

SME Platform-Challenges & Opportunities



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Background

Small and medium enterprises (SMEs) represent innovation and potential for growth into tomorrow's successful businesses. For several reasons, SMEs find it difficult to access capital markets to raise equity. In many countries, markets have created new segments to cater specifically to such needs. These markets

help SMEs raise risk capital and provide investors the opportunity to directly participate in their growth.

SEBI has taken a landmark decision by issuing guidelines for establishing Stock Exchanges for the Small and Medium Enterprises (SME). An exclusive SME platform will pave the way for fast growing companies to get access to funds and offer a new asset class to investors.

Characteristics of Indian SMEs

It is a well established fact that SMEs play a very important role in a developing the local economy. They have been a key engine of economic growth, job creation, wealth distribution 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 or investment in fixed assets or the size of their net-worth. There is no universal definition of SMEs as the concept of size is relative with reference to the local economies.

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 sectors which are very traditional to the most modern and cutting edge industries competing 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. 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'.

India can today boast of a very large banking sector which meets a reasonable level of the debt requirements of the SME sector. 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 banking sector. While there is a fast growing VC/ PE industry in India, the requirement of capital is much larger and therefore there is 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 of a SME Exchange

An exclusive stock exchange for SMEs will enable SMEs 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. The companies can also use their stock as currency for acquisitions. It gives an opportunity to the early investors to unlock the value of their holdings.

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. With an exit route visible, 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.

Governance aspect

SME Exchange, while ensuring product innovation, should ensure that there is no compromise on risk management. Conversely, small and growing companies are riskier investments and as such require higher

quality of scrutiny. SEBI has placed the responsibility of gate-keeping on the exchanges, and will not be giving observations on SME offer documents. This should be taken as an opportunity to establish processes to suit the issuer and investor profile expected on such a platform.

SMEs need handholding for initiation into Capital Markets. They have to be introduced into the journey of becoming process-driven, rather than promoter-driven. Many good SMEs stay away from the Capital Markets as the many compliance requirements perplex them. The Exchange must strive to make the processes simpler, though not weaker, and assist the SMEs in being prepared. NSE has developed a unique web-based interface which has made the quarterly compliances much easier and quicker for the corporates. Such initiatives ensure that compliances are not viewed as a burden by the issuers.

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 unclear purposes, siphon public money, or worse, 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 exchange will also provide an exciting opportunity to informed investors to invest early in future 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

Global experience: Many countries have made efforts to set up a separate platform or exchange for SMEs and not all have been successful. The success of the exchange is hinged on its ability to create meaningful value proposition for all market participants. Internationally, there have been a few successes in junior markets. The most quoted successes are the NASDAQ market of US, which identified itself with the technology businesses. AIM market of LSE, London is also a much talked about alternate market. AIM's success in last 5-6 years enabled issuers from different countries to get listed. AIM uses the services of Nominated advisors (NOMADS) for admitting issuers on the platform. Other markets are ALTX of South Africa, GEM of Hong Kong, Mothers of Tokyo and TSX venture exchange in Canada.

Cost: 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 and also use of technology.

Liquidity: The next big 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 help create some minimum liquidity in the listed scrips, however, it is critical that the market making mechanism works in a credible manner. NSE offers another trading option to companies listed on its SME platform – the call auction mechanism, which will aggregate liquidity in short trading sessions and thereby reduce volatility.

Information dissemination: Facilitating extensive research coverage for the listed SME scrips is also critical for investor interest. Exchanges should proactively work on this aspect. For example, NSE has tied-up with CRISIL to provide research coverage on companies listed on its main board as well as SME platform, improving access to information for investors. Further, the entire experience can be made much smoother with smart 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 other incentives given by government to investor on junior platforms in other places in the world.

What SMEs need to do to prepare for listing

While a new SME exchange will enthrone a large number of SMEs, they need to understand the fact that they need to prepare months and sometimes years in advance to list on a bourse. 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 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. The companies should have a credible plan for utilizing the capital effectively so that the promised growth plan is realized. Last but not the least, the promoters should be committed for long term shareholder interest and all their actions should be aligned to meet this objective.

NSE's Emerge

NSE recently launched its SME platform – Emerge. Emerge has been uniquely positioned as a platform where fast growing companies with scalable business model and good management teams can raise funds for their varied business needs. The platform is for informed investors who have a medium to long term investment horizon to find venture kind of opportunities.

NSE has taken steps to ensure a robust third party diligence of the companies. NSE has also introduced certain voluntary processes which will help the issuers in building credibility. SMEs will be given handholding support in their journey to raising capital on a public 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 exploit these opportunities and grow exponentially. The Indian landscape has also changed & the Indian markets have matured substantially over the past decade and are now ready for a product like an SME Exchange.

Several Indian SMEs have taken advantage of the growth opportunities in the past two decades and grown onto large multinational corporations. 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 handsome returns, which have brought the biggest and most reputed investors in India. 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. 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.
