

A STUDY ON FINANCING GAP IN MSME SECTOR IN INDIA

Anil P S* Dr. Gajendranaidu**

*Pursuing PhD in Bharathiar University and Associate Professor, Gnanam School of Business, Thanjavur.

**Professor and HOD, Auden College of Engineering and Technology, Bangalore.

Abstract

Micro small medium enterprises in India contribute a considerable quantum in GDP every year. This research article based on secondary data collected from various journals, annual reports of ministry of MSME Govt. of India, and other such reports studied the financing issues of the sector. It also evaluated the effectiveness of available financing options as well as the gap in the financing of this sector. To study the financing gap the author also studied the various other factors too. The general land scape and organizing pattern also studied to evaluate the performance of MSME units. The application of equity fund in this sector is new dimension of the study.

Key Words: MSME Sector, Land Scape of MSME, Equity Fund.

Introduction

In India MSME plays a vital role in the economic development of the nation by contributing 11.5% of GDP consistently every year. It acts as a catalyst for the socio economic transformation not only by generating employment opportunities in both rural and urban areas of the country but also promoting rapid industrialization in the country to the length and breadth of the country by eliminating regional imbalances. The most important factor of this sector is identification of the requirements of the area and utilization of the available recourses locally to reduce the cost of production. It prevents poverty, unemployment and migration from rural to urban.

Definition of MSME

According to Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, Enterprises engaged in the manufacture or production, processing or preservation of goods as specified below:

- A micro enterprise is an enterprise where investment in plant and machinery does not exceed Rs. 25 lakh;
- A small enterprise is an enterprise where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore;
- A medium enterprise is a one in which the investment in plant and machinery is more than Rs.5 crore but does not exceed Rs.10 crore. In case of the above enterprises, investment in plant and machinery is the original cost excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification

Enterprises engaged in providing or rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and other items not directly related to the service rendered or as may be notified under the MSMED Act, 2006 are specified below.

- A micro enterprise is an enterprise where the investment in equipment does not exceed Rs. 10 lakh;
- A small enterprise is an enterprise where the investment in equipment is more than Rs.10 lakh but does not exceed Rs. 2 crore;
- A medium enterprise is an enterprise where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore

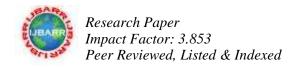
As per the private financial institutions in India, the internal definition of MSME can be explained with the help of the following table.

However the use official definition given by the MSMED Act for reporting purposes is reliable and valuable.

Background of Indian MSME Sector

Growth of MSME sector recorded high in India. According to report of fourth All India census of MSME conducted proves that the sector contributes significantly in increasing the number of units, generating employment opportunities and market value of fixed assets.

The growth rate is 11.5% which is higher than the overall GDP rate that is 8%. There are more than 6000 products other than the traditional household and cottage industries products today by MSME sector in India. This shows that every sphere of human life and products from this sector is available.



Types of MSME

Regarding the number of MSME units, unorganized MSME units are more than the organized. In the organized sector itself, registered units are only 1.8 million as compared to 28 million unregistered units. The unorganized units are more than 30 million units.

According to the MSME census by Ministry of MSME, Govt. of India, the sector has recorded an effective growth rate of 4% annually for the past few years from 2008-10 onwards. The registered sector is dominated by the unregistered units.

Different Types of Ownership and Growth Impacted by Multiple Constraints

There are more than 5 types of ownerships in MSMEs in India. Among them proprietorship of business is common (94.5%) whereas the rest all together only 5.5%.

Although the MSME sector has been growing at a faster rate than the overall industrial sector, MSMEs experience multiple constraints that threaten to derail the sector's growth trajectory. Some of key hindrances that MSMEs face

Inadequate Market Linkages

Other than cluster-linked and ancillary MSMEs that have natural linkages with large enterprises, MSMEs are having poor market access. The non-clustered MSMEs are divided, and hence, are unable to shape themselves in order to reduce purchase cost from large enterprises or reorganize the retail chain.

Lack of Infrastructure

Inadequacy of infrastructure such as power, water and roads upsurgesoperating costs for MSMEs and marks their businesses uncompetitive. Insufficient access to backingof infrastructure dejects these units from implementingwhere newer technologies available.

Inadequate Finance

MSMEs ponderencounters in accessing finance as one of the biggest constriction in growth. Various researcheson the MSME sector also propose that the multiple growth constraints can be mostlyrelated to insufficient access to finance.

Lack of Managerial Competence

Micro and small enterprises in particular largely comprise first-generation entrepreneurs, who have had a limited structured training on resource planning, capital management and labor management.

Outdated Technology

While large industries like automotive, forging, software development sector wantcutting-edgeknow-how in operations, the majority of the small and medium enterprises are lacking the same. A low technology base outcomes in low productivity, which makes these enterprises not competitive in nature.

