

The Potential of Bank Venture Debt Financing for SMEs/Startups in Indonesia

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ABSTRACT

Venture Debt brings a new financing direction for SME/Startup. This paper aims to analyze the potential of Bank Venture Debt in Indonesia and the expected impact on the performance of SMEs/startups, exploring the risk and the risk countermeasure for banks. Through qualitative research method with literature review and theory, and venture debt modal to conduct detailed analysis and with the Indonesian SMEs/startup and Bank related personnel interviews to support the result of research of Bank Venture Debt. The results show that the venture debt is feasible to implement in Indonesia. Due to the rapid development of the market, changes in demand and supply have led to the positive impact being more significant than the negative impact for SMEs/startups, but in terms of market compliance and the bank's operating system is still blank and needs more strategy and policy support from the government. The end of research based on the Indonesian environment puts forward the potential solutions to venture debt.

Keywords: *Venture Debt, Financing Tool, SMEs/Startups, Performance Impact, Bank Risk Aversion, Indonesia*

1. INTRODUCTION

With the continuous development of economic globalization and the development of SME/startups can precisely reflect the competitiveness of a country in the global economy. However, there are two main reasons why SMEs/startups financing is difficult in the stage of development: The cost-benefit ratio tends to grow negatively, leading to investors are difficult to judge what kind of return the SMEs/startups invested can get in the future development. SMEs/startups are that they have no or few credit records. Generally speaking, SMEs/startups are at a disadvantage in the whole market environment.

This paper will conduct a potential of Bank Venture Debt from the financial environment of Indonesia, and summarize the expected impact on SME/Startup by combining the demand and supply of Venture Debt in Indonesia. And combined with the operation and compliance risks and other comprehensive analyses, put

forward solutions for the development of Bank Venture Deb in Indonesia.

To solve the issue of financing difficulties of SMEs/start-ups in Indonesia, this paper makes a potential analysis through the new funding product-Bank Venture Debt, to improve Indonesia's global competitiveness at the SMEs/startups level.

According to the national conditions of each country, there are already many countries around the world offering Venture debt products for SMEs/startups to promote the development of new enterprises.

Global - The United States is the first country to provide Venture debt. In the early 1990s, the Silicon Valley Bank took the lead in creating the linkage business of investment and loans and successfully transformed from a traditional bank into a world-famous technology bank. In British, the "Business Growth Fund" was established in April 2011, aimed at SMEs to provide

equity investment funds to support the development of enterprises.

China - Venture debt is known as an investment-loan linkage in China. In 2016, the investment-loan linkage of Scientific and Technological Entrepreneurs for the first time. By 2017, the Bank of China had provided the investment-loan linkage service for more than 2,500 technology enterprises, with total financing of more than 25 billion yuan.

Indonesia - In 2019, Bank CIMB Niaga and Genesis Alternative Ventures established venture debt to finance startups in Indonesia by setting up an initial fund of 300 billion Rupiah. Indonesia's BRI Ventures' new option is called BVI Venture Debt and the initial offering will be as much as IDR 60 billion. Generally speaking, only a small number of financial institutions in Indonesia provide Venture Debt for SMEs/startups at present, but the requirements are mainly based on stable cash flow. The Indonesian market is optimistic about the prospect of Venture Debt, but it needs more time for the market to accept this new financing product.

Venture debt is a form of financing that combines direct and indirect financing, the model refers to the combination of "Debt+Equity" of financial institutions such as banks [1], Venture Debt is not only a product of banks and other financial institutions for the purpose of profit but needs the support of the government, the development of relevant policies and the establishment of relevant Venture capital funds to help the capital market of SMEs/startups, as well as the control of risks faced by banks and other financial institutions [2].

A mezzanine loan - This is a form of financing that is between senior debt and equity financing in terms of risk and return. As shown in Fig. 1., the golden period of Venture Debt is in the early stage of Series A and Series B after SMEs/startups successfully exit the Valley of Death.

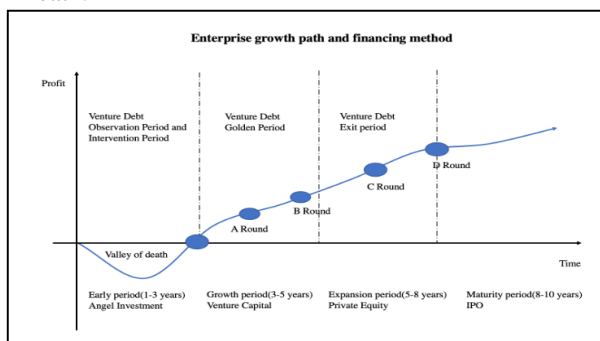


Fig. 1.Enterprise Growth Path and Financing Method [3], showed the venture debt from entry period to growth until exit will follow the enterprise growth path

Debt - Venture debt, as a combination of debt and equity, is essentially a subprime loan that orders as collateral in the early stage. During the financing period, SME/startup must repay its loans and repay the corresponding interest to the financial institutions.

