Unleashing the potential of SME Exchanges in India: Challenges and Prospects

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Micro Small and Medium Enterprises (MSMEs) are the foundation of a growing economy and play a crucial role in uplifting the socio-economic status of the people. With reference to India, MSMEs are major contributors to Gross Domestic Product (GDP) and exports with a share of approximately 30% and 50%, respectively and are second to agriculture in terms of employment. Therefore, their growth becomes extremely critical for sustainable and balanced development of the economy. However, these enterprises continue to face various headwinds. One of the most significant of these is the challenge of 'access to affordable finance'. The inherent characteristics of the MSMEs like family-owned businesses, reliance on informal channels of credit, conventional technologies etc., put them at a disadvantaged position vis-à-vis the large corporates. This dichotomy between MSMEs and the large corporates also extends to the market-based finance i.e., capital markets which has remained elusive to the MSME sector.

Fortifying SMEs through Capital Markets-

While there is a large pool of Banks and other financial intermediaries providing debt financing to MSMEs at competitive rates, awareness amongst MSMEs regarding equity options is limited. Through the life cycle of MSME financing, at initial stage the businesses are funded by own capital of the entrepreneurs which later graduates to debt from banking / financial institutions. During the growth stage of the MSMEs, the entities seek broadening of the shareholding structure and assistance from VC / PE firms. This is where a significant role can be played by capital markets in providing fillip to and an alternate for the vertical growth of the MSMEs.

However, the case in India is a peculiar one. The MSMEs shy away from growth to continue availing benefits extended to the sector. The challenge is exacerbated due to the large presence of informality in the sector creating obstacles in establishing formal credit connect. Therefore, challenge is firstly formalization of MSMEs, followed by capacity building, credit connect, growth and lastly access to capital markets.

The constraint with bank financing is the requirement of collateral / asset-based lending by banks, high interest rates due to information asymmetry and large turnaround times in processing. Difficulty in compliance with the above requirements limits the formal credit offtake by the MSME sector. Nevertheless, Bank financing shall continue to remain a key source of finance for MSMEs in India.

However, sophisticated entrepreneurs in the MSME space, often perceived as ambitious drivers of Startups, are realizing the advantages of equity financing namely, improved debt-equity ratios leading to lower financing costs and healthier balance sheets; opportunity for secondary equity financing through expansion of the investor base; providing room for growing business from expansion to acquisitions; employee stock ownership plans (ESOPs) providing incentives to employees to be integrated with the company and avail benefits of being shareholders. Through this mechanism some entities may seek longer financing options and improved ability to take bank finance. Few SMEs may also participate in listing on exchanges to enhance the visibility of their products and improve their credibility leading to increase in value of shares.

Overleveraged balance sheet of growth stage SMEs necessitates requirement of equity capital over debt finance to improve sustainability of the enterprises. Raising equity through capital markets may even be favoured over investments by VC/ PE firms due to difference in valuation by such VC / PE firms and enterprises[1].

Listing on exchanges is an aspiration for entrepreneurs around the world. Fulfilling these aspirations of SMEs and providing support to the growth drivers of the economy, India set up two bourses for the SME sector- BSE SME platform and the SME 'Emerge' by NSE.

These bourses provide listing opportunities to SMEs with minimum compliances and costs compared to the main board. The listing norms for SMEs on the bourses are less stringent and are designed to encourage SMEs for listing. These exchanges act as a match-making platform for SMEs seeking equity and investors seeking investment opportunities in high-growth SMEs. But the central question pivots on the ease to serve as an alternative platform to the VC/PE route of funding?

Limitations hindering full potential of SME Exchanges and prospects for future growth:

During 2021-22, `1.13 lakh crore was mobilised through 121 IPO / FPO issues, out of which 70 issues amounting to `958 crore, less than one percent of the total, was listed on the small and medium enterprises (SMEs) platform of the BSE and the NSE[2].

