I. Introduction and Context

Country Context

1. India has been amongst the world's fastest growing economies. In the last decade, India grew faster than 89 percent of the world's nations. Real GDP expanded at an average annual rate of 8.3 percent between FY2003-04 and FY2011-12. Growth has been accompanied by an impressive reduction in poverty with about 140 million lifted out of absolute poverty between 2008 and 2011, and, while disparities remain, overall India's growth has been inclusive.

2. A key driver of this growth has been in the service sector while the manufacturing and agriculture sector remain important due to their potential to absorb large segments of the labor force. The service sector (including construction) now constitutes over 67% of GDP, up from 59% a decade ago, an increase that also highlights the transformational changes in the structure of the Indian economy with a marked shift towards this sector. Service sector growth has been broad based in terms of sub-sectors ranging from Information Technology (IT) and financial services to social
sectors such as education and health services. The services sector has a broad geographic spread across India’s states. Several low income states (LIS) such as Madhya Pradesh, Tripura, Manipur, Chattisgarh and Bihar outperforming many others in the growth rate of services sector. This statistic also underscores the potential of this sector to contribute to furthering inclusive growth. The manufacturing and agriculture sectors, despite declining shares in GDP composition, remain important as labor intensive sectors and function as key sectors that absorb employment at a higher rate.

3. However, economic growth has slowed down in recent years. FY2013 and FY2014 have seen growth reduced to below 5 percent levels, though it has picked up sharply in the first quarter of the current fiscal year (growth rebounded due to strong industrial recovery aided by growth in investment and exports). Capital flows are back, signaling growing investor confidence. Inflation, which has moderated from double digits, continues to be at an elevated level averaging just above 8 percent since January 2014. The current account deficit has returned to the low pre-global crisis levels, as recovery in India’s major export markets and a competitive exchange rate following last year’s depreciation, helped stimulate exports.

4. For India to retain its high growth trajectory to meet its poverty reduction goals, it needs to address the recent economic slowdown and boost efforts to create jobs and foster entrepreneurship for its burgeoning population. The link between economic growth and poverty reduction has been well established and this has also been evident in India where most of the best performing states have reduced poverty faster than the national average. Reinvigorating economic growth is a key prerogative for the Government of India (GoI).

5. A priority for India is to create 10-15 million jobs per year for the next decade to provide gainful employment to its growing young population. Rapid job creation, both in terms of formal employment as well as entrepreneurship, is key to generating the number of economic opportunities needed. The issue is not just the number of additional jobs (140 million by 2020), but also the type of jobs and the opportunities for young people to create their own jobs, start their own companies, and in turn, grow companies that will create more jobs. India needs more productive jobs, with growing labor earnings and the prospect of formalization; jobs that support upward mobility and take households into the ranks of an emerging middle class.

**Sectoral and Institutional Context**

6. Central to this challenge of boosting growth and job creation is the micro, small and medium enterprises (MSME) sector which contributes around 45 percent to manufacturing output and about 40 percent of exports (directly and indirectly). Furthermore, entrepreneurship and business creation by MSMEs is crucial for large-scale employment generation. There is widespread recognition within India, and globally, that vibrant MSMEs are a key engine of economic growth, job creation and greater prosperity and that a vibrant entrepreneurial ecosystem fosters innovations and contributes to greater dynamism in the economy.

7. However, the growth of the MSME sector has been constrained by lack of access to finance. Lack of adequate finance is one of the biggest challenges inhibiting MSME growth. Financial institutions have limited their exposure to the sector due to a higher risk perception, information asymmetry, high transaction costs and the lack of collateral. The MSME census of 2006-07 estimated that about 87 percent of MSMEs did not have any access to finance and were self-financed. The IFC-Intellecap study shows that demand-supply shortfall in finance to MSMEs is
substantial. Credit towards micro and small enterprises represent only around 13-15 percent of formal financial institutions portfolio. In addition, poor investment climate, infrastructure and market linkages, and financial market infrastructure and legal framework gaps are additional constraints. While these are all important areas, these are the subject of parallel initiatives that seek to address them, and hence are not a focus of this project, which instead aims to complement such other efforts.

8. Addressing finance constraints for MSMEs is of utmost importance. Financial constraints hamper growth, competitiveness, responses to shocks as well as employment and investment decisions at the firm level and thus affect the performance of the economy at large.