Equity - Warrants mean that a party to an agreement can buy its shares at an agreed time at an agreed price. SME/startup obtains corresponding financial support through its Warrant as a mortgage, and the bank obtains double income through lending to SMEs/startups, namely debt income and equity income.

1.1. Literature Review

Based on the literature review, this part concludes that there are 2 major features of Venture debt in the financial market:

• Medium and Short-term loans with Shorter Financing Cycles.

When SME/startup conducts external equity financing, which mainly depends on the development stage of the company, the type of financing, the amount of financing, and the internal process of the investment institution. From Table I. that showed venture Debt is a "Debt+Equity" model, the essence of Venture Debt is still Debt financing. As a general pre-loan due diligence, it usually takes about 1-3 months for the bank. Venture Debt has a much smaller funding cycle than equity.

Table 1 comparison apply and return cycle between 3 major type of financing

Type of Financing	Rights	Collateral	Apply Cycle	Return Cycle	Challenge
Conventional Loan	Debt	Fixed Assets	1-3 Months	6-24 Months	No/lack for Fixed Assets
Venture Debt	Debt + Equity	Warrant	1-3 Months	First: 6-24 Months Second: 3-7 Years	Temporary cashflow impact
Venture Capital	Equity	Shares	6-18 Months	3-7 Years	Equity Dilution

Resource: Collect from website

• Unsecured or less Collateral and with Warrant.

As an asset-light company, SME/Startup is seldom able to provide fixed assets. And after the SME/startup decides to sign the warrant agreement and before the execution of the warrant, the financial institution will be more focused on the point of paying off the bank's monthly accounts payable to maintain a good credit record. Meanwhile, the Focus Point in Table 2, Conventional Loan mainly aims to ensure the safety of

the loan, while Venture Capital mainly focuses on sustainability and long-term returns. Venture Debt falls right in the middle.

Table 2 comparison focus point in dd process between 3 major type of financing

Type of Financing	Focus point in Due Diligence Process
Conventional Loan	Repayment Ability, Collateral(Fixed Assets, Deposit, etc)
Venture Debt	Company and Founder Background, Business Size, Cashflow(Runway), Business Forecasting, etc
Venture Capital	Background, Monetization model, growth, Cashflow(Runway), Sustainability and scalability, etc

2. METHODS

2.1 Research Design

Since Venture Debt figures don't make a special distinction in the company's financial statements, Therefore, this study decided to use Qualitative analysis. By analyzing through the Literature review, Interviews, and Participation Observation to get the information about the characteristics of Venture Debt in the macro and microenvironment Indonesia, and summarizing the supply-side and demand-side of Venture Debt in the Indonesian market, this paper provides an analytical basis for the potential of Bank Venture Debt and provides the solution for the potential of Bank Venture Debt in Indonesia.

2.2 Data Collection

Literature review - As a fundamental part of the research, Collecting and reading a large number of Venture Debt-related literature and materials, to analyze the characteristics and to understand the overall development of Venture Debt in the world. Through the literature on the Financing of SMEs/startups, this paper analyzes the pain points encountered by SMEs/startups in Financing. Then, the potential of Bank Venture Debt is further analyzed by reading the literature about the actual market situation in Indonesia and analyzing the risk points that the bank pays attention to in expanding its business. And through the comparative analysis of the characteristics of Bank Venture Debt and SMEs/startups, we finally, find out the solution for the risk for Bank Venture Debt.

Interview - Since the main objects of this study are commercial banks and SME/startups in the Indonesian market, the mode of the interview is adopted in the process of research. The interview is mainly divided into the following four steps : (1) Create the Interview

questionnaires and ensure the expected answer for questions. The Interview of this study is mainly divided into 2 parts: senior management of SME/Startup and senior management of banks; (2) Determine the relevant interviewees and appoint the interview time; (3) Conduct interviews and take notes; (4) Make a summary of Interview Questionnaire after the Interview

Participation Observation - Based on the experience in the financial institution and banking industry, combined with the operation mode and risk of bank loan, combined with the interview of relevant bank personnel, this paper analyzes the potential of developing Venture Debt for banks, and puts forward the development direction and effective suggestions.