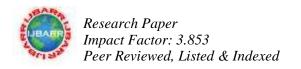
The 2007 MSME Census signposted that only 5 percent of enterprises in the sector had access to some form of prescribed finance, while over 92 percent of the units lacked access to any arrangement of institutional finance. Studies on financing designin the sector and the MSME census suggest that MSMEs choose self-financing, which not just includes the savings of the entrepreneurs, but also the finance availed from friends, family and relatives.

Demand for Finance in MSME Sector

The general demand for finance in the MSME sector is assessed to be INR 32.5 trillion. The mainstream of finance demand from these units are in the form of debt, projected at approximately INR 26 trillion. Total demand for equity in the MSME sector is INR 6.5 trillion, which makes up 20 percent of the overall demand. The sector has high leverage ratios with average debt-equity ratio of approximately 4:1. But these leverage ratios are not even across the sector and variations exist based on the size of the enterprise. The unregistered enterprises, which comprise approximately 94 percent of the MSMEs, account for INR 30 trillion (\$600 billion) of the finance demand. This demand estimate does not take into account the demand for finance by unorganized enterprises.

Debt Finance Demand in MSME Sector Demand

Financial institutions have traditionally limited their exposure to the sector due to the perception that these businesses carry high risk and high cost of delivery, and have limited access on the immovable securities. To estimate the viable debt demand that can be addressed by financial institutions, the study does not take into account the demand from the enterprises that are either considered unviable in the near term, or those that voluntarily exclude themselves from formal financial services.



- Since most of the units in this sector are either sick, or doing at limited operational efficiency almost 38% of overall
 debt demand is not viable and addressable.
- Informal sources of finance is so easy to get and formalities are also simple. Hence a large number of units in this sector like small retailers, repair shops etc. are preferring only informal sources of finance.
- Based upon the above listedeliminations, it is assessed that the total debt demand of INR 26 trillion, at least 38 percent or INR 9.9 trillion is the amount of the viable demand that can be financed by the formal financial sector.

About 90% of the total viable and addressable debt demand (approximately INR 8.9 trillion is from unregistered enterprises, and the balance demand of INR 1 trillion is from registered MSMEs.

Out of the viable and addressable demand of the debt of this sector, requirement of the working capital is the biggest component of capital which is estimated at 61% of total capital requirement. Studies on the year on year balance sheets and other available data of MSME states that gross working capital that is total current assets requirement is 74% and fixed capital requirement is only 26%. This shows the importance of working capital requirements on MSME UNITS.

Debt Demand on the Basis of Size of Enterprises

Recent statistics saythat out of INR 9.9trillion total finance provided by financial institutions, to MSME sector, INR 4.4 trillion has been granted to micro sector, INR 2.9 trillion to small sector and 2.6 trillion to medium sector. The micro and small sector alone got74 percent of this debt demand, and hence form the focus of the priority sector lending norms.

Micro Segments

Most of the micro units are operating in order driven industries like, retail shops, repair and service stations, hotels and restaurants, small textile shops etc. wherein they require a huge working capital requirement. Following features are remarkable:

- Study of the viable and addressable debt demand shows that a minimum 10.6 million micro enterprises in the country create a viable financing section for formal financial institutions in the near future.
- Top researches in this field shows that the average credit requirement of a micro enterprises including manufacturing and services sector is estimated to be INR 0.3 million to INR 0.4 million.
- Most of these enterprises mainly deal for cash terms, and hence no proper maintenance financial record is available. This makes financial institutions difficult to assess the credit worthings of such units.

Small Segment

Small scale sectorinvolve higher levels of capital investments. It operates in manufacturing and knowledge-based service industries. Entrepreneurs who run small units have a comparatively better knowledge levels of external sources of finance.

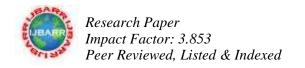
- Evaluations show that 0.7 million small units are viable for financing and addressable by organised financial institutions.
- The credit requirements of these units including manufacturing and service sector assessed to be INR 4.5 million. It is very difficult for them to reach formal financial institutions to get the finance with their limited collateral securities.
- Although established small scale industries like knowledge based enterprises tend to use bank instruments for most of
 their business transactions. Lack of maintaining financial credentials will again increases the gap of accessing formal
 finance.

Medium Segment

Medium enterprises show a more probable demand for debt, and these units are able to access multiple sources of finance. Businesses in the segment are typically structured as limited companies that allow for mixture of alternative form of capital such as equity.

The average capital requirement of medium sized units in manufacturing as well as service sectors together is INR 40 million – INR 55 million.

- Medium-sized organizations are professionally managed and as a result they are able to explore financing from multiple sources.
- The history of these units are traceable. The have good relationship with so many good financial institutions. Hence they can easily access to financial services



Breakdown of Debt Demand by Type of Enterprise

61 % of the viable debt demand by formal financial institution is available to manufacturing sector, whereas the services sector accounts for the balance 39 percent. Consequently, the stake of manufacturing and services in the feasible debt demand that can be addressed by financial organizations in the immediate term is INR 6 trillion and INR 3.9 trillion correspondingly.

