, where the return is a reward such as a membership if the project matures successfully. Equity based crowdfunding is another type of crowdfunding where funds are raised at the start-up stage by offering equity interests.

Even though India has become a popular global business destination today, crowdfunding has been restricted to just micro financing and donation-reward based funding categories. Given the perception of risk involved in the financing of MSMEs, crowdfunding has emerged as an alternative source of capital. Crowdfunding enables such enterprises to solicit funds in smaller sums from a large number of investors via the internet. The idea is presented and pitched to a larger group of people. If they see value in the idea, a contribution is made towards it. In return, a reward is given which can be in any form - tangible or intangible. Crowdfunding in India is still in its nascent stage with models primarily based on charity (donation) and reward-based funding and evolving to debt and equity based.

There are multiple crowdfunding platforms in existence today that help MSMEs reach the investors. This process reduces the documentation process involved considerably in getting funds. The idea is validated by multiple people, so the chances of being supported by people when it launches are good as well. Platforms such as Catapooolt, Indiegogo, Keeto, Wishberry etc. are such crowdfunding websites which charge a very low fee and help the participants with their funding process. For example, Milaap a crowdfunding website, where people can donate and lend has raised over INR160 crore[21], mostly for micro-loans.

Today, there are many crowdfunding platforms whose model has evolved from donation and reward-based to debt and equity based. Rang De and Impact Credit (by IIX foundation) are examples of such a model. They are used for smaller loans which fulfill the requirement of cheap microcredit at very low interest rates of around 6 per cent to 10 per cent[22]. Guardians of Dreams, which is a social sector startup in the child care space has been the benefactor of the Rang De platform. All this is made possible by maintaining transparency in the system. The interest rates are published on the website and offline meetings are conducted to keep all the stakeholders updated. This has resulted in a repayment rate of as high as 93 per cent[21]. Swabhimaan is yet another initiative targeted towards women entrepreneurs.

Reach, presentation, public relations and marketing, validation of concept and efficiency are some of the advantages of crowdfunding over traditional financing methods. MSMEs get access to accredited investors, polish their idea into an attractive value proposition, promote their ideas through social media, refine their offering and thus streamline their funding efforts.

Key regulatory issues and trust pertaining to crowdfunding

In India, the concept of crowdfunding is garnering attention but regulatory policies are entirely defined. Additionally, there is the potential danger as many money laundering schemes can run in the name of crowdfunding. Unlike India, countries like the U.S. and Europe are ahead in term of legal issues around crowdfunding. Crowdfunding was made legal in the U.S. by the passing of the Jumpstart Our Business Start-ups (JOBS)[23] Act. Also, such crowdfunding is regulated if a certain threshold such as the amount raised or the number of investors is surpassed. While the U.S. and European regulators have already started bringing laws into action, Indian regulators are now looking at formulating policies around this funding concept. When done, it would play a crucial role in enabling the startups.

Although crowdfunding is not new in India, online crowdfunding involves low levels of trust. With the ecommerce industry facilitating online spending, such issues are expected to be resolved over time as people begin to spend more and more online, and thus develop a trust quotient. Another challenge to extend the benefits of crowdfunding for these platforms is to work alongside the regulators to create credibility and transparency in the system.

18. Overview on Innoven Capital, Crunchbase, 6 june 2017
19. Innoven Capital invests $37 M in 17 startups in Q4, looks to invest $100 M in next fiscal year, Yourstory , 10 April 2017
20. Trifecta Capital, Bloomberg Database, 7 June 2017
21. Milaap is enabling social development through an online peer to peer model, Yourstory, 19 December 2016
22. How Rang De is using crowd funding to make microloans cheaper, 04 May 2017
23. Crowdfunding at Glance, Fundable.com,5 April 2017

A look at global fintechs in the lending space

Crowdfunding: A game changer in the MSME lending space in UK

Crowd funding is becoming increasingly popular in the MSME lending space in the U.K. U.K.-based crowdfunding companies such as crowdcube, Seedrs, Funding Circle and ThinCats are heavily piggybacking on this trend.

Funding Circle, the largest MSME debt platform, has raised GBP70 million[24] so far through equity crowdfunding. ThinCAT[25], the latest fintech on the block has raised close to GBP15 million for 90 companies in 18 months. Crowdcube[26] and Seedrs[27], have raised from as little as GP20,000 to GBP1 million for 15 MSMEs in the last one year.

