# MSME –A Rising Star on Indian Landscape

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MSMEs constitute a vital sector promising high growth potential for the Indian economy as it encompasses both manufacturing and services. MSMEs are a major engine of growth and employment generation in the country and a major constituent of exports. In 2015-16, there were close to 63 million MSME units in the country that employ nearly 111 million people across various sectors. The MSME sector contributed to nearly 29% of the GDP while the contribution to total exports was at around 43% in 2015-16. The sector has recorded a growth rate of 7% in 2015-16. It assumes greater significance in the light of the 'Make in India' campaign operationalized by the government. In addition, the Digital India revolution has also provided a good scope to promote MSME participation in the Information, Communication and Telecommunication (ICT) sector.

## Problems faced by MSMEs

Despite the sector's strategic importance in overall industrialization strategy and employment generation, as well as the opportunities that the Indian landscape presents, the MSME sector confronts several challenges. The problems confronting these sectors are known as these are inherent in their operations given their structures. While the technological hurdles and financial problems are persistent, some of the other problems faced by this sector are high cost of credit, low access to new technology, poor adaptability to changing trends, lack of access to international markets, lack of skilled manpower, inadequate infrastructure facilities, including power, water, roads, etc., and regulatory issues related to taxation, labour laws, environmental issues etc.

Any improvement in their status would require adequate flow of credit from the formal banking sectors as this has become a precondition for their operations, which has appeared to be an obstacle in the overall growth of this segment. Traditionally public sector banks have been the lenders for formal credit to MSMEs. Private sector banks and NBFCs have been steadily extending credit to MSMEs. However, lately other lenders have also entered the MSME lending space such as FinTech companies. FinTech companies leverage on growing technological advances like smartphones and innovative and flexible credit products. These companies are providing the financial assess to MSME's by extending the loans themselves, connecting MSMEs to banks and financial institutions using marketplace model and by becoming financial product aggregators.

Despite, the main challenges in procuring finance for them are as follows.

First, the flow of credit is limited as while it is part of the priority sector lending and banks have to lend to them, they are reluctant to do so as the probability of NPAs is high especially during the downturn. Despite credit to this sector qualifying as priority sector credit and banks being advised to achieve 20% y-o-y growth in credit to MSMEs, a little over 90% of units in this sector remain excluded from access to finance or depend on self-finance. For export-oriented SME units the demand for trade finance becomes even more critical; particularly in the context of vulnerability to volatility in exchange rates, as was noticed in the last few years. Their problem is aggravated by the fact that when there is a downturn, the large companies who are their main purchasers delay in either picking up their products or making payment on time. This increases their receivables leading to greater reliance on banks finance. While there has been talk of setting up of factoring exchanges to enable them to churn their receivables, there has been limited traction here.

Second, the cost of borrowing is high as the risk perception is more compelling for banks. Therefore, while the other companies are able to borrow say within 100 to 200 bps over their base rate, SMEs end up paying 400-600 bps over the base rate. Hence, debt servicing becomes a challenge given that they do operate on thin margins to begin with and as a corollary, their propensity to default becomes higher.

Third, unlike their medium and large counterparts, these units are not in a position to borrow from international markets as they are too small to draw confidence. Therefore they can never take advantage of the lower interest rate situation in global markets

Consequently, the support from banks to this sector is hence quite low with less than 10-12% of bank credit going to the SME segment. Most of these non-registered enterprises do not even maintain proper books of accounts and are not formally covered under taxation areas. Therefore, banks find it difficult to lend to them.

## Recent measures

After realizing the potential for the MSME sector in India, the government of India has embarked on undertaking various measures to boost the MSME sector and tackle the issues faced by the sector.

- The policy interventions such as demonetization and introduction of GST have led to massive formalization of the businesses of MSMEs. GST compelled MSMEs to register in order to claim tax-credits. GST led to lower tax burden and easier compliance. The single tax will enhance the efficiency, improve demand and competitiveness. Due to lower costs there will be ease in starting new business. It will also lead to faster logistics and delivery along with better use of capital and lower interest cost.
- The formalization under GST is generating enormous financial information database of MSMEs' businesses and finances. It is expected that this big data base will be useful for improving financing of MSMEs' capital requirement, including working capital.
- The thrust towards digitalization has been advocated both by the present government as well as the banking and financial services industry for this purpose. Several new players, individually and in collaboration with banks and other institutions, have entered into the digital lending and information space.
- Further, the proposed onboarding of public sector banks and corporates on Trade Electronic Receivable Discounting System (TReDS) platform and linkage with GSTN would also be beneficial for MSME financing
- In the Union Budget 2018-19, the govt. allocated Rs. 3,794 crore to MSMEs sector for giving credit support, capital and interest subsidy and innovations. The FM had highlighted the importance of Fintech companies in growing the MSME sector.

