

India's SME sector

by Mr. D.R. Dogra, MD & CEO CARE Ratings

@ All India Association of Industries on India SME Sector 26th February 2014

India's growth has been affected significantly in FY13 and FY14. Historically seen that whenever such a slowdown takes place, SMEs affected in a dual manner: fall in demand and hence sales and profits and lower access to credit. Their reaction invariably is three fold: cut costs, especially wages, seek out alternative sources of finance and postpone investment.

The SME segment has borne the major brunt of this slowdown in the following ways:

1. Access to credit has been difficult and when available, the cost has been high. They cannot take recourse to the ECB market as the larger units can and hence they have been affected by the slowdown.
2. The risk perception has been higher for SMEs as they tend to get affected both in terms of sales and receivables. Sales have been affected especially where their product is being channeled to the larger companies as inputs. Payment cycles have been affected and this gets reflected in their own ability to service loans and hence the creation of NPAs.
 - o Timely payments from customers will help SMEs in reducing their working capital requirements leading to lower interest costs, improved profitability and a positive impact on the long-term health and sustainability of India's SME sector. Delays in settlement of dues adversely affect the recycling of funds and business operations of the SME units. It is, therefore, critical to ensure that the small entities are able to raise liquidity against their receivables.
 - o Factoring not yet all pervasive for these units.
3. The global slowdown has affected Indian exports and given their significant share in our exports, there has been a major setback though this is turning around as can be seen in FY14.
4. Overall their profitability has been squeezed more than that of the larger companies as their costs remain high due to inherent challenges like access to infra, labour, power, raw materials etc.
5. In particular they have been affected on the cost side by exchange rate fluctuations though the export oriented units have gained on the exports side due to the rupee depreciation.

A turnaround in the global scene in 2014 is good news for the SMEs

- Export markets to be more robust this year (grow by 10-12%)
- Exchange rate however, will continue to be vulnerable given that the tapering programme will be executed fully in the course of the year which will impact their earnings and cost. (to be Rs 61-63/\$)
 - o Need to manage these risks through appropriate hedging strategies.
 - o Need to hone such skills and a professional approach needed. Can this be done immediately? Probably not as these are structural issues.

How about domestic situation?

- Interest costs will not come down any time soon as RBI will lower rates only when inflation is stable at a lower level. A maximum of 50 bps can be expected in second half of FY15 provided inflation moves according to RBI's schedule. Given forex volatility even if they can access foreign markets, their cost will remain high.
- Banks will still be wary of lending to them given the issue of NPAs which has surfaced.
- Domestic industry is not likely to improve soon – which means that their ancillary links will remain fragile. Industrial growth will be around 2-3% - our policy framework will be in place only after June-July.
- The government needs to start spending on projects so that the backward linkages are built with the larger companies and through them to the SME segment. This will not be too aggressive this year.
- It will still not be congenial to make investments in this environment.

Generic information on SMEs in India

A. Profiling this sector

- Indian MSME sector consists of approximately 45 million units
- Produces more than 6,000 products ranging from traditional to high-tech items, providing
- High product diversification: 67% of its produce is from manufacturing goods, followed by 17% in services and 16% in repairs and maintenance.
- Employment provided to around 101 million people.
- Contribution to economy
 - Accounts for 45% of the manufacturing output.
 - Contributes nearly 8-9% to the country's GDP
 - Accounts for 40% of the country's exports

It is evident from the above profile that the SME segment is an integral part of the economy and it is only appropriate that the government has been focusing on this sector in a progressive manner. We can also see that given the multitude of problems that they confront, the entire process of bringing them up to the next level will take time.

B. Qualitative contribution to the economy

- It plays an important role in providing backward and forward linkages to the large private sector.
- **Large number of SME units help build competitive spirit not only among the domestic market but also in the export markets.**
- It also plays a significant role for developing the nation through high contribution towards domestic production.
- Plays a crucial role in reducing regional imbalances, assuring more equitable distribution of national income and wealth along with its contribution to economic growth and development.

