

MSME Financing



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Introduction

Every tree was once a seed and every business in the world started small before it became big. Small businesses usually begin with an idea generated by a few individuals. Most of these entrepreneurs invest their own money and often take the help of family and friends in the form of loan or equity to start the business. Once successful, these businesses require additional investment for expansion. It is then that the grim reality of raising finances shows up. But for larger companies, the situation is not so bad. They in a better position since they have access to various sources of finance such as banks, capital markets, private equity or other sources of credit throughout their lifecycle.

MSMEs in India

MSMEs (Micro, Small and Medium Enterprises) have long been recognized as an important element of the Indian economy, and even the leaders of the pre-independence era were strong supporters of this sector. They envisioned a vibrant and dominant MSME sector. They perceived MSMEs as an alternative to 'exploitation' by multinational firms.

With the advent of planned economy from 1951 and the subsequent industrial policy followed by Government of India, both planners and the Government earmarked a special role for small scale industries (SSI) and medium scale industries in the Indian economy. There was due protection accorded to both the sectors till 1991 when India adopted a policy of liberalization and globalization.

The Indian MSME sector has been greatly influenced by Gandhian Economics, sharing its founding principles of simplicity, humanism, social justice, co-operation, non-violence and harmony. Some of the key features of Gandhian development theory are self-sufficiency, balanced growth, doctrine of trusteeship, sustainable development and austerity. Operational features of MSMEs such as decentralization of production and consumption that takes place as close to the source of production as possible are on similar lines as *Khadi*.

Mahatma Gandhi believed that "just as the capitalist cannot make his capital fructify without the cooperation of labour, similarly the working man cannot make his labour fructify without the cooperation of capital." Gandhiji's thoughts emphasize the economic fact that labor and capital need to work together and in tandem for an economy to flourish.

Importance of MSMEs in an economy

In every developing country, MSMEs play a significant role as a key growth engine. Today, Indian micro, small and medium enterprises (MSMEs) account for 17 percent of the gross domestic product (GDP), 95 percent of all industrial units, 45 percent of manufacturing output and 40 percent of all the exports of the country. The number of small-scale units has increased from an estimated 6.79 million units in the year 1990-91 to over 13 million in the year 2007-08. Second only to agriculture in terms of providing employment, MSME sector has more than 70 million people working. In the last five years (since 2007), MSMEs have outperformed GDP and IIP (Index of Industrial Production) growth rates with an impressive Compounded Annual Growth Rate (CAGR) of 11.5 percent.

When the performance of this sector is viewed against the growth in the manufacturing and the industrial sector as a whole, it instills confidence in the resilience of the MSMEs. They have, in fact, been playing a critical role in the socio-economic development of Indian economy. They have been facilitating the growth objectives relating to:

- Employment generation through labour intensive mode of business at low capital cost
- Significant export earnings
- Import substitution
- Complement large industries
- Ability to develop frugal innovative technologies (Jugaad)
- High contribution to domestic production and local consumption
- Reduce regional imbalances with equitable distribution of wealth

Given the growth story of MSMEs, the development of entrepreneurs is critical to India's growth and development. India cannot enjoy the fruits of demographic dividends without creating jobs for the nearly three million graduates

who pass out of colleges every year. Only a highly decentralized sector like Small and Medium Enterprises (MSMEs) can absorb these many people in any given year. Therefore, new entrepreneurs and new funding models to help grow their business are the need of the hour. Majority of the new entrepreneurs of today are still self-financed. There is a widely held perception among young entrepreneurs that it is very difficult to get bank loans when an enterprise is at its infancy. Similarly, banks perceive that first time entrepreneurs are a higher risk. These apprehensions and perceptions have co-existed among the entrepreneurs and bankers for a long time now.

MSME Challenges

Unlike the agricultural sector, MSME sector is not considered as a vote bank by successive governments after independence. MSMEs have not been receiving the attention and priority they deserve. Of late, it is becoming increasingly difficult for MSMEs to secure both land and capital, as the importance has grown tremendously towards bigger corporates in the name of employment generation.

Financing challenges

Economic theories support the concept of low capitalization with the use of cost effective localized resources to achieve an effective return on investment (ROI). However, to fully optimize resources and opportunities, MSMEs need timely and unrestricted access to financial services, which has historically been severely constrained. Borrowing funds typically costs MSMEs three times more than it costs Fortune 500 companies.