- MUDRA Yojana launched in April, 2015 has led to sanction of Rs 4.6 lakh crore in credit from 10.38 crore MUDRA loans. 76% of loan accounts are of women and more than 50% belong to SCs, STs and OBCs. It has been proposed in the Budget to set a target of Rs 3 lakh crore for lending under MUDRA for 2018-19 after having successfully exceeded the targets in all previous years.
- In February 2018, the RBI granted a relaxation on NPA recognition of MSME entities registered for GST. The entities registered under GST with aggregate exposure of less than Rs. 250 million will be granted extension of maximum 180 days to repay the unpaid dues between Sept'17-Jan'18 to banks and NBFCs, without a downgrade in the asset classification
- The RBI also removed priority sector credit caps on MSMEs (services). The existing credit caps of Rs. 50 mn per borrower for micro and small and Rs. 100 mn per borrower for the classification under priority sector have been done away with.
- In February 2018 there were changes announced in the Credit Guarantee Scheme for MSMEs. The annual Guarantee Fees (AGF) will now be on outstanding loan amount rather than sanction amount. The coverage of the Credit Guarantee Scheme (CGS) would now be extended to MSE retail traders segment. Significantly, the extent of guarantee coverage is up to 75% from existing 50% for proposals above ₹50 lakh. Also loans with Partial Collateral Security under Credit Guarantee Scheme would now be included in the scheme. All this will benefit the units in this sector.
- Small Finance Banks focus on lending to un-served and underserved sections. These banks are mandated to extend 75% of Adjusted Net Bank Credit (ANBC) to the sectors eligible for classification as priority sector lending (PSL) with at least 50% per cent of its loan portfolio to loans upto Rs. 25 lakh.
- New players have entered the MSME lending landscape in form of P2P companies

## Credit rating - Access to capital

GST has mandated the registered entities to prepare formal accounts in the given timelines. This enable increased efficiency, decrease in cost. As the financial information is made available in the more formal manner it will help in improving the rating of these entities, which would further enhance the access to markets for funding of capital requirements.

**Benefits of credit ratin**

- Enables establishment of credibility with stake holders: A good rating may help an entity to establish comfort & confidence with customers, suppliers, collaborators, lenders, etc. This in turn facilitates the better SMEs to differentiate themselves from others.
- Long term sustainability: Credit rating enables timely planning for riskier capex. It helps in better financial discipline.
- Credit growth: it helps lenders to tap the entities falling under high growth trajectory. It also facilitates faster decision making.
- Capital management: credit rating gives independent opinion on the credit quality of the rated entity and also assesses the capital adequacy norms.
- Self-improvement tool: The rating also helps an important self-improvement tool as it provides insight for benchmarking.
- Relatively easier access to funding: A better-rated entity can explore wide untraditional sources of funding, which not only reduces the access time but also opens up the possibility for borrowing at a lesser cost.

CARE Ratings introduced SME rating in 2006 in association with National Small Industries Corporation (NSIC), which is intended entirely for Small and Medium Scale Enterprises. This rating indicates the relative level of financial strength and performance capability of an MSME entity compared to other MSMEs. The rating is based on four major parameters such as management, business, industry and financials. On the cumulative basis, CARE Ratings has rated 1.33 lakh SMEs in FY17.

**CARE Ratings' Start-up Rating**

CARE Ratings' has taken an initiative to score start-ups based on the assessment of the idea of the start-up and its ability to convert the idea into sustainable operations. The rating indicates stage of the start-up as information for the users. While assigning the rating two broad parameters are assessed;

- **Stage Indicator –** Indicates at which stage the entity is in depending upon the progress from idea level to operational level to growth
- **Start-up Score -** Assessment of the idea of the start-up and the ability of the start-up to convert that idea into sustainable operations –**'0' to '100'.**

Certain other parameters which have a bearing on the rating are target market, competitive advantage, revenue model, speed of implementation, investment required in technology, regulatory compliances and investments made by private equity fund or venture capitalists.

## The way ahead

Clearly we need to enhance the share of credit to this sector to enable them to grow. It is a huge universe, which is linked to not just supplying products for medium and large industry but also self-employment. Apart from traditional products of cash credit, term loans, bills discounting, packing credit etc. one must resort to innovative products like factoring, reverse factoring, SME collective bonds and SME IPO without book building process. Furthermore, a separate vertical in banks can be setup which would be mandated to provide finance to MSMEs at a lower rate by borrowing through External Commercial Borrowings (ECB).

To address information related issues while reducing the cost involved, one option can be extensive use of credit score model. Another option can be use of credit rating and due diligence services offered by Credit Rating Agencies (CRAs). Credit scoring offers a modern alternative for the traditional method of evaluating loans for small businesses where loans were approved on the basis of the banker's qualitative judgment and the financial condition carried significant weight in the appraisal process. Due diligence report provides valuable inputs to sanctioning authorities on the profile verification and SWO analysis of the MSMEs.

**Some other routes that may be explored are**

- Equity financing would open up another promising avenue of financing to the MSME, which has remained untapped as a source of credit for the MSME sector.
- Lending with availability of credit enhancements – credit enhancements in financial markets don't just work as partial financial support mechanisms that come into play in case of contingencies but also work as confidence boosters by virtue of the aforementioned characteristic.
- Creation of SME Finance Companies – just as in the case of infrastructure finance companies or micro-finance companies that are not engaged in real economic activity but in the financing of it, SME financ companies may be established in the country.
- Loans to SME clusters. Currently banks lend to individual units with weak credit profiles that often turn to NPAs. This perhaps, may be avoided if lending is targeted to an SME cluster, such that borrowing costs, funds received and burden of repayment are shared by member units of the cluster rather than by a single unit.

- Linking lending to ratings. This allows for transparency in lending regime, inducing confidence in SME units to access bank finance

MSME financing would be a critical factor for the development of this sector and the economy. The RBI and the government have taken steps to make this possible. Banks would need to see viable business models by looking at all options to ensure that such lending is attractive on a standalone basis. The use of an external credit rating adds a kind of an enhancement for judging the creditworthiness of the unit. The SMEs on their part have to also get their act together and become more professional in their operations so that the team comprising the regulator, bank and the units work better together to deliver finer results. ■

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