C. Challenges for the SME segment

Despite its significant contribution to growth, SME sector does not get the required support and hence, faces a number of problems. Some of the major concerns are:

- **Access to finance:** Credit to SMEs qualifies as priority sector credit and banks have been advised to achieve 20% y-o-y growth in credit to MSMEs.
 - o Yet 93% of units in this sector remain excluded from access to finance or depend on self-finance or the unorganized market, which is not sustainable in the long run.
 - o Besides, access to finance through bank credit, SME sector access to capital markets is limited.
- **Openness to external sector:** SME sector is unable to face the stiff competition from global competitors. Besides, the tough competition from global players the uncertain global economic scenario also poses challenges to this sector.
 - o Hence, this calls for change in government policies and strategies- instead of encouraging protection of these units; ***there is a need to enhance collaboration of SME units with large domestic corporates, multi- and trans-national corporations (MNCs/TNCs).***
- **Availability of infrastructure, technology and skilled manpower:**
 - o The existing infrastructure which generally includes power, water, roads, etc. is highly inadequate.
 - o Non availability of suitable technology and usage of obsolete technology leads to low production capacity thereby constraining further modernization and expansion of the sector.
 - o Lack of professionalism, training and labour laws has rendered limited skill and knowledge to this sector. It thus continues to operate in an informal set-up.
- **Management issues and SMEs sickness:**
 - o Considerable delays in settlement of dues by the large-scale buyers to the MSME units have been witnessed due to slowdown in industrial growth. This adversely impacts their recycling of funds and in turn their business operations.
 - o Vulnerability to exchange rate fluctuations leads to considerable losses to SME's while managing their transactions pertaining either to procurement of raw materials or exports of finished goods.

Solutions for SMEs

For finance:

- Use of business correspondent (BC) model, which provides greater reach of banks and better loan performance. The personal connection enhances the customers' accountability to the BC, which in turn improves loan performance and repayment rates.
- SMEs can be given preference by providing relaxation of KYC norms.
- SMEs need to be encouraged to take the venture capital route.
- SMEs can be given incentives to raise capital through the equity route.
- SMEs should be given short and long term credit along coverage of insurance and also export development and investment funds (EDIF) can be created in order to promote exports.
- Credit enhancement can be provided by creation of mutual guarantee schemes wherein foreign buyers can act as guarantors.
- SMEs should be encouraged to contribute periodically to Technology Development funds (TDFs). Also while using the BC model, the disbursement of loans can be linked to performance. This way they would get involved with upgradation and also have a stake in progress.
- FDI should be promoted in SME segment. Multilateral agencies can be provided with incentives to lend to SMEs.

Role of CRAs:

Credit Rating of MSME helps provide banks with insights on industry, opinion on credit worthiness and brief about business profile which facilitates faster decision making. We have observed that these enterprises have been deriving value from rating and have been coming to us progressively in larger numbers. Dissemination of information on SMEs through credit rating agencies like CARE helps in bridging information asymmetry.

- As rating helps in identifying single day delay in interest/principal servicing as default, it indicates the earlier signs of risky assets. Also, movement in rating captures the change in the financial risk profile, providing for timely planning for riskier assets. Credit rating also inculcates discipline in ensuring timely debt servicing by borrowers and also creates awareness about bank norms.
- Credit rating agencies help in reducing information asymmetry by bring out rating reports which provide information on borrower's strengths and weaknesses, Management overview, Financial overview, Operational overview, Future plans and Industry insight specific to firm/company's operation
- CRAs also provide risk-based pricing of bank facilities: Higher risk weighted assets entails higher interest rates thereby improving profitability of banks.
- CRAs reflect the risk weight associated with the ratings provided (long term & short term).
- CRAs offer an independent and unbiased opinion on credit risk associated with loans extended by the bank
- It facilitates the comparison between banks' internal rating and rating by CRA and factors contributing the same.

Others

- Clustering – Cluster support by IT and ITES systems will result in strengthening of productive activity.
- PPP – Public private partnership will help in creation of viability gap funding for SMEs
- Internal efforts such as working towards cash flow management and innovation in operation would result in increase in productivity.
- There is a need to set up more business associations like SME associations which would help SMEs with added information on latest technology, best trade practices, and much more.
- Improvement in training would also result in better operations of the enterprise. This will bring them closer towards the skill levels observed in larger industry.