Manufacturing Sector

Though the manufacturing sector accounts for a minor share of enterprises, operations are more capital-intensive, as a result of which working capital prerequisiteinclines to be complex in the manufacturing sector than that in the services sector. Some of the features of finance requirements of manufacturing MSMEs are:

- The average requirement for capital expenditure in manufacturing enterprises is projected to be INR 0.5 million per year.
- The claim for working capital in the manufacturing sector is driven primarily by originalities that tend to operate with significant amount of trade finance.
- At over 100 days, working capital cycles in the manufacturing sector are typically quite long because of which regular working capital necessities also tend to be higher.
- Originalities that forage large supply chains are known to experience longer working capital cycles as payment cycles are precipitate and depend on many players within the supply chain, causing higher working capital demand.
- Originalities affianced mainly in export are mainly unprotected to currency exchange rate oscillation. In case of adverse currency drive, the working capital needs of the enterprises increase.

Services Sector

Service industries such as retail trade, repair and maintenance, and restaurants are typically cash businesses with shorter turnaround, because of which their overall external capital requirements tend to be low on an average. Some characteristic traits of the demand of services enterprises are:

- The stake of working capital as a quota of the average debt demand for services enterprises is assessed to be nearly 41 percent.
- Services initiativesnecessitate less outside capital, other than for such things as premises revampprocurement and renovation of equipment. However, wantsubstantial capital backing during the initial stages.
- Most of these initiatives, they have limited admittance to permanent collateral securities which makes access to formal money.

Equity Finance Demand in MSME Sector

The general equity request in the sector is assessed to be Rs. 6.5 trillion, with short-term equity prerequisite accounting for Rs. 4 trillion, and long-term equity making up a demand of Rs. 2.5 trillion.

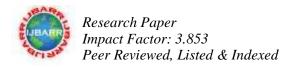
Study of financing designs in the MSME unitsproposes that initiatives use in-house money and informal sources to fund the short-term equity demand and 25 percent of the long-term equity demand.

Withoutcapitalists' equity contribution, the equity demand from outside sources is assessed to be Rs. 1.9 trillion. However, all the equity demand may not be viable and addressable as 95.7 % of initiatives are organized as either as sole proprietorship or partnerships that are not agreeable to external equity mixture.

Small Size Equity Investment in the MSME Sector

Based upon the study of the typical capital structure, the total equity request in the sector ranges from INR 0.1 million for micro enterprises to INR 24 million for medium enterprises. Excluding the entrepreneur's contribution towards short-term and long-term financing, the average investmentbe likely to be lower.

- Micro and small enterprises have limited access to external equity primarily because only minorities of firms afford
 early-stage equity capital. Even if the equity were made accessible, the approval would remain low due to: (a) legal
 structure of enterprises that prevent infusion of external equity; (b) small level of readiness and capability of
 organizations to succeed formal sources of equity capital; and (c) entrepreneur's apprehensionconcerning control and
 management.
- Medium sized unitsestablish a more balanced debt-equity ratio with assessments of average 2:1 leverage. This is
 owing to the improvedskill of the industrialist to fund capital, a more agreeablelawfularrangement and the incidence
 of business models that are ascendable.



Challenges for Enterprises in Equity Infusion

The capability of an initiative to takeoutside equity rest on its authorized structure. Joint stock Companies and partnerships limited by liabilitiespermitfinanciers to pervadeoutside equity in the organization. Other legal patterns such as sole proprietorship and partnershiphandover unlimited liability to the equity financier, hence discouraging equity mix in such entities.

A devastating 95.7 percent of MSMEs in India are sole proprietorships or partnerships and consequently, are unable to drawoutside equity. Though change in the legal pattern of an entity to limited company or limited liability partnership is a choice, it involves taxation and compliance outlays for the initiatives, frequently rendering the business planmonetarilyunrealistic.

Equity financiersnecessitateclearness in both economic record-keeping and governance. As a result, it is frequently the medium entities and established small entities which are able to keep their financials crystal clear, and tend to attract more equity investors.

Findings and Conclusions

Some of the interventions that can help transition the MSMEs into profitable funding opportunities for the financial sector include:

- a. Creatingalertness among businesspersons about how to get formal sources of finance that can lead to the growth of their organization,
- b. Promoting entrepreneurs to maintain high level of financial transparency and plan their monetary necessities improved,
- c. Forming an efficient policy environment to recover sick units and make them financially feasible,
- d. Providingmaturationcare to early-stage enterprises and,
- e. Increasing the enterprise knowledge on various low-overhead legal structures available to them.

Growth in the level of formal finance to the MSME sector could unlock enormous potential for the sector's growth and corresponding contribution to GDP. The overall finance gap in the MSME sector estimated should be channeled through formal sources of finance. The overall debt and equity finance is split into filling the debt gap and an equity gap.

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