9. In responding to the challenge of enhancing the provision of financial services to MSMEs, an effort to adapt this response to India's evolving economic structure and focus on spurring key areas within the MSME sector that are particularly relevant for growth and employment, is critical. This requires a focus on three key areas. First, accelerating entrepreneurship finance is crucial for generating large-scale employment, but also providing solutions to myriad problems by supporting innovative solutions in sectors such as education, health, climate change, IT and financial inclusion. Indian startups are developing disruptive technologies across a broad range of areas such as education, healthcare, clean tech solutions, productivity and social sectors, etc. Furthermore, India is seeing a vibrant growth of first time entrepreneurs (64 percent of startups), including the now globally relevant firms such as Infosys, Bharti (Airtel), HCL, etc. Second, supporting the services sector which accounts for 67 percent of GDP and encompasses 71 percent of MSMEs (compared to an estimated 29 percent of total MSME enterprises being in the manufacturing sector) would provide an impetus to growth and exports (India is one of the world's largest service exporters and its exports in computer and information makes up over a third of all Indian services exports). Sectors such as education, health, entertainment, financial services, are the fastest growing sectors in the India economy, and are not only the drivers of economic growth, but also have the potential to significantly contribute to employment for future generations as India’s economic composition continues to shift. Service sector growth has also propelled growth in several low income states and has therefore contributed to promoting inclusive growth in the country. Third, supporting manufacturing growth, given that 75 percent of the MSMEs total output come from the top ten industries in manufacturing. The manufacturing sector is a priority for the Government of India (GoI) which is concerned by the share of MSME manufacturing in GDP dropping, just as the share of manufacturing to GDP has also been declining. GoI is targeting an increase of the sector share relative to GDP to 25 percent by 2022 from the current 16 percent. Further, enhanced provision of finance to India’s manufacturing sector can help revive the sector whose performance is lagging behind compared to other countries, particularly China, and can contribute to maximizing the growing opportunities resulting from the rapidly increasing labor costs in China.

10. Rationale: Limited financing to these three vital areas – early stage/start-ups, services and manufacturing – within the MSME sector has been a critical constraint. First, financing for startups below venture capital stage is scarce, and debt is virtually non-existent. Startups require financing throughout their growth path, from seed to scale. While India has seen rapid growth of venture capital (VC) and has one of the most developed VC financing markets among emerging economies, below VC stage, the flow of capital to early entrepreneurs is still limited and only available in the forms of equity. Currently, banks lend mainly based on collateral or capital assets. As such startups, even those that have received angel equity investment and which are demonstrating promise, tend to be inherently lean and based on intangible assets, and are regarded as risky. They do not qualify for
debt financing that can help scale up operations and make the transition to attracting venture capital easier. The lack of financing not only severely hampers the growth of startups, but also dramatically reduces the incentives for entrepreneurial activity. A 2012 Planning Commission report (also called the Mitra Committee report) on ‘Creating an Entrepreneurial Ecosystem in India’ estimates that Rs3 lakh crores (US$55 billion) would be needed to foster a vibrant entrepreneurial ecosystem in India. Second, the service sector lacks the ability to provide physical collateral. This lack of physical assets inherent in service sector activities, and in MSMEs in general, means that they face constraints in accessing bank financing. Third, lack of finance to manufacturing MSMEs has contributed to constrained growth and reduced competitiveness. The Inter-Ministerial Committee for Accelerating Manufacturing in MSME Sector emphasized the vicious cycle of credit issues, where lack of access to formal sources of finance leads to alternate and more costly sources of funds, resulting into low net cash inflow which increases the risk profile of the small units and reduces their credit worthiness. This, in turn, further exacerbates lack of access to formal sources of finance. Manufacturing enterprises account for 73 percent of the MSME’s viable and addressable debt gap (while services MSMEs make up 27 percent).

11. The GoI sees a strong and vibrant MSME sector as crucial to India achieving sustained high growth for the next couple of decades and as a vehicle for inclusive growth, to stimulate domestic demand and consumption. The 12th Five Year Plan (2012-2017), the National Manufacturing Plan, various recent committee reports and policy announcements by the new government including in the July 2014 Budget, clearly articulate the critical role early stage, services and manufacturing sector MSMEs to supporting sustained growth and employment. The plan further recognizes the need for government policies to help MSMEs improve access to finance and to risk capital. This focus on MSMEs has been echoed by the Reserve Bank of India (RBI) that has advised banks to achieve a 20 percent year-on-year growth in credit to MSMEs to ensure enhanced credit flow to the sector.