Crowdfunding is here to stay due to the following reasons:

- First, the lenders on this platform are netting an average of 10 to 11 per cent.
- Second, crowd funding typically takes 30 to 60 days as compared to 6 to 12 months via traditional routes.
- Last, crowdfunding is currently not very heavy on regulations which makes the process agile and swift.

Brewdog[28], which is the U.K.'s fastest growing food and beverage (F&B) brand raised GBP13 million via bonds and equity on Crowdcube. This amount was funded by 2,700 people in a matter of three weeks, adding to the company's crowdfunding community of more than 55,000 people.

Fintech for Value Added Services (VAS) for MSMEs

Besides funding, fintechs are dabbling with opportunities to provide cost-effective solutions for value added services like cash flow management systems, easy invoicing and Point of Sales (POS) management systems.

Skippr, an Australian fintech start-up, empowers MSMEs by enhancing their cashflows, which in turn helps them to negotiate better terms with suppliers, buy more inventory and have better insight into their business.

InvoiceSharing, another U.K. based fintech startup which is disrupting the invoicing space with easy to implement, cost-effective and free trial tools. It provides a low-cost electronic invoice infrastructure with integrated accounting robot to help clients manage general ledger accounts, split capital expenditure purchases from invoice and assign cost centres.

Similarly IntelligentPos, solution based on POS management, is seeing wide-scale acceptability in MSMEs catering to F&B, retail, agri-based and consumer goods space.

24. Funding circle powers past $70 million, Mortage Finance Gazette, 10 January 2013
25. Why Crowdfunding is increasingly popular for SME financing, The Guardian 31 January 2013
26. Case studies on Crowdcube crowdfunding platform, Crowd Cube official website, 1 January 2016
27. Equity crowdfunding platform Seedrs to launch in secondary market, The TechCrunch , 7 May 2017
28. Crowdcube first unicorn as Brewdog is valued at £ 1Bn, CrowdCube , 10 April 2017

Changing regulatory and policy reforms

In a wave of technology driven reform, the government and Indian regulators such as Ministry of Corporate Affairs (MCA), Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), etc. have from time to time, carried out amendments in various enactments/regulations to enable a smooth combination of technology with the existing ways of doing business.

The Indian regulators have issued new/revised regulations/guidelines to keep up with the changing mode of business such as:

The RBI has allowed banks to trade in PSL certificates. This was proposed to allow a more efficient implementation of the PSL mandate. The merit of this was also to allow the most efficient lender to provide access to the poor, while finding a way for banks to fulfill their PSL norms at a lower cost. The RBI has also allowed the setting up of small finance banks which will provide loans on small scale and work towards financial inclusion.

With respect to the lending business, the RBI has in the past issued a consultation paper on peer-to-peer lending. However, formal guidelines on the same are still awaited. One of the key points in the consultation paper was to have a peer-to-peer lending platform registered as an NBFC.

SEBI does not regulate crowdfunding, as yet. SEBI in the past has issued a consultation paper on crowdfunding. However, formal guidelines on the same are still awaited.

