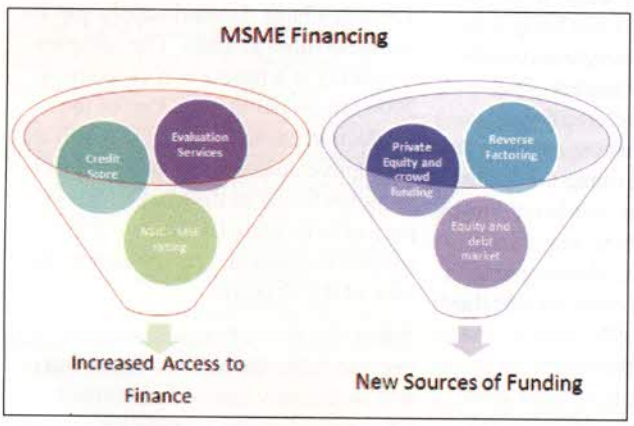
D. R. Dogra

Exploring Alternative Financing Tools in MSME Space

Exploring alternative financing tools in MSME Space MSMEs are indeed the backbone of the economy with a significant employment generation potential and a major source of entrepreneurial innovation. They have been playing a pivotal role in the country's overall economic growth. Bank credit to this segment has grown at a CAGR of 30% in the last five years ending FY13 (refers to the period April 01 to March 31). However, a lot more needs to be done to make this sector a power house of entrepreneurship, employment generation and innovation. More than 92% of MSMEs in India are yet to get access to finance from institutional sources.

With this backdrop, it is felt that traditional banking needs to go through radical changes in its approach while catering to MSMEs. This need to bring changes is necessitated not only by the requirement to reach out to wide spread enterprises across the country and manage a trade-off between growth and margins, but also keeping in mind the need to closely monitor a large portfolio of small loan accounts. Some innovative financing tools elaborated below could be extremely useful in this regard.



Factoring:

The first tool, which is yet to find any significant presence in India despite its extreme suitability for the MSME sector, could be factoring and reverse factoring. Factoring is a form of receivables finance whereby a business sells or assigns its receivables (e.g. invoices) to a finance company, called a factor, at a discount in exchange for immediate funding for running its day-to-day operation. Though the reverse factoring technique is similar to the traditional factoring in many ways, the key distinction is in the initiating party. In reverse factoring, the buyers (generally large corporates) initiate the transaction in order to help their small suppliers finance their receivables. This encourages the banks to lend to small enterprises as the banks feel comforted by their credit exposure to large corporates instead of small enterprises. This also helps avoid wastage of time and effort in comprehensive credit evaluation of several small borrowers.

Large corporates in turn can utilize channel partner (supplier / customer / dealer) evaluation services of Credit Rating Agencies (CRAs), such as CARE Ratings, to de-risk themselves. A mechanism like this creates a win-win proposition for all stake-holders, viz, MSMEs, large corporates and bans.

Credit Scoring Models

The second tool could be extensive use of credit scoring model. The banks, in developed countries, use computerized loan-evaluation system, referred to as credit scoring, to assess prospective borrowers and predicting probability of default. The credit scoring tool, which leverages technology and statistical techniques extensively to handle large data, was originally designed to handle consumer loans. However, owing to its simplicity, speed, cost effectiveness and reliability, this tool is nowadays being used equally effectively for lending to small businesses. Credit scoring is an innovative substitute for traditional method of evaluating loan proposals of small businesses, wherein loans were approved on the basis of the banker's qualitative judgment and the financial condition, including collateral security, carried significant weight in the appraisal process.

External credit Rating of Enterprises

In the post BASEL-II regime, banks have been giving significant weightage to the external credit rating assigned by independent Credit Rating Agencies (CRAs). Banks have also entered into MoU with CRAs for providing credit support at concessional rate to rated enterprises. CARE Ratings and National Small Industries Corporation Ltd (NSIC), a Corporation under Ministry of MSME,

Government of India, have an alliance to rate micro and small enterprises under the Performance and Credit Rating Scheme. The scheme helps the rated enterprises access credit at competitive cost based on their delivery capability and financial strength. The ratings are assigned by the empanelled rating agencies. NSIC offers financial 75% subvention towards the rating fee expenses incurred by the enterprises. The scheme commenced operation in 2005 and nearly 1 lakh enterprises have already been rated since then. The process of rating turns out to be a learning experience for small enterprises in the areas of risk management, financial discipline, business best practices and benchmarking wit peers.

Building ecosystem for equity support

Fourth would be balancing the equity needs of MSMEs through seed equity financing along-with normal bank credit. While Private Equity (PE) investment in larger enterprises has

gathered significant pace in India, equity investments into small and medium enterprises (SMEs) is yet to make a mark. The venture capital funds and angel investors have been showing interest in technology companies and a few sunrise sectors like renewal energy, environmental conservation, social entrepreneurship, e-commerce, etc. The trend needs to grow to make a serious impact on the equity needs of small enterprises. However, setting up exchange for SMEs in India could be considered as

Crowd-funding is about seeking funds (in small amounts) from multiple investors through a web-based platform or a social networking site for a specific project, business venture or social cause which could help start-ups raise funds

an important development towards promoting culture of equity. The private equity investors, venture capitalists and angel investors who have been taking exposure at an early or growth stage of SMEs could realize their gains by exiting these enterprises through public issues on the SME exchanges.

Though listing of enterprises on SME exchanges has seen some movement, the issues relating to market making and finding enough number of interested merchant bankers to support public issues of SMEs need to be addressed. Furthermore, SMEs are still finding it almost impossible to raise funds through debt instruments like Non-Convertible Debentures (NCDs) and commercial paper. To its credit, RBI has relaxed minimum eligible rating for issuance of commercial paper, from A2 to A3. However, market is lacking in its appetite for papers rated A2 and below. It seems, innovative policy interventions are required to be made for ensuring requisite liquidity and instilling confidence among investors. It is pertinent to add here that measures like third party evaluation of issues by credit rating agencies could also assist in building investor confidence.

Crowd Funding

Crowd funding has emerged as another innovative concept for fund raising. Crowd-funding is about seeking funds (in small amounts) from multiple investors through a web-based platform or a social networking site for a specific project, business venture or social cause which could help start-ups raise funds. The concept is still in the initial stages. SEBI has come out with a consultation paper on crowd-funding in July 2014. It could emerge as a serious fund raising tool for enterprises struggling for capital, especially for those having innovative and path breaking business ideas or the ones which propose to address key social and environmental issues of wider interest.

Way ahead

Availability of timely credit at competitive cost has remained the biggest challenge for MSMEs in India in the past several years. The challenge got aggravated owing to demand shock in the recent past and the rising working capital requirements with elongation of credit period. The international experience in the areas of bond market in European countries,

crowd funding in USA and UK, and SME exchanges in China suggest these alternatives are most likely to thrive if the exercise is carried out at national or regional level which unites local borrowers and investors through dedicated platforms.

We must keep in mind that all the above suggested innovative tools and concepts could turn out to be helpful only if transparency and quality of governance in corporates and enterprises keeps improving. This will build trust and instill confidence among lenders and investors within and outside India.

D. R. Dogra is Managing Director & CEO, CREDIT ANALYSIS & RESEARCH LTD.