Capital Market Option for SMEs

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Small and Medium Enterprises (SME) have come a long way since the seeds of this sector were first sown in the second Five-year Plan. Today, this sector plays a pivotal role in the growth of the economy, contributing about 40 percent to industrial output and producing over 8,000 value-added products. It also accounts for about 45 percent of the country's exports.

Despite constituting more than 80 percent of the total number of industrial enterprises and supporting industrial development, SMEs in India suffer from the problems of sub-optimal scale of operation and technological obsolescence. Further, these organizations face competition from their global counterparts because of liberalization, change in manufacturing strategies and the turbulent and uncertain market scenario.

What is SME?

Every country has its own definition of what is considered a small and medium-sized enterprise. The classification can be based on the firm's assets, number of employees, or annual sales. In the United States, there is no distinctive way to identify SME - typically it depends on the industry in which it competes. In the European Union, a small-sized enterprise is a company with less than 50 employees while a medium-sized enterprise is one with fewer than 250 employees.

In India, according to 'The Micro, Small and Medium Enterprises Development Act', 2006 the enterprises can be classified as

(a) In the case of the enterprises engaged in **the manufacture** or **production** of goods pertaining to any industry specified in the first schedule to the Industries (Development and Regulation) Act, 1951, as –

- (i) a micro enterprise, where the investment in plant and machinery does not exceed twenty five lakh rupees;
- (ii) a small enterprise, where the investment in plant and machinery is more than twenty five lakh rupees but does not exceed five crore rupees; or
- (iii) a medium enterprise, where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees;

(b) In the case of the enterprises engaged in providing or rendering of **services,** as –

- (i) a micro enterprise, where the investment in equipment does not exceed ten lakh rupees;
- (ii) a small enterprise, where the investment in equipment is more than ten lakh rupees but does not exceed two crore rupees; or
- (iii) a medium enterprise, where the investment in equipment is more than two crore rupees but does not exceed five crore rupees

Whatever the definition, and regardless of the size of the economy, the growth of SME's throughout the region is crucial to the regional growth.

SMEs – Small is Beautiful

The Importance of Small and Medium Enterprises in any economy cannot be overlooked as they form a major chunk in the economic activity of nations. They play a key role in industrialization of a developing country like India. They have unique advantages due to their size; they have comparatively high labor-capital ratio; they need a shorter gestation period; they focus on relatively smaller markets; they need lower investments; they ensure a more equitable distribution of national income; they facilitate an effective mobilization of resources of capital and skills which might otherwise remain unutilized; and they stimulate the growth of industrial entrepreneurship.

According to a UNIDO report, Support for SMEs is generally based on three assumptions. First is that, it sustains a broad and diversified private sector and creates employment and thus benefits the country as a whole; second, a strong SME sector will not emerge without support from the state, but they suffer disadvantages in the markets because of their size; third, the programs aimed at smallest enterprises, have been justified more in terms of their welfare impact than their economic efficiency.

Performance of micro and small scale enterprises							
Year	Number of units (lakhs)		Production (Rs. crores)			Employment	Exports
	Regd.	Unregd.	Total	(at current price)	(at const. prices)*	lakhs	(Rs. Crores)
2002-03	15.91	93.58	109.49	311,993	210,636	260.21	86,013
2003-04	16.97	96.98	113.95	357,733	228,730	271.42	97,644
2004-05	17.53	101.06	118.59	418,263	251,511	282.57	124,417
2005-06	18.71	104.71	123.42	476,201	277,668	294.91	n.a
Source: Development Commissioner (SSI)			*1993-94 prices				

Problems characterizing the SMEs
The UPS Asia Business Monitor (UPS ABM) 2007 report highlights some of the major problems faced by Indian SMEs.