While there has been an improvement in the performance of the SME IPOs, challenges still persist for SMEs to list on the exchange. The foremost challenge that emerges is the high eligibility criteria posed to SMEs, thereby failing to appreciate the lower growth that is characteristic of this sector in areas of technology, innovation, and resources, thus restricting the pool of SMEs that have the capacity to list on such exchanges.

Another challenge emanates in the form of valuations of the SMEs. Higher valuations raise the demand for SME IPOs which in turn warrants a high return on investments. While valuations are backed by the fundamentals of the company, it poses a challenge for the SMEs in view of their vulnerability to various economic and market forces. The performance of these companies could be impacted in the wake of tightening liquidity in the system[3], global headwinds impacting operations, leading to lower valuations and lower rewards to the investors. This may result in positioning SMEs as ‘risky businesses’ to even the sophisticated investors that are permitted on the small bourses.

Apart from the challenge of awareness and capacity building of SMEs with regard to the listing on the exchanges, compliance of regulatory obligations also poses a challenge for SMEs as they are required to adhere to various regulations of SEBI, Companies Act etc., while listing on any of the exchanges. Further, penalties imposed due to non-compliance of regulatory requirements is a cause of consternation. This is a risk which make SMEs reluctant to join the capital market as it may adversely impact the credibility and image of the SME company.

Given the traction that IPOs, in general, have gained in recent years as well as the rise in the retail investors in equities, with the opening of 3.46 crore demat accounts during 2021-22, as against 1.42 crore demat accounts opened during the previous year, the time is opportune to support SMEs and an urgent need to review and rationalize the listing requirements of SMEs. For instance, for listing on SME exchanges, SMEs in India are required to have a track record of at least 3 years or in case it has not completed its operation for three years then the SME should have been funded by Banks or financial institutions or Central or state government or the group company should be listed for at least two years either on the main board or SME board of the Exchange. Further, they should have positive cash accruals (earnings before depreciation and tax) in any of the year out of last three years and its net worth should be positive[4]. These guidelines along with other compliance costs result in only few sophisticated enterprises to apply for listing on SME exchanges. The basic difference between risk capital and debt funding gets blurred when an SME exchange fails to establish a set of financial rules for raising capital as distinct from that of banks.

It is important to relax a few of these guidelines to widen the access to capital markets. For instance, ‘the National Equities Exchange and Quotation (NEEQ) of China, has relatively low listing requirements and shorter listing timeline which have greatly expedited financing for small, high-growth internet enterprises. Listing on the NEEQ requires a company to have a valid existence for only two years, whereas the main exchanges in China require three years. Unlike the other boards that have minimum pre-IPO profit requirements, the NEEQ only requires a company to have ‘sustainable profitability’ and does not elaborate on what these requirements are. NEEQ only allows qualified investors to participate and caps the number of shareholders at 200 to protect the retail investor from high-risk securities’[5].

It is imperative to clearly communicate to both promoters of SMEs and sophisticated investors how listing will lead to greater valuations and higher disclosures thereby attracting more capital that can help businesses to grow faster and more sustainably over the long term while also enabling personal wealth creation and liquidity for promoters. The success of startups with clear policies of the government to provide capital support at an early stage through participation of high networth investors and low regulation has added a new dimension to the textbook definition of MSMEs. Risk and return go hand in hand with market forces discovering valuation yet underpinned by a strong disclosure regime. A review in enhancing the limit of the post issue paid up capital of the company (face value) presently at ` 25 crores may also be undertaken.

In conclusion, democratizing the access to capital markets by SMEs is a pressing priority. Regulators may consider relaxing the listing requirements and compliances without compromising the structure, integrity and stability of the SME exchanges. The strive should be to make capital markets more inclusive and approachable with the smaller MSMEs being inspired to list on exchanges.

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1 IFC | An Assessment of the State of Risk Capital Finance to the Micro, Small and Medium Enterprise Sectors in India
2 RBI Annual Report 2021-22
3 A direct growth driver: The benefits of listing on SME Exchange | Economic Times
4 BSE SME | Criteria for New Listing
5 U K Sinha Committee- Report of the Expert Committee on Micro, Small and Medium Enterprises