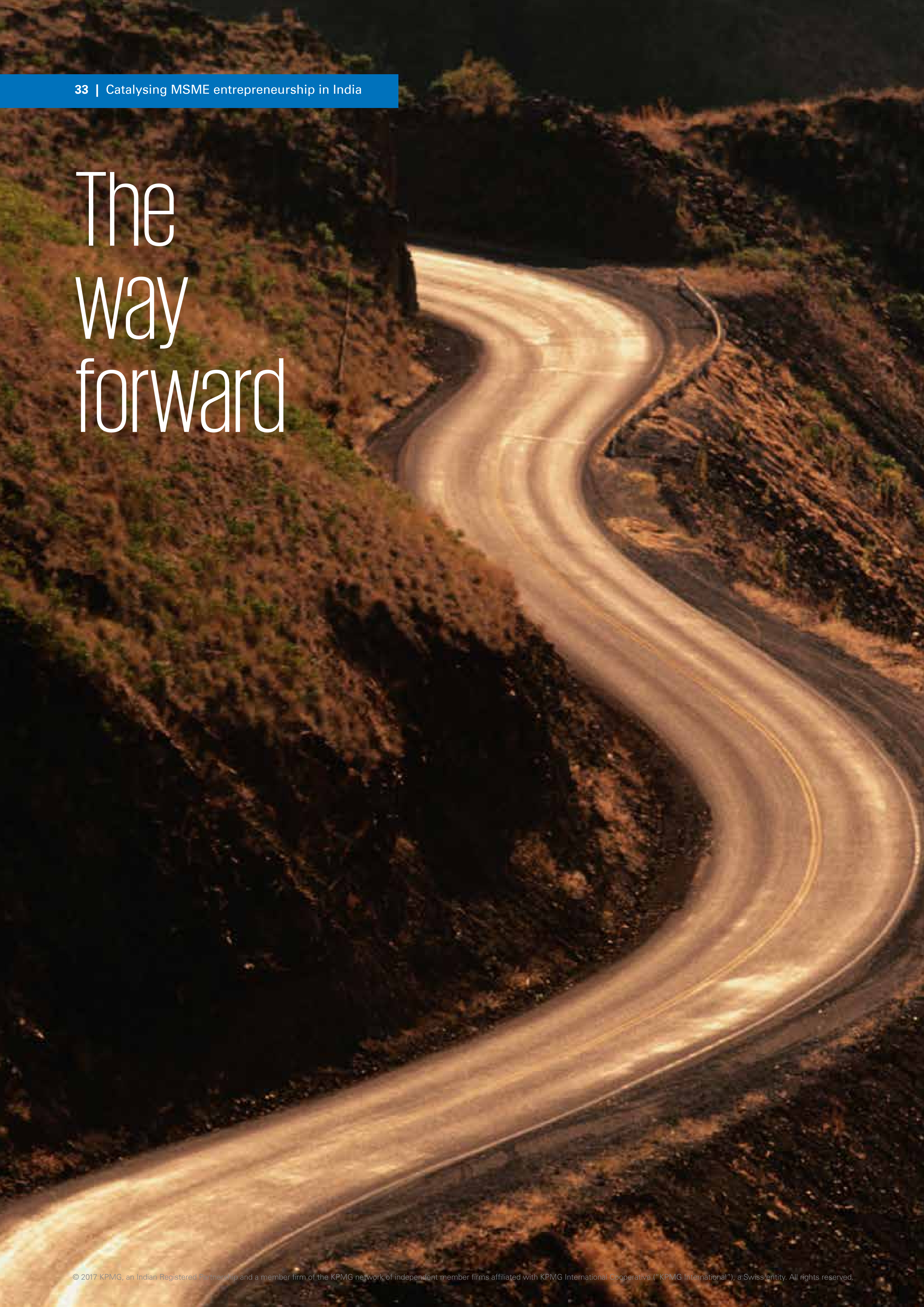
As a matter of ease of doing business, there are various procedural changes made to the Companies Act, 2013 by the MCA. The latest one includes no separate registration for Permanent Account Number (PAN) and Tax Deduction and Collection Account Number (TAN) and companies need to make a consolidated application while incorporating/registering themselves with the MCA.

The government has started acknowledging that the MSME sector faces immense hurdles during their initial days when it comes to credit, access to top-notch technology and meeting regulatory compliance. To further boost their ease of doing business in this front, the government has set aside a INR100 crore fund to help small and medium scale enterprises by setting up help desks, awareness camps and relevant infrastructure which MSMEs can utilise to solve their technology problems related to compliance. The programme is also expected to spread awareness about updated accounting and taxation norms among firms.

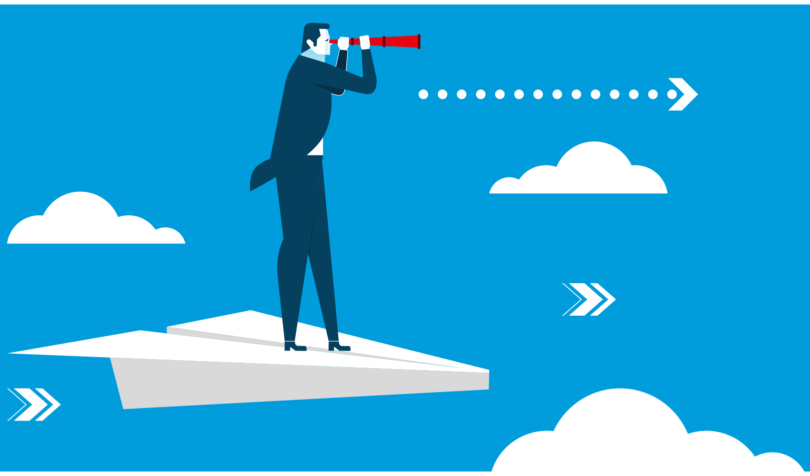
The Government has also notified the Insolvency and Bankruptcy Code, 2016 (the Code). This Code provides a market determined, time-bound mechanism for orderly resolution of insolvency, wherever possible, and ease of exit, wherever required.