12. The proposed project supports the objectives of the GoI by facilitating access to finance for MSMEs with a focus on enhancing the capacity of Small Industries Developing Bank of India (SIDBI), the development bank for MSMEs and microfinance; to deliver and develop financial products to MSMEs in the areas of early stage debt finance, and services and manufacturing sector finance. The project also supports SIDBI transition to new focus areas, including creating markets for new financial products and services for first generation entrepreneurs and new models for service sector financing. It supports SIDBI transition as a ‘market making’ financial institution in line with its recently formulated strategic business plan. It uses innovative financing products for the first time as SIDBI moves towards emergent areas in services and early stage startups; which would strengthen the MSME eco-system. The project aims to use innovative channels to address issues around information asymmetry and credit risk by leveraging information from multiple sources (eg. angel investor community for early stage debt financing, or franchisers for service sector financing, and credit bureaus) which will be supported by the parallel technical assistance designed to support implementation and enhance project quality and overall, to facilitate long term sustainable development beyond the term of the project.

13. Assistance will be provided through SIDBI directly (particularly relevant for early stage financing, service sector financing and manufacturing sector financing linked to better management practices, all areas where interest from other lenders is lacking), as well as through other participating financial institutions (PFIs, refinancing). By demonstration, the project will catalyze private sector financing, leveraging SIDBI’s role as the apex development bank for MSMEs. Capacity building of the intermediaries in the targeted areas of the project, would also contribute to
sustainability of the effort and enhanced outcomes.

14. The GoI and SIDBI have requested the project which will focus on the financial intermediation to the MSME sector, and complements other ongoing and parallel efforts by the GoI and industry to address the other constraints that inhibit MSMEs growth and employment potential. The proposed project also complements other World Bank engagements with the GoI for the MSME sector and builds on previous successful financial sector engagements with SIDBI (2004 and 2009).

**Relationship to CAS**

15. The proposed operation fits with the Government program (as discussed above) and is also aligned with the Bank's Country Partnership Strategy (CPS, 2013-2017) with its focus on inclusive growth, jobs, and private sector development. In particular, the CPS highlights the need to facilitate access to finance for MSMEs especially to boost the manufacturing sector. The CPS cites this as a concern since MSMEs are an important source of wage employment and with 8 million people entering the labor force every year, capturing these employment opportunities could allow India to reap a substantial demographic dividend. In that light, the project contributes to the CPS first area of engagement on integration through improved infrastructure, by increasing access to finance of MSMEs in the manufacturing sector and contributing to its dynamism. The project also directly contributes to the CPS third area of engagement on inclusion by supporting MSMEs and directly contributing to the achievement of the CPS outcome indicator on additional loans to MSMEs.

**II. Proposed Development Objective(s)**

**Proposed Development Objective(s) (From PCN)**

16. The proposed PDO is: ‘to improve access to finance of startups and MSMEs in manufacturing and service sectors including through innovative financial products”.

17. By doing so, the project aims to contribute to a broader overarching development objective of fostering inclusive economic growth, including through coverage of low income states and first generation and other early stage entrepreneurs, and increasing jobs. Funded MSMEs are expected to be formal sector firms.

**Key Results (From PCN)**

18. The key results indicators will include:
   a. Outstanding MSME loan portfolio (growth) in early stage and startup financing of PFIs (see endnote 24. in Annex);
   b. Outstanding MSME loan portfolio (growth) in the service sector of PFIs;
   c. Outstanding MSME loan portfolio (growth) in the manufacturing sector of PFIs;
   d. Value of startups supported through the project;
   e. Non-performing loans (NPLs) in PFIs’ portfolios.