2.3 Data Collection Analysis

Data Analysis is mainly divided into two parts. The first part uses the Analysis model to analyze based on theoretical knowledge, and the second part summarizes the Analysis results based on the first part combined with the interview results to verify the Analysis results.

This paper will analyze Venture Debt Model in combination with the compliance requirements of Indonesia, and conclude the compliance risk and risk response plan of Bank Venture Debt in Indonesia.

3. RESULTS AND DISCUSSION

For SME/startup, there are high risks and costs in the early stage of development, and a large number of talents and funds are needed in the early stage, including in the middle stage of market expansion, and a large amount of cash flow is also needed to support the rapid expansion of the business.

3.1 Demand of Venture Debt

As of May 2019, data from the Indonesian Information and Communication Technology Creative Industries Association (MIKTI) shows that of the 1,009 start-up companies in Indonesia, 52.7% are located in the Jabodetabek region. The Minister of Communications and Information also explained that according to the Startup Ranking page, Indonesia ranks fifth in the number of global start-ups, with 2,193 in 2019, second only to the United States, India, the United Kingdom, and Canada a. According to the latest data, Indonesia has 816,000 small and medium enterprises, employing 7.9 million people, contributing 27% of GDP b. According to estimates by the International Finance Corporation (IFC), 54% of SMEs in Indonesia are interested in getting bank loans. The SME Finance Forum report shows that the need for financing by Indonesian SMEs/startups is

much higher. According to the report, Indonesia's financing to MSMEs is the US \$56.6 billion, with potential demand of US \$222.4 billion, while the financing gap for MSMEs is the US \$165.8 billion, equivalent to 19% of GDP.

SMEs/Startup should grow faster than the economy as a whole, and a major problem for SMEs in Indonesia is and remains access to finance. In a survey, 15% of SMEs listed lack of capital as one of their top three business challenges. Informal SMEs (19%) are significantly more affected, but semi-formal SMEs (10%) and formal SMEs (11%) also face this barrier. In general, Indonesia is in a period of rapid development of SME/Startup, and the issue of financing difficulties for SME/Startup is gradually exposed in the development stage.

3.2 Expected Impact on the performance of SMEs/startups

According to the characteristics of Bank Venture Debt, this part will analyze the impact of Bank Venture Debt on the performance of SMEs/startups in combination with the characteristics of SMEs/startups.

The Positive and Negative Impact of cash flow on performance, based on the interview, one of the interviewees said, if SMEs have enough cash flow, we can develop every business that we want to develop. Bank Venture Debt will have two impacts on cash flow: The positive impact on development efficiency, the more abundant cash flow, the higher the efficiency of business development. The negative impact of interest on cash flow, SMEs/startups need to pay the corresponding interest to obtain the loan.

The Positive Impact of Warrant on performance, the bank venture debt has a Warrant. Based on the interview, one of the interviewee from SMEs mentioned, that we are very hard to get a loan from a bank without a fixed asset. In the bank venture debt, a warrant is equivalent to the existence of collateral. This means that SME/Startup has broadened a financing channel and found a network for subsequent financing. The cost of funds of the bank is originally lower than that of other financial institutions and the dilution degree of equity is also included. The higher the valuation of the company, the fewer shares the investor can get. But based on the interview there are two of the interviewees were reminded that the Owner must calculate the Warrant very carefully to ensure that the owner will not be affected when the investor executes the warrant.

The Positive Impact of cooperation with banks on performance. This is not only because of the lower cost of funds but also because of the ability to tell investors a better "story". Based on the interview, one of the

interviewees said, Banking Industry is a "Trust Business", based on trust and credit. Cooperating with the bank means not only for a better reputation but also for the funding network and on the basis of cooperation with the bank, will be easier to win the trust of investors.

3.3 Supply of Venture Debt

As of June 2020, There were about 1.53 thousand rural banks and 110 commercial banks available. According to OJK and Statista's statistics for the period ending March 2021, The top 5 banks (Bank Rakyat Indonesia, Bank Mandiri, Bank Central Asia, Bank Negara Bank Tabungan Negara) account for nearly 50% of the total assets of the banking system. However, the proportion of loans to SMEs/ startups in all Indonesian banks is only 11%, which indicates that banks need to pay more attention to the development of SMEs/startups. Bank Indonesia regulations instruct all commercial banks in Indonesia to channel a minimum of 20% of their total loans to SMEs in 2018. During the interview with the relevant personnel of the startup, he mentioned: Although Bank Indonesia has this 20% requirement for all commercial banks, more commercial banks will choose to pay Bank Indonesia a penalty.