Timely implementation of government policies is another major bottleneck faced by MSMEs. The Indian government has taken concrete steps on this front by launching the 'MSME ESiksha Portal' a real-time monitoring system for follow-up actions on pending decisions relating to policies and governance.

The way forward



Need for a new definition



MSMEs have rightly been identified as the engine of growth for the Indian economy. They not only contribute over 37 per cent to the GDP of the economy, but also employ more than 80 million people. Hence, their growth is essential for sustainable and equitable growth of the economy[01].

The current definition of MSMEs categorises them based on the capital investments i.e. investments in machinery and equipment, and does not take into account other business aspects such as a number of employees, turnover of the entity, etc. and basis the industry type as in countries like the U.S. and EU nations. For all practical purposes, financial institutes rarely rely on the current definition and use their own criteria for thresholds in assessing and extending capital. Further, the inconsistencies in the laws and schemes applicable to thresholds needs to be streamlined. There is a need for a new definition that incorporates factors such as the number of employees, balance sheet totals, turnover, ownership criteria etc. and regulatory policies and schemes aligned to it.

Currently, there are varied criteria and thresholds applicable for the various regulatory policies and schemes in place. There is a need to enhance the definition and simplify the policies and schemes applicable to the criteria. For e.g. in the case of PSL norms, the norms identify MSMEs based on their investment in plant and machinery. However, the same were last updated in 2006, and hence, under the current scenario there is a need to revisit the definition of MSMEs under the PSL norms. The existing threshold of investment level should be considerably increased to have a larger section of MSMEs under the PSL guidelines.

Hence, there is a need for a comprehensive definition of MSMEs and the investment criteria should be linked to the inflation index as provided under the income tax laws.

01. MSMED Act 2006

Flexibility and innovation in financial institutions

Banks still form one of the largest source of financing for MSMEs in India and have been traditionally reluctant to address the needs of this segment given the low ticket size and higher risks and costs involved. Given the immense growth in this segment and regulatory requirements, while banks are focused on this segment, there is a need for banks to adopt more innovative approaches and adapt to changing conditions to make bank financing easier and attractive for MSMEs.

Progressive techniques can be adopted from digital lending platforms which employ alternative methodologies like big data and analytics on data from other sources in assessing the credit worthiness of a borrower. Credit rating using psychometric testing and ratings based on alternate data like utility bill payments, digital footprint, etc. can be employed to improve the rating methodology.

Given the asset-light nature of service enterprises, their ability to provide immovable collateral is a challenge. This acts as a hindrance in availing capital from the lenders. Therefore, innovative models of assessing credit worthiness and lending to service enterprises in MSME sector must be explored.

Additionally, lending processes, which are quite often perceived to be complex and cumbersome, need to be simplified and automated for faster and flexible credit limits and loan processing across the growth stages of the MSMEs. Technology and digitalisation can play an impactful role here.

New players in the ecosystem such as crowdfunding, lending platforms, etc. have emerged as lucrative financing alternatives for MSMEs. Banks and financial institutions could consider joining forces in this space to leverage these models of financing for mutual benefit.

Focus should also be placed on building capacities of small financial institutions as against large financial institutions through training and skill development. This would emphasise on building financial awareness. Small financial institutions have a better understanding of the local context, so these can be better placed to outreach MSMEs. There is also a need to increase awareness among banks about credit schemes such as Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), as MSMEs often face hurdles when bank staff are not aware of such policy measures by the government, leading to delays.

A growth conducive regulatory framework

A growth conducive government policy framework is quintessential to build an enabling ecosystem for MSMEs. The government needs to simplify the complex regulatory policies in place and create policies for greater financial inclusion of the MSME sector.

Suitable incentives need to be provided to fintechs working towards addressing the MSME financing challenges. In order to realise the advantages of these alternative lending models which are backed by technology, a large proportion of the Indian population needs to be tech-enabled. As most of the funding activities are still under the purview of nationalised banks, there is a growing need to build and promote the alternatives to give a fair chance to small businesses.