Some of the problems/ challenges the SMEs facing are:
- Unable to capture market opportunities, which require large production facilities and thus could not achieve economies of scale, homogenous standards and regular supply
- Experiencing difficulties in purchase of inputs such as raw materials, machinery and equipments, finance, consulting services, new technology, highly skilled labor etc.
- Small size hinders the internalization of functions such as market research, market intelligence, supply chain, technology innovation, training, and division of labor that impedes productivity.
- Emphasis to preserve narrow profit margins makes the SMEs myopic about the innovative improvements to their product and processes and to capture new markets.
- Unable to Compete with big players in terms of product quality, range of products, marketing abilities and cost.
- **Absence of a wide range of financing and other services those are available to raise money and sustain the business.**
- Absence of Infrastructure, quality labor, Business acumen and limited options / opportunities to widen the business.
- Poor IT and Knowledge infrastructure.

These hurdles need to be addressed to ensure that the sector grows steadily and becomes globally competitive.

Limitations / Characteristics
At the same time one has to understand the limitations of SMEs, which are:
- Low Capital base as the entities are likely to be unquoted.
- Concentration of functions in one / two persons
- Inadequate exposure to international environment
- Inadequate contribution towards R & D
- Lack of professionalism. Typically the ownership of the business is restricted to a few individuals / family groupIn spite of these limitations, this sector has grown by leaps and bounds and has caught the fancy of corporate India. In fact, SMEs fared better than most large organization, between 2001 and 2006. For example, the net profit of companies with a turnover of Rs. 50 crore – Rs 100 crore appreciated by over 700 percent in that period, compared to an increase of over 150 percent in the net profit of large corporations. During the same period, SMEs also outperformed large corporations in net sales and operating profits.

SMEs have been established in almost all-major sectors in the Indian industry such as:
- Food Processing
- Agricultural Inputs
- Chemicals & Pharmaceuticals
- Engineering; Electricals; Electronics
- Electro-medical equipment
- Textiles and Garments
- Leather and leather goods
- Meat products
- Bio-engineering
- Sports goods
- Plastics products
- Computer Software, etc.

Need of Funding

The sustained economic growth during the last decade coupled with opening up of global outsourcing opportunities in favor of Indian and booming consumerism in the domestic markets have propelled the SME sector in India. A large number of SMEs have witnessed growth rates in the range of 50-100% every year. Even to sustain these growth rates, these companies need to invest in capital expenditure and set up expansion projects for which there is a significant need for growth capital.

SME firms tend to spend a lot of money on IT and as a result, these businesses are strongest in the area of innovation. The need to attract capital to fund projects is therefore essential for small and medium-sized enterprises. To be competitive SME firms require “out of the box” solutions even if it involves surrendering some functionality.

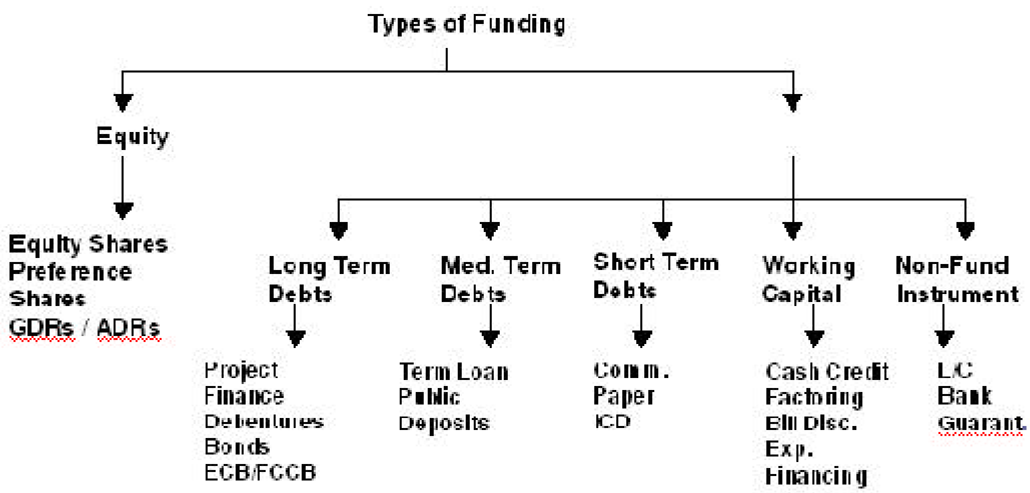
The Critical Challenge of Funding:

Flexibility as well as low start-up and operating costs have enabled SMEs to spring up, to reposition and adjust themselves quickly in response to market and economic changes. Moreover, they easily contract and expand in a short time. SMEs have not survived the impact of big enterprises and the law of economies of scale but have carved out niches for themselves, which enable them to coexist with big enterprises.