**III. Preliminary Description**

**Concept Description**

Component 1: Spurring early stage finance

19. This component will support pioneering early stage debt financing (including angel and venture debt) where angel investment has already been provided. Specifically it will focus on debt/
mezzanine products to firms that have demonstrated viability of the business idea, that may have already received angel equity investments, but which face constraints in scale up on account of lack of access to debt financing. This addresses one of the key recommendations, amongst others, identified in the Mitra Committee (2012) to develop and scale up debt offerings in order to build a pipeline of startups that will contribute to a vibrant entrepreneurial ecosystem in India. According to the Mitra report, India has the potential to build about 2,500 highly scalable businesses that could generate revenues of Rs10 lakh crore (US$200 billion) in the next 10 years. Given the probability of entrepreneurial success (where approximately only 1 in 5 startups will succeed at VC stage), this implies that India needs to build a pipeline of over 10,000 startups. This would require a substantive increase in financing entrepreneurship development. This component will also help SIDBI scale up its pilot program (National Innovation Finance Program) which focuses on early stage debt financing and that has shown promising results so far. Key elements of the approach that will be supported through the parallel technical assistance accompanying the project will be measures that can help address information asymmetry issues and keep credit risks to acceptable limits. Such measures include leveraging information from other stakeholders in the angel financing eco-system in India such as the venture capital industry, angel networks, accelerators, industry associations and experts, etc, in addition to applying customized appraisal tools (building from SIDBI’s current experience and supported through the TA) in assessing prospective proposals.

Component 2: Supporting service sector financing models

20. This component will provide funding for direct financing by SIDBI and refinancing to PFIs to introduce new models of financing that use asset-light models of financing and customized appraisal methods that rely on business viability and cash flow assessment (rather than typical models that rely on collateral as a primary criterion for eligibility) and are hence tailored to the needs of the service sector. Such new models – that have been successfully piloted by SIDBI could leverage industry associations for specific sector knowledge and information about the firm’s performance that can help reduce information asymmetries. Cluster centric financing models based on tested and tried models of cluster financing and development (including through financing links fostered with cluster associations) could be explored, building on SIDBI’s past experience with such models. In addition, a particular focus on franchisee financing would be explored. The franchising industry in India is expected to quadruple between 2012 and 2017 contributing to almost 4 percent of India’s GDP in 2017 from a current estimated 1.4 percent of GDP. The industry is also expected to create job opportunities for an additional 11 to 14 million people by 2017, contributing to the overall India’s objective of 10-15 million jobs per year for the next decade. If achieved the industry will account for almost 10 percent of the targeted growth in workforce. Innovative financial products to franchisees along the lines of vendor financing or channel financing structures, as well as adequate support from the franchising ecosystem, including from the franchisor and from industry associations, could help address financing issues (for example: leveraging the strength of the franchisor and the franchisor-franchisee relationship or creating a central depository collating information on franchisees such as in the US models).

Component 3: Supporting finance to manufacturing MSMEs

21. Component 3 will support access to finance of MSMEs in the manufacturing sector, in line with SIDBI new focus on manufacturing. Through (mainly) indirect financing through SIDBI and other financial intermediaries the component will complement bank lending to the sector. Models of cluster financing/vendor financing and development could be among the financing models.
22. This component could also facilitate Loan Extension Services to MSMEs. In that light, the lending activities under this component would be supplemented with Loan Extension Services (LES), where each loan appraisal could go through a quick opportunity assessment for overall improvement of the unit. These services would tap a wide range of improvements including energy efficiency, cleaner production, lean management, and so forth, which would contribute to increase MSMEs competitive advantage.

Parallel Technical assistance to PFIs and Implementation Support

23. Efforts will be made to include coordinated financing of technical assistance funds to support capacity building particularly in areas of research and development on early stage financing models and PFI (including SIDBI) capacity building in credit appraisal (especially as early stage debt financing and service sector financing will require differentiated appraisal skills) and new product development. This component will be funded through parallel but coordinated development partner funding from partners – discussions have been initiated with partners such as GiZ (German agency for technical cooperation that was part of the Bank led previous SME financing project with SIDBI and currently has an existing TA engagement with SIDBI) and IFC. Support will also be provided for implementation support to SIDBI.

24. For each component, consultations with banks, industry associations, financing institutions and other stakeholders will be conducted to ensure stakeholder inputs to the project and applicability, as well as to leverage partnerships to maximize scale up.

25. SIDBI has in the past implemented the SME Finance and Development Project (SMEFDP) financed by the World Bank. As part of this earlier project, SIDBI had streamlined the safeguards management mechanisms in to lending appraisal mechanisms and had implemented a Environmental and Social Safeguards Framework. An updated framework will be used for safeguards management under the proposed project.

IV. Safeguard Policies that might apply

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V. Financing (in USD Million)

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