Crowdfunding and peer-to-peer lending have huge potential in India. However, the regulatory policies around them need to be strengthened. Current regulations proposed by the SEBI in the consultation paper around crowdfunding and P2P lending are more investor friendly. P2P lending models will be more of a loan marketplace for small and collateral free loans and policies around those need to be defined. The paper suggests that P2P lending platforms should be registered as a NBFC with RBI. Key aspects that needs to be kept in mind while formulating these regulations are confidentiality of information, KYC, Fair Trade Code etc., as against the full-fledged leading NBFC.

The paper also suggests that one of the conditions for a company to be eligible as Accredited Investor under the crowdfunding platform is that such a company should have minimum net worth of INR20 crore. In our view, minimum net worth criteria of INR20 crore specified for companies to be eligible as the Accredited Investors is on the higher side and hence, it is recommended that the same can be in the range of INR3 to 5 crore. This suggestion is in line with the minimum net worth required for an NBFC. Various high net worth individuals also prefer to invest through companies and hence, this limit of INR20 crore may be deterrent factor for them. This way the base of lenders on crowd funding platform could increase which may eventually lead to the development of crowdfunding in India.[02]

The government and financial institutions need to work in harmony for all players in the MSME lending ecosystem to thrive and address the current challenges plaguing them. Institutions such as the SEBI, which helped establish an MSME exchange on both the BSE and the NSE, need to ensure that the listing norms require minimal disclosure without hampering the interest of investors, have relaxed public shareholding requirements, make sure paperless processes take effect and provide an opportunity for anchor investors to invest in MSME stocks on the exchange.[03]

A major source of financing for MSMEs comes from non-MFI NBFCs. These NBFCs are reliant on banks for their funding. Policies can be made around NBFCs to give them incentives for a more focused lending approach to MSMEs. Also, the funds disbursed for MSMEs must be tracked to ensure proper utilisation of funds.

Regulations and frameworks must be developed to manage short-term and long-term crisis. As the MSME sector suffers from closure very often, the process of closure or rehabilitation must be smooth and cost-effective. A rehabilitation framework must be in place to manage short-term crisis as well as a business closure framework to manage a smooth business exit.

For banks, lending to MSMEs must be made a lucrative and profitable option through policy measures such as increasing the limits under CGTMSE, effective monitoring of CGTMSE policy, simpler restructuring of MSME Non Performing Assets (NPAs) and low cost credit schemes for micro industries and budding startups.

02. Consultation Paper on peer to peer lending, Reserve Bank of India, April 2016

03. SMEIPO platform- Learning and way forward, Mahavir Lunawat, 2 June 2016

The new tax system is expected to provide an opportunity to MSMEs to get easy access to credit as GST filings can act as an alternate source of data. This would eventually reduce the risk for lenders by accessing authentic information on micro and small businesses, thus leading to reduced cost of business and speeding up of lending process. Handholding small companies to move to the new tax structure and making them GST-compliant is a pre-requisite to availing these advantages. Until then, they cannot fix new prices for their goods. MSMEs will have to move to a much advanced technology to manage audit reports, tax credits, payments and more.

As mentioned in the previous sections of the report, the Finance Act, 2017 has prescribed lower tax rate of 25 per cent for domestic companies whose total turnover/gross receipts for the financial year 2015-16 does not exceed INR50 crore. However, this beneficial rate of tax is not available to the newly incorporated companies even though their turnover/gross receipts does not exceed INR50 crore. Hence, it is suggested that the benefit of lower rate of tax be extended to newly incorporated domestic companies too.