However, the most common problems for SMEs are the lack of access to market information and technology, the low quality of human resources and the lack of access to capital.

Funding Options:

Broadly speaking, funding can be in the form of equity or debt as elaborated in the graph below:



SME funding in the country has largely been seen as a part of regulated lending by a network of state-created institutions. While this is an achievement on part of the banking sector and demonstrates the sector’s credit absorption capability, there is a definite and visible lacuna. The financial sector needs to step up lending to the sector. Depending on the requirements of each niche market segment and sectors, credit delivery would vary from pure debt finance to providing risk capital or a hybrid of both.

Most of the SMEs are set up by professionals with limited personal resources to meet the growth capital requirements. According to the ministry’s provisional estimates, Rs 1,25,163 crore has been disbursed by public, private and foreign banks in 2006-07 to the sector, 23% higher than the preceding year’s level of Rs 1,01,385 crore. Although debt is available at competitive rates, most of the SMEs tend to operate at high gearing limiting their ability to raise fresh debt. Hence there is an immense thirst for growth capital emanating from the rapidly growing SME sector.

Despite efforts by financial institutions and public-sector bodies to close funding gaps, SMEs continue to experience difficulty in obtaining risk capital.

Capital Funding Options:

Equity financing can take the following forms:

- ✓ <u>Redeployment of retained earnings</u> where the internal surplus generated form the operations are redeployed into business instead of being distributed

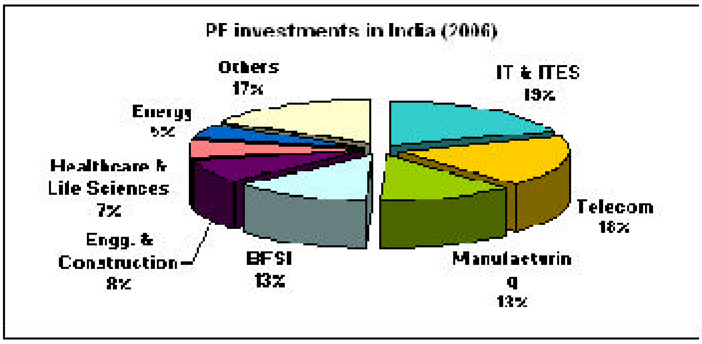
✓ <u>Private Equity and Venture Capital Funds</u>

While there was a sudden surge in the private equity activity in India during the technology boom, the recent growth in the industry is more of a broad-based one mainly driven by not one sector in the economy but is spread across various sectors such as manufacturing, engineering, pharmaceuticals, telecom, infrastructure, retail apart from the traditional IT sector.

Private Equity and Venture Capital Funds are fast becoming the preferred option for SME due to the inherent advantages of higher visibility and value addition associated with these options. PEs, in particular, has been finding interests in SME because of their huge growth potential.

This trend is mainly driven by the fact that sectors like manufacturing, engineering, pharma, etc have emerged as globally competitive industries providing a compelling value proposition in terms of outsourcing opportunities to multinational companies in developed countries. While the Indian private equity market is offering a broad range of investment opportunities across various sectors, during the last five years, the M&A market has also started developing concurrently, offering excellent exit options to the VC funds. The availability of exit options in terms of IPO's, secondary sale and through mergers and acquisition has definitely changed the mindset of the global investors on India and hence a large number of global private equity players entered the Indian market during the last three to four years.

Private Equity firms invested a record $7,474 million over 302 deals in India during the 12 months ending December 2006. (These figures exclude investments in real estate.). The amount invested during 2006 was over three times that during the previous year, which itself was a record one (witnessing 148 deals totaling $2,225 million). Venture Capital investments – including the Early- and Growth- Stage categories accounted for 35% of PE deals (in volume terms) during 2006.