In recent years, digital transformation has become a new trend in the development of the financial industry. With the increase of options for potential customers, the market share of banks has gradually declined. Therefore, in addition to digital transformation, banks should also innovate their existing businesses and expand the scope of financial services. They must maintain and increase their market share and reduce the impact of market competition with digital finance.

3.4 Compliance Analysis

The Financial regulatory authorities in Indonesia are mainly the Financial Services Authority (Otoritas Jasa Keuangan-OJK) and the Bank of Indonesia. In addition to explicit ratio and numerical accident in various data indicators of the bank, there are also clear stipulations on the investment behaviors in the banking industry, such as the proportion of the investment amount to the overall core equity of the bank and the industry requirements for investment. According to Articles 3 and 5 of POJK 6/2016, the participation of commercial banks classified as Buku 1 is prohibited. Only commercial banks classified as Buku 2 or above can participate in the investment. Meanwhile, Article 3 of POJK 36/2017 stipulates that banks can only participate in equity stakes in financial services companies.

At present, OJK does not have clear regulations on Venture debt products, and mainly focuses on the

supervision of banks and traditional financial products. Based on the interview, Interviewees from banks mentioned that Regulation does not have a part about Venture Debt, but I believe there will be when the market matures.

3.5 Financial Analysis

Venture Debt is a product of competition in this emerging market. From Table 3 we can see that in the data of these 7 banks, the average interest rate of their loan products for SMEs is 13.2%, and most of them require SMEs to provide the collateral. Venture debt is essentially a subprime loan that Warrants as collateral in the early stage. Due to the high risk of subprime loans, the interest rate of subprime loans is usually 2% ~ 3% higher than that of ordinary mortgages. Therefore, when the bank develops the product of venture debt, the interest rate can be increased from the average value of 13.2% to 14.2%-16.2%. At the same time, when the warrant expires and the bank exercises its conversion rights, the converted SME/Startup shares may become another part of the bank's income.

Table 3 The comparison of the lending product for SME from several bank

Bank	Bank-Level	Target Market	Product	Interest	Collateral
Commonwealth Bank	2	UMKM	CommBank BizLoan	14.3%	No
Bank Sampoerna	2	UKM	Kredit Mikro	17%	Yes
Sinarماس	2	UKM	SIMAS UKM	16%	Yes
HSBC	3	UKM	Pinjaman Usaha	14.4%	Yes
Bank DKI	3	UKM	Monas SME	15%	Yes
Danamon	4	UKM	Solusi UKM	9.6%	Yes
Mandiri	4	UMKM	Kredit Usaha Rakyat	6%	Yes

- a. Resource: Collect from each website of the bank
- b. UMKM: Micro, Small, and Medium Enterprises; UKM: Small and Medium Enterprises
- c. With this comparison of 7 traditional UMKM products, the average interest rate is 13.2%

3.6 Technical Analysis

On the market, Fig 1. has shown two general models of operation of the Venture Debt, there is the "Bank + subsidiary" model and the "Bank +VC/PE" model.

Through these two analyses of these two models, there are two important points for the bank: (1) Risk tolerance, Although banks cover by raising interest and Warrant, the bank is determining the development of

venture Before debt, it is necessary to evaluate the risk more carefully. (2) Internal operating capabilities. In the pre-lending stage, banks need to have an understanding of their own internal operating capabilities, including talent capabilities and operating procedures.

3.7 Risk Analysis

Through analysis in the Indonesian market, there are 3 major risks can be seen in Fig 1:

Market Risk – In order to reduce the exchange rate cost, SME/Startup will seek financing through other channels. As a result, the banking industry cannot occupy the market share of SME/Startup customers in terms of interest income. Secondly, a large number of foreign funds pouring into the Indonesian market will lead to the devaluation of the Indonesian rupiah, which may lead to the re-emergence of inflation.

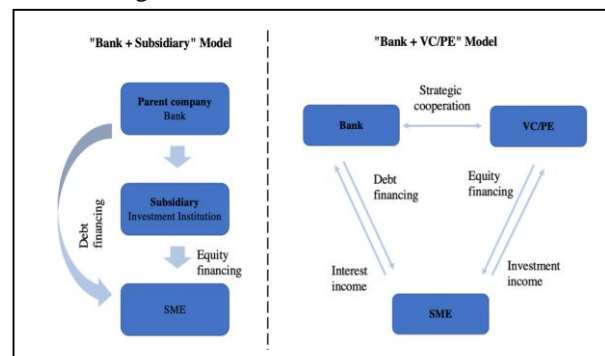


Fig. 2. Operational Modal of Venture Debt (Collect from website), (1)Bank through the subsidiary that financial institution to take the warrant, (2)Bank through VC/PE to take the warrant.