According to the International Finance Corporation (IFC), of the 445 million micro, small, medium enterprises in the developing world, over 70 percent do not use the services of financial institutions. In India, the numbers are more discouraging, with over 92 percent of MSMEs running on self-finance. Global financial crisis and the resultant liquidity constraints have further deteriorated MSME's access to credit, which has affected the growth of MSMEs and impeded overall economic growth and development.

MSME's fund requirements are not large enough for them to enter the equity market or to raise capital through bond or debenture issues. They have to depend on banks for their financial needs. Such formal sources of funds require MSME owners to mandatorily provide higher collaterals and personal guarantees. Moreover, banks have a limited reach into rural areas where MSMEs usually exist which leads to poor risk appraisal due to lack of local knowledge. This makes bank financing even more difficult. As a result, banks finance only 20 percent of the MSME fund requirement. Stringent lending guidelines and risk-averse nature of financial institutions compel many MSMEs to often rely on informal sources of capital such as borrowing from relatives or moneylenders and the unorganized market for their financing needs.

Adding to the woes of raising funds, MSMEs often face challenges on operational and business aspects too. They have limited capability and expertise to create business plans, hire consultants and other experts, and the organized financial sector perceives this as a high risk and low profit business due to high administration costs.

Conventional wisdom and general perception is that the default risks of MSMEs are high and they are financially vulnerable. Banks face challenges like lack of transparency in financial reporting and other information since most MSMEs follow a sole proprietorship or partnership structure. It is difficult for financial institutions to take an informed lending decision given the poor quality of information provided by the owner. MSME entrepreneurs tend to mix business and personal finances which poses a challenge for creditors to accurately analyze the credit worthiness of these enterprises. The diverse nature of MSMEs and difficulty in identifying clear success factors further add to the challenges faced by banks.

According to an OECD report "manufacturing firms with fewer than 20 employees were five times more likely to fail in a given year than larger firms". Thus, MSMEs are at a particularly severe disadvantage when trying to obtain financing relative to larger and more established firms. In addition, there is a high administrative and monitoring cost for small scale lending which is another disincentive for banks while lending to MSMEs.

During FY 11, private sector banks and public sector banks have shown more than 35 percent growth. However, public sector banks account for 77.5 percent of total credit given to the MSME sector and advances for FY11 grew by 35.3 percent to Rs 3.76 lakh crores. This clearly shows that the lending to MSME sector is not by choice but due to the Government policies and push from RBI.

Table 1: OUTSTANDING BANK CREDIT TO MSME**(Rs. crore)**

As on last reporting Friday of March	Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial Banks
1	2	3	4	5
2005	67,800	8,592	6,907	83,498
2006	82,434 (21.6)	10,421 (21.3)	8,430 (22.1)	1,01,285 (21.3)
2007	1,02,550 (24.4)	13,136 (26.1)	11,637 (38.0)	1,27,323 (25.7)
2008	1,51,137 (47.4)	46,912 (257.1)	15,489 (33.1)	2,13,538 (67.7)
2009	1,91,408 (26.6)	46,656 (0.0)	18,063 (16.6)	2,56,127 (19.9)
2010	2,78,398 (45.4)	64,534 (38.3)	21,069 (16.6)	3,64,011 (42.1)
2011 Provisional	3,76,625 (35.3)	87,857 (36.1)	21,461 (1.9)	4,85,943 (33.5)

*Source: Reserve Bank of India.***Branding and Marketing Cost**

MSMEs are facing high cost of borrowing due to asymmetric information and at the same time the prohibitive cost of branding and marketing results in tremendous margin pressure.

Inability to capture new markets and compete with big players/Chinese counterparts in terms of quality and pricing is a major challenge. With growing access to modern means of communication, MSMEs stand to gain by harnessing the power and reach the 'web' has to offer. The price of print and other media for marketing is unaffordable to most small enterprises. MSMEs are left with little choice but to become internet savvy. Web marketing has proven to be an effective and economical marketing tool. Indian MSMEs need to recognize the fact that in this era of globalization, they aren't competing against themselves but with their counterparts across the globe.

