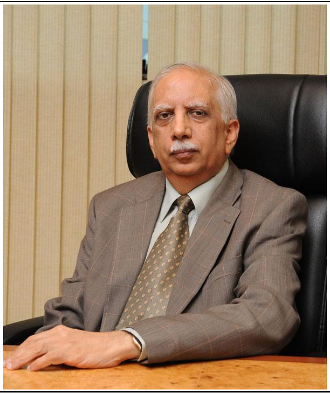
SME Exchange - Challenges and Opportunities



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Background

SEBI has taken a landmark decision by issuing guidelines for establishing Stock Exchanges for the Small and Medium Enterprises (SME). The decision of an exclusive SME platform will lead to very high expectations in the entire SME community as this has been a major demand of various industry bodies in recent past.

In this regard, it would be pertinent to take a stock of the SME sector in India and the role that a vibrant SME exchange could play to provide a boost to this sector.

Characteristics of Indian SMEs

It is a well established fact that SMEs play a very important role in a developing the local economy. They are a engine of economic growth, job creation, wealth distribution, promoting entrepreneurship, geographical dispersal of units and effective mobilization of resources (capital and skills). Due to their small size and entrepreneurial spirit, they are able to adapt to changes quickly, use innovation as a key competitive strategy and have high growth prospects. Various yardsticks have been used to define an SME. They have been categorized based on the size of their turnover, investment in fixed assets or the number of employees. There is no universal definition of SMEs as the concept of size is relative with reference to the local economies. In India, we have defined the Micro, Small and Medium Enterprises (MSME) in terms of investment in plant & machinery for manufacturing sector and investment in equipment for services enterprises. Within the MSME sector, the linkage of the Exchange would be with the SME sector.

Till a couple of decades ago, Indian SMEs were more in traditional brick & mortar sectors and were more focused on the local markets driven by protection provided by way of sectors exclusively reserved for them. However, over the last decade, a paradigm shift has taken place in the profile of Indian SMEs. Today, they present a very diversified profile in terms of sectors, stage and geographic locations. Indian SMEs operate in wide range of sectors and compete with the best in the world. SMEs in new economy sectors like IT, IT enabled, organized retailing, education, entertainment, media, etc. represent the new and modern face of Indian SMEs. A recent trend has been outsourcing of production to the SME by the large Corporations. This is more pronounced in consumer goods, textiles, leather, auto components. This also provides opportunities for SMEs to scale up.

Indian SMEs are also taking an active role in social sectors and very innovative business models are being proposed to solve the innumerable problems of rural population in areas like financial inclusion, healthcare, education, etc. Services are the major source of economic growth, accounting for more than half of India's output with less than one third of its labor force. India's demography is well placed with a large proportion of the population being in the 'working age'.

The credit requirements of the SME sector are primarily met by branch network of commercial banks in India. In view of the importance of the sectors, many banks have set up dedicated MSME branches in industrial clusters. However, the SMEs which are growing very fast or are in the new economy sectors which do not create assets still face problems of getting adequate debt funds from the formal financial sector. While there is a fast growing VC/ PE industry in India, but these focus on bigger investment primarily due to limited exit options in SME investment. There is, therefore, a need to create an alternate channel of capital for deserving SMEs. The exchange should complement the existing risk investors in the country, in addition to creating alternative sources of capital for the SMEs.

Opportunities out of a SME Exchange

In view of the emerging scenario which offers growth opportunities, using finance through alternative channels will become important for SMEs.

An exclusive stock exchange for SMEs will enable them to consider approaching capital markets as a new and viable option for raising capital in an efficient manner and scale up their businesses to compete globally. In view of the regulator's definition of post listing paid up capital of Rs 25 crore, a large spectrum of SMEs would be eligible to list on the SME platform and the amount of capital raised could also be significant.

Once listed, they will enjoy a higher profile and greater visibility, which will in turn improve their credibility with various stakeholders like customers, vendors, employees, etc. Being listed will help the SMEs to attract better quality talent and improve retention by incentivizing the employees. SME Exchange, while ensuring product innovation and without compromising on risk management, will ensure compliance and process requirements on one hand, and broad base equity funding on the other.

Currently, the early stage investors in the companies including Angel and Venture Capital investors have limited avenues for exit from the SME investments. With a special exchange for SMEs, the exit will be made easier. Globally, the VC funds prefer bigger deals in larger companies due to limited exit options from equity in SMEs. With an exit route available, there will be higher incentive for VCs to invest in start-ups and small businesses, promoting entrepreneurship. The very nascent angel industry in India will have an opportunity to grow as more of their investments get funded by VCs and who in turn get exits at the SME exchange. This along with other initiative of Government of India to support start ups in incubators, will lead to higher quantum of financing for innovation based businesses. Financing of start ups provides a funnel of projects for the bigger VC funds which look at late stage, bigger size investment. The setting up of a SME Exchange will indirectly create a funnel which will over a period of time attract VCs into India.

It is universally accepted that SME Exchange/Platform could function provides a new source of capital to SMEs and reduces their dependence on debt financing. As is well known, every company, including SME should have an appropriate debt-equity ratio to enable maintaining an ideal capital structure. Heavy dependence on debt capital from banks and financial institutions would definitely bring distortions in the capital structure in addition to increasing the vulnerability of the SMEs' cash flows in adverse economic conditions. In respect of Innovative technology focused, product development, or companies with high intangible cost in the initial stages, debt may not be the appropriate instrument of financing in view of uncertain cash flows. In such cases, SMEs should be enabled to access the capital market for raising equity capital so that an optimum debt equity mix can be structured.