Compliance Risk - (1) In the regulation of BI and OJK, there is definitely the type of collectability, mention the Non-Performing Loan(NPL) can not above 5% and mention about the bank's should strict management of its own asset quality and various data are still hard indicators that banks face. (2) The compliance risks encountered by banks also include the implementation of Warrant. (3) When an Indonesian bank Venture Debt executes its warrant, it may involve overseas laws. It could escalate into an international legal dispute.

Operation Risk - For bank loan products, the increase in the number of SMEs/Startups led by asset-light tech players is a new field for the bank's risk control system. The traditional risk management system based on the collateral will move to the risk management system of Venture Capital and pay more attention to the business volume of SME/Startup and the forecast of future development. The bank needs new talents to enter the entire risk control system to reassess the risk points of the entire product. In general, the risks of Indonesian banks' operations are mainly due to the lack of knowledge of

Venture Debt products and the lack of relevant talents who can implement the risk control system.

3.8 Banks' risk countermeasures for Venture Debt

There are mainly three important parts involved: the stability of the bank's internal risk management system, how to transfer, and how to improve the operating system:

Robust risk management system. According to the characteristics of Venture Debt business, combined with the existing credit review system of the bank, conduct various pre-loan due diligence on SME/startup. In the early stage of customer development, it is necessary to establish a minimum standard for the bank to accept potential customers, such as time of establishment and Runway, etc. When the real due diligence begins, in addition to confirming the repayment ability of the SME/startup, it also needs to confirm the execution of the SME/startup, which also includes a prediction of the future development of the SME/startup. In the process of post-loan can set different post-loan supervision requirements for SME/startup based on the due diligence results of post-loan.

Potential risk transfer. Risk transfer is a way that banks often use to avoid risks. Venture Debt is a credit loan product, when SME/startup cannot repay, it will lead to the increase of non-performing loans of the bank. Therefore, the purchase of insurance for loans has become one of the risk diversification methods of Venture Debt, thus increasing the bank's ability to resist risks. Assignment/sale of venture debt and find a partner with higher risk acceptance and assign Venture Debt Assignment/Sale to another financial institution to ensure that Venture Debt is not beyond the risk range that the bank can bear.

Complete Operation System. Bank can cooperate with VC/PE companies and VC/PE pays more attention to the future development of SME/startup when conducting due diligence on customers, while banks pay more attention to the customer's ability to repay the amount. The bank can cooperate closely with VC/PE to ensure that the customer's loan can be repaid on time, and it can also understand the development prospect of SME/STARTUP and judge the execution ability. On the other hand, the bank can set and manage the liquidity and non-performing loan and determine the proportion of Venture Debt in all the bank products, so as to ensure that the overdue Venture Debt will not greatly affect the overall business of the bank.

Option of the debt-for-equity swap, after the loan part of the Venture Debt, has been paid off, it can be converted into shares so as to increase the Investment return of the bank as long as the loan is still warranted within the term of validity.

4. CONCLUSIONS

Given the rapid development of the economy and the proliferation of SME/Startup, Bank Venture Debt can solve and can quickly provide cash flow, it also can broaden the network for future financing of SME/Startup with a small impact on ownership. Bank Venture Debt is potentially feasible under the circumstances of financial markets and the need for Bank transformation. The current market in terms of compliance and the bank's operating system is still blank for Venture Debt, which will be a challenge for Bank Venture Debt. How the bank expands the product and with which model of Venture Debt will ultimately depend on the planning of a development direction of the financial market by the regulator.

The government should more carefully in light of the current economic development speed of Indonesia and the historical development of other countries, point out the development direction for new possibilities and new products in the financial market and formulate relevant laws to make Indonesia's financial institutions more diversified at the business level. And the government need to educate SME/startups and ensure that they can maximize their own performance during business development, so as to strengthen the competitiveness of SME/Startup and improve the overall competitiveness of the entire country in the international market. The bank should update its Risk Management system and operating system in a timely manner in accordance with the development of the market, and be able to prepare for new opportunities while waiting for the market to mature. At the same time, we will introduce more talents with relevant experience to keep pace with the market at any time to ensure that we are ahead of competitors and maintain market competitiveness at any time.

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