Growth and Sustenance Related Challenges

A recent report in the newspaper 'Mint' claims that entrepreneurs of established MSMEs are losing their hunger for growth. The excitement and perseverance seen in the first generation of entrepreneurs does not seem to transfer to subsequent generations. Due to asset price inflation, asset values may have increased many times, beyond their expectations. This never before seen wealth usually leads to lack of motivation among the younger generation to retain and expand their businesses.

Subsequent generations may also lack the family support enjoyed by their previous generation with breaking down of the joint family system. Unless the M&A market picks up, it is difficult for an entrepreneur to encash the business value and one day it dies naturally.

Human Resource and Employee Retention Challenges

It is in the interest of any company irrespective of its size to realize the importance of a competent workforce. In an effort to keep profit margins high, small companies tend to neglect critical HR activities.

Low investment ability and lack of in-house training facilities results in a higher attrition rate for MSMEs when compared to large corporates. This leads to nearly 20 percent higher employee costs. Lower profit margins constrain MSMEs in offering competitive packages. They usually do not have a dedicated Human Resource Department which can provide effective screening process and manage resources effectively. People acquisition, development and retention activities will help small organizations to control costs and focus time and energy of other aspects of business.

Table 2: COST COMPARISON OF LARGE & MSMEs in IT

	Large Companies	MSMEs
Land	Get large tract at very reasonable cost	Face high cost & often lock up too much of capital
Per Seat Capital Cost	100 percent	160 percent
IT & Communication Infrastructure	100 percent	183 percent
Redundancy, Business Continuity	Yes	No
Facility & Admin Cost	Low	Disproportionately high
Financing	Huge Cash Flow	No Bank Loans
Variability of Revenue	Low (100 percent)	Very High (500 percent)
Employee Cost	100 percent	120 percent

Infrastructure related challenges

Most of the MSMEs are located in semi-urban and rural areas. They are facing challenges due to inadequate infrastructure facilities, including power, water, roads, etc. Other adverse effects of location are procurement of raw materials at a competitive cost, access to the modern technology and technicians to operate those machines etc. The Government's decision to encourage only SEZ and do away with the most successful STPI scheme has meant steep decline for the Indian IT sector. Countries like Philippines are reaping the benefits of Indian Government's indifference.

Overcoming Challenges

In order to overcome the huge number of challenges faced by MSMEs, they need support from all stakeholders including government, banks, other financial institutions, market participants, research institutes, media, etc. MSME entrepreneurs need to introspect and upgrade their own skills especially finance related skills, which helps them in resolving financing challenges.

According to a report by the Ministry of MMSME, only about 13 percent of the small enterprises obtained technical know-how. Going further, the investment in R&D will emerge to be the key differentiating factor for survival and growth. As the country integrates into a global village, the MSME sector will have to respond accordingly.

MSMEs often tend to compromise on quality when the pressure on profit margin grows. This is another important business aspect that a small organization needs to give due consideration to survive.

India currently ranks a lowly 132 among around 183 countries in terms of 'ease of doing business'. The rank is even worse at 181 for 'dealing with construction permits'. The role of government is a critical one to overcome many challenges and to create a favorable growth environment.

Government support

MSMEs have been the thrust area of government policies for the last few decades. Every Government has continuously supported MSME sector through different policy initiatives as recommended by several committees, taskforces and study groups. Some of the recent developments are:

- Indian MSMEs can now raise funds through capital markets since SEBI has approved MSME platforms in both the stock exchanges.
- With the ambition of creating 500 million skilled workers by 2022, institutions like Ministry of MMSME, Prime Minister's National Council on Skill Development, National Skill development Corporation (NSDC) – a public private partnership initiative announced by the Finance Minister in his 2009 budget speech, are working towards training and providing financial support to various programmes for the development of entrepreneurship and employment opportunities.
- Setting up of the Rs.5000 crore India Opportunities Venture Fund along with SIDBI
- As per the Public Procurement Policy for goods produced and services rendered by Micro and Small Enterprises, Ministries and Central Public Sector Enterprises are required to procure a minimum of 20 percent of their annual purchase from Micro and Small Enterprises.
- While introducing 100 percent FDI in the single brand retail, Government proposed the policy of mandatorily sourcing 30 percent of their requirements from micro and small industries.