Stage funding Analysis - 2006 and 2007Q1

Particulars	Number		Value	
	2006	2007 Q1	2006	2007 Q1
Early Stage	20%	13%	3%	2%
Growth Stage	15%	17%	7%	17%
Late Stage	35%	44%	49%	53%
PIPE	22%	22%	21%	25%
Buyout	5%	2%	15%	2%
Others	3%	2%	5%	1%

Private Equity Players nurture its investments and try to help the companies transform from closely held promoter-centric organizations to a more institutional businesses by instilling corporate governance standards, transparence levels and international business practices. The aim is to make these companies socially responsible entities with sustainable business potential before they become public. The most preferred exit option would be through an IPO. The other exit options which the PE Players pursue include strategic sale option to other investors and promoter buyback

- ✓ IPOs (Initial Public Offering)

SMEs may choose to fund growth by rasing equity on the Stock Exchange to access funds outside traditional funders such as banks. They can spread and share the risk of high growth strategies by sharing equity ownership.

Around 85 Companies have raised $5.5 billion through Public issues in Financial Year 2007; the SME segment could only grab 5% of the total chunk.

New Small and Medium Enterprises (SMEs) have also been unable to tap the markets to raise equity and debt, to fund their plans. This is due to the fact that the minimum market capitalization required for companies to get listed on the BSE and NSE is Rs 5 Crores and Rs 25 Crores respectively, which such SME's find it difficult to maintain and achieve.

Investors and the companies, which are listed only on Regional Stock Exchanges (RSEs) have been impacted severely, as the RSEs are recording either nil or negligible trading volumes. Investors in such small and medium companies are therefore unable to find an exit route and realize fair market value of their investments. The companies listed only at RSEs find it extremely difficult, if not impossible, to raise fresh resources from the capital markets in the absence of price discovery of their securities in the secondary market.

The Stock Exchange, Mumbai (BSE) and the Federation of Indian Stock Exchanges (FISE) realized and believed that the time is ripe to ignite growth by putting the smile back on the SMEs and also allow new SMEs to bloom. Small businesses could become the backbone of our economy, and an avenue for massive employment generation.

BSE and FISE (which represents 20 RSEs), jointly created an alternate national platform named ***BSE IndoNext***, to enable SMEs to raise equity and facilitate trading in such companies, both old and new.

The ***BSE IndoNext*** has helped the investors to reach the BSE IndoNext traded scripts in addition to the network of BSE, also through the network of about 7,000 members of RSEs, who cater to the investors in the far - flung areas of the country and, thus, contribute to the development of the capital market. BSE IndoNext thus, envisages harnessing advantages of creating a single national trading platform, with a large number of member participation, which would help achieve a fairly vibrant trading platform for SMEs.

However, these options require strict regulatory compliances which most of the SMEs find it difficult as they lack a professional set up to match upto the requirements. Financial Intermediary should come forward and bring good quality SMEs which are already listed on the RSEs to the "Active" Stock Exchanges whereby they can realize their actual potential/ worth.

As on April 2007 there are around 463 companies listed on "S" group with a Market capitalization of INR 89087 Crores and average daily turnover of INR 118.35 crores.

- ✓ FPO's/QIP

Another route of raising funds for listed SME's can be through the Follow-on Public Offering (FPO) or through Qualified Institutional Placement (QIP). FPO route can be used by the SME's as a method to increase the investor base, thereby creating liquidity and trading interest. The QIP route can also be preferred by the SME if the inherent strengths of the company attract institutional investors.

Conclusion

The SME sector is and will continue to be an important cog in the wheel as far as GDP growth is concerned.SMEs play a critical role in providing job opportunities, enhancing the quality of human resources, nurturing entrepreneurship culture, fostering creativity and opening up new business opportunities.

Therefore, at a time when the process of transformation of the economy has thrown up major challenges, it is important that not only the SME segment should strive for inherent advantages of higher visibility and value addition associated with these options but also the financial sector and avenues should gear up for catering to this new segment and, in turn, fuel its growth in the coming decades.