Enabling infrastructure

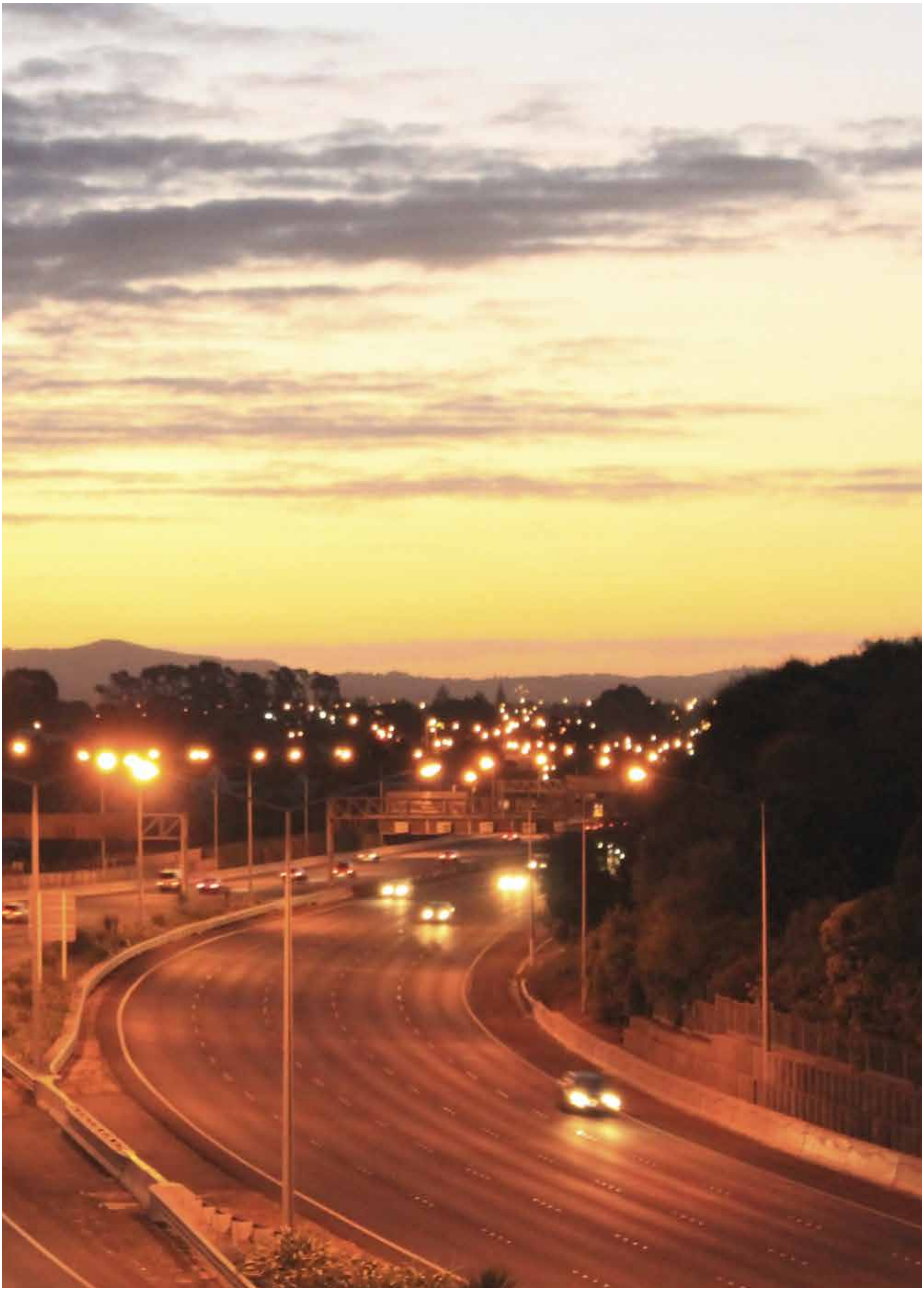
MSMEs are generally located in rural areas or far flung old industrial estates. The basic infrastructural requirements such as roads, water or power are inadequate in proportion to MSMEs' needs. Also, market infrastructure, technological support, access to e-commerce and infrastructure in the form of R&D labs etc. are also inadequate. All this act as a hindrance for MSMEs to compete globally. Hence, there is a need for upgradation of basic and supporting infrastructure.

As per 'The new wave Indian MSME- An action agenda for growth', a study by KPMG in India and CII (March 2016), significant support can be created for MSME sector in the following ways:

- Allocation of land in all industrial corridors amongst other industry players at different rate slabs to help these businesses in their initial stage.
- Linking all the stakeholders in the eco system- starting from banks, MNCs, investors, global customers, R&D institutes, skill development institutes etc. with MSMEs. This would provide them an enabling environment to grow their business with ease.
- Enabling knowledge sharing amongst MSMEs using cloud technology, ensuring their competitive development.
- Formation of MSME clusters around townships and modern cities, urban and rural areas and increasing investment on physical infrastructure (road, rail, water and air) providing them greater connectivity.
- Collaborating with Academia to provide mentoring and technical support by building incubation hubs.

Also, in order to build a competitive advantage, inculcating entrepreneurial skills is important. This can be done by educating them through structured trainings by experts. Such trainings would help them acquire knowledge and skills to improve their business.

These are some of our recommendations to strengthen the ecosystem and bolster the MSME sector and perhaps move the needle in the coming years.



Acknowledgements

This report would not have been possible without the commitment and contribution of the following individuals.

KPMG in India

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