Since, they are subject to higher scrutiny and higher governance requirements, listed companies will also usually be able to get better rates when they approach their banks for debt financing. Additionally, capital infusion improves the leveraging capacity to attract more funds for growth. SME Stock Exchange would facilitate fund raising by SMEs in India which are growing rapidly. The listed companies will eventually start attracting the institutionalized investors also and they will surely get better visibility enabling them to reap the benefits of other funding options.

The exchange will also provide an opportunity to informed investors to invest early in leaders of Indian Corporate sector. An SME Exchange will help to bridge the gap by channelising pools of risk capital towards its application into high growth ventures.

Challenges for a new Exchange

Many countries have made efforts to set up a separate platform or exchange for SMEs and not all have been successful. The success of an exchange hinges on its ability to create meaningful value proposition for all market participants.

We have already discussed the issuer's perspective, that is, access to capital in an efficient and cost-effective manner. However, for an SME, this is not enough. These entities are fledglings and need handholding for initiation into Capital Markets. They have to be introduced into the journey of becoming process-driven, with emphasis on Corporate Governance. Many good SMEs stay away from the Capital Markets as they are not equipped to handle the compliance requirements. The Exchange must strive to make the processes simpler, which the SME can comply with considering their limited resource and managerial strength.

For the market to function, it is important for the exchange to ensure that this does not become a platform for unscrupulous promoters who may raise funds for non-viable projects, divert investors' money, or in the worst scenario, become a vanishing company. So, to ensure protection of investors' interest, it will be important for the regulators to put in place adequate controls and processes such that only good quality entities are allowed access to the market.

The cost for listing should also significantly get reduced on this platform to make it a serious place for raising capital by good quality issuers. Presently, the cost of raising capital for small issuers is significantly high and it discourages them to approach capital markets. The costs could be reduced by different processes vis-a-viz the main Boards and also use of technology.

The next major concern for this market will be liquidity. Experience on the main boards already shows that apart from the top 20 – 25 % of the listed entities, liquidity in the remaining scrips is low and in some of the smaller scrips it is almost negligible. Globally also junior boards have repeatedly faced problems of liquidity drying up, especially when there are economic downturns. It is important for the Exchange to devise structures to ensure that there is continued interest in the listed companies. The proposed market making on the SME exchange should be to help create some minimum liquidity in the listed scrips, however, it is critical that the market making mechanism works in a credible manner. The market makers should be provided suitable incentive so that they have sufficient interest in the providing liquidity.

Facilitating extensive research coverage for the listed SME scrips is also critical for investor interest. Exchanges should pro-actively work on this aspect. Further, the entire experience can be made much smoother with use of technology to cut down on cost and processes and improve communication.

Significant awareness would also need to be created to bring the right kind of investors in the market. The investors on this platform should be able to appreciate the risks of investing on smaller companies which have lower predictability in terms of business or earnings potential viz. a viz. the companies listed on main board. However, the return potential could also be attractive for the investors to take a decision to invest in smaller companies.

India has a large number of Institutions and they should all be tapped to invest in the SME securities. Efforts should also be made to ascertain incentives given by Government to investors on junior platforms in other places in the world.

What SMEs need to do prepare for listing

While a new SME exchange will enthuse a large number of SMEs, they need to understand the fact that it will require months and sometimes years in advance to prepare for a listing on the exchange. Significant awareness has to be created amongst SMEs as to how should they prepare themselves for getting listed and raising capital. They have to be made aware of the importance of creating an organization structure, including corporate governance, which can handle growth and which is credible to the investors. Meeting with all the compliances and obligations after listing also requires in house competence which would need to be developed.

Availability of suitable specialised organizations which could help SMEs to prepare for accessing capital market at reasonable cost and will help bringing credibility for the issuers which get listed on the SME platform.

Conclusion

The Indian SMEs today stand to exploit unprecedented opportunities driven by a fast growing domestic economy and increased credibility of Indian SMEs in the global markets. Availability of adequate capital for growth is one of the key factors required to make the SMEs tap these opportunities and grow exponentially. The Indian landscape has also changed and the Indian markets have matured substantially over the past decade and are now ready for an institution like a SME Exchange.

Several Indian SMEs have taken advantage of the growth opportunities in the past two decades and grown onto large corporations, some with global operations. Several such success stories have been there in sectors like telecom, IT, financial services, manufacturing, etc. Enroute to this growth journey, they have also provided their investors with high returns. The management bandwidth of the Indian SMEs is also much more matured today as they manage cross country operations, raise capital from external investors and aggressively look for M&A activity both in domestic and overseas markets. The entry of professionals in setting up SME units, outsourcing of production by bigger units, particularly multinationals, have accelerated the growth of SMEs in India. SMEs in India have demonstrated tremendous agility and resilience in the face of changing economic contours in the domestic as well as global markets.

The regulator's decision is significant in view of the not so successful past efforts in setting up a junior platform. Therefore, all the Institutions, viz. the regulators, the exchanges, the Banks, risk investors, capital market intermediaries should work in close co-ordination to create the right eco system for the SME platform. It will be a giant step in the country's development and lead to wider and more constructive creation and distribution of capital. The Exchange will provide the critical link in SME investment by providing the liquidity and the visibility to the listed companies.

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