There are many other schemes, which were announced and implemented during last decade. Out of those existing schemes the most popular and significant ones are:

- The Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGMSE) was launched by the Government of India to facilitate collateral-free credit to the micro and small enterprise sector. This scheme covers both the existing and the new enterprises. The Ministry of MMSME and SIDBI established a Trust named Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) to implement the Credit Guarantee Fund Scheme for Micro and Small Enterprises. Under this scheme, term loans and working capital facility of up to Rs. 100 lakh per borrowing unit are extended without collateral security or third party guarantee to a new or existing micro and small enterprise.
- Performance & Credit Rating Scheme - NSIC had formulated this scheme for small enterprises and as its implementing agency, is operating the scheme through accredited rating agencies. The fee to be paid by the micro, small & medium enterprises for the rating is subsidized by the Government to the extent of 75 percent. The independent risk evaluation by a third party has helped both banks and MSMEs in reducing the information gap and improving credibility respectively.
- Credit Linked Capital Subsidy Scheme (CLCSS) - a scheme for technology upgradation of MMSMEs. The scheme aims at facilitating technology upgradation by providing upfront capital subsidy to SSI units, including tiny, khadi, village and coir industrial units, on institutional finance (credit) availed by them for the modernization of their production equipment (plant and machinery) and techniques. The Scheme (pre-revised) provided for 12 per cent capital subsidy to SSI units, including tiny units, on institutional finance availed by them for induction of well-established and improved technology in selected sub-sectors/products approved under the Scheme.

Government can create a more favorable environment by introducing differential taxation for MSMEs similar to the individual tax rates, decrease in number of taxes, extension of credit rating subsidy to renewals etc. Investment in infrastructure development like ports, roads etc. would directly or indirectly help MSMEs in overcoming their challenges.

Born Global MSMEs

The “born global” firms are those which involve in a significant export based international activity from the beginning. Usually MSMEs need to establish themselves in the local market before expanding to the international level. However, these MSMEs are born with the ability to produce export quality products and services. This trend was first seen in high technology start-up companies and was later adopted by low-tech companies. This kind of a model not only serves the local market but also the international market where the quality of products and services is much higher.

MSME Clusters

MSME clusters have been successful in promoting consistent growth of small companies all over the world. The success of these clusters is largely due to the collaboration and sharing among these closely held small individual firms. These clusters are informal networks of smaller firms with a foundation of cooperation and sharing. Clustering is a proven way for MSMEs to grow and sustain their business for a long time. It helps develop core competencies among smaller players and enables them to be part of a specialized supply chain within the cluster. Interdependency is the key factor for the success of these specialized firms as they are all part of the overall production process, complementing each other in some way. Cooperation among firms enables capacity building and flexibility to scale up or down at any time. In a cluster, everyone benefits if one firm is able to get a big order.

According to a ASSOCHAM report, clusters like Ludhiana, a city in Punjab, produces 95 percent of country's woolen knit wear; Panipat, a small city near Delhi accounts for 75 percent of the total blanket production in India; Tirupur near Coimbatore contributes 80 percent of the country's cotton hosiery exports; Agra has more than 6,000 MSMEs manufacturing about 0.15 million pairs of shoes in a single day. This highlights the power of clusters and their consistent dominance in the field.

Role of Credit Rating Agencies in improving MSMEs' access to finance

Credit rating agencies could play a vital role in bridging the information gap between formal sources of finance and small business owners. Rating agencies assess a firm's financial strength and ability to honour business obligations. A rating agency can provide a comprehensive, transparent, reliable and independent view of the business which benefits both the lender and the borrower.

Summary

MSMEs play a vital role in the economic and social development of the country. The MSME sector contributes significantly to the country's GDP, employment and exports. There are numerous opportunities for this sector to enhance efficiency and serve both domestic and international markets. As an African proverb goes, "The best time to plant a tree is twenty years ago. The second best time is now", now is the best time for MSMEs to upgrade their competencies to prepare for the new era with rapid product life cycle. In the coming days, let us hope that with better support from Government and financial institutions along with cooperation, adaptability, innovativeness and resilience, MSMEs overcome all challenges including those of financing.
