Cracking the SME Riddle

Driving Profitable Growth in SMEs

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Funding and finance make the world go around, and the SME world is no different. The concern nevertheless, is that currently there is restricted overlap in these two worlds and financial flows are not well synthesised to support growth in SME sector.

On the one hand, we have the banking sector – one of the most dynamic spaces in India's financial markets. The banking sector of the country has long been the conventional source of funding for most corporate entities, particularly manufacturing units. As financial inclusion has turned to become the new mantra for sustainable development, the banking scene has undergone progressive reforms to widen and deepen its reach, making access to finance more viable to small borrowers.

A prominent section of small borrowers are SMEs, the other side of the same coin. While they may be small, their impact and significance in the Indian economy is huge and cannot be ignored. The SME sector accounts for about 45% of the country's manufacturing output; contributes around 40% of the total exports of the country and employs around 59.7 million persons across 26.1 million enterprises (the second largest employer after agriculture in the country). Moreover, the pace of growth of this sector has been tremendous that it is often regarded as the potential new engine of growth for the country.

However, if this 'new engine of growth' is not yet entirely geared up it may be attributed to the lack of adequate lubrication. In other words, the sector is yet to turn into a huge revenue generator and diversify its product base, precisely because it lacks the financial wherewithal to start with. Operating at the very small grass-root level, SMEs have grown fast but they are yet to realise their full potential.

The fundamental roadblock for SMEs

Just as in the case of other large manufacturing units, bank finance continues to be the preferred source of funding even for SMEs. Also, in the context of size and risk appetite, SME units (which are usually conservative) naturally turn to bank loans (from public sector banks, regional rural banks, urban co-operative banks and government FIs) as a means of funding their business operations, apart from resorting to self-financing (which again is not very large). Outstanding bank credit to MSME sector stood at Rs 6.8 lakh crore as on March 31, 2013; registering a growth of nearly 30.0% over the previous year. This growth however, may be attributed to the mandatory PSL targets prescribed by the RBI to banks rather than to voluntary lending profitable by banks.

Although the demand for funds by SMEs is high it remains rather un-satiated as structural and institutional concerns prevail over bank lending decisions i.e. the willingness to lend is low. Yes, the SME sector is a fast growing segment, but these units are labour-intensive units, characterised by limitations in production capacity and small product variety. Weak financial and operational management renders these units less efficient relative to large corporate entities, thereby also affecting profitability.

At the risk of over-simplifying this concern for banks, as lenders to borrowing SME units, it may be stated that the wafer-thin profit margins of SMEs tend to impact their borrowing profile and repayment potential thereof. Hence, the counterparties i.e. banks are wary of lending to this segment as SME loan portfolios are more prone to turning into non-performing assets (NPAs).

Indeed, the SME finance scenario is a classic case of a vicious circle reinforcing hindrances in the growth and development of the sector. With few financial resources at their disposal, (be it for the procurement of raw materials or marketing of finished goods or expansion) SMEs find it difficult to finance operations. 50% of SMEs are owned by marginalised sections of society that are dependent on external financing in order to establish operations, let alone to carry out business profitability.

But this very weak credit profile of SMEs restricts large-scale lending to the sector by banks and other financial institutions. Hence, 'need', in the case of SMEs is in itself the 'vice' too; making it an imperative to break-out of the vicious circle.

Keeping SME finance as the central theme, this article examines critical problems of the SME sector, the need to make lending to SMEs attractive for banks and making available new financing solutions in order to develop a sustainable and profitable growth path for SMEs.

Where do SMEs fall short of potential?

Despite the scale at which they operate, SMEs have the potential to form the foundation of export competitiveness for the country and develop a niche in global markets. Also, given their flexibility and ability to operate with low investments and low working capital, there is immense scope for them to integrate with large manufacturing units leveraging both forward and backward linkages. In reality however, SMEs have been on the sidelines of mainstream economic activity (both manufacturing and services). This warrants us to take a fresh look at the SME landscape and examine hindrances in their path of growth.

First and foremost is the **lack of access to finance**. 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, 93% 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 we have noticed this year. In an environment of limited liquidity, global financial instability, weakening of domestic economic fundamental and lower trade flows, domestic credit and trade finance have come to entail higher costs. This has to some extent further cut out SMEs from the realm of mainstream external funding.

Secondly, the SME sector has **limited openness to the external (global) sector**. On the product side – the lack of innovation and diversification have negatively impacted both the product baskets and product quality of SMEs. Moreover, indigenous SME units are often at a pricing disadvantage, which negatively impacts their bottom lines. In terms of financing opportunities, SMEs are restricted to high-cost domestic lenders, rather than being able to access funds from abroad where interest rates are relatively much lower. Undeniably, it is hence, difficult for SME units to stand stiff competition against global players.

Thirdly, **inadequate and unreliable infrastructure, poor technology and lack of skilled manpower** keep SME units trapped in an informal sector regime. The absence of a well-defined institutional framework limits ability to pool resources and dampens SME productivity. Although, the concept of SME clusters may be applauded, they are yet to take-off in the true spirit in India. Dedicated SME clusters are not merely land areas that bring together a few SME units but are also strategic collaborations on infrastructure, technology, financial and skill base between independent units.

Lastly, **financial management, especially of receivables** is of high significance for SMEs. Limited financial resources, lack of organizational, financial and management skills and inadequate infrastructure have also lead to an increase in sickness in the SME sector. Financial flows of SMEs are not that robust and tend to further negatively impact the already small profit-margins and overall credit worthiness of these units. Indeed, the share of SME sector in aggregate bank NPAs has been high and in double-digits (at 14.9% as at end-March 2012, just a bit lower than the 17.6% in 2011).

The problem of financing and opportunities beyond

While, finance is not the only roadblock for SME growth, it definitely is a major one and lies at the root of the 'vicious circle' discussed earlier. Accordingly, the government and capital market regulators of the country have in the recent past come up with a number of financing ideas for SMEs. These ideas span across the financial life-cycle of an SME unit; starting from the raising of funds, to their utilisation and repayment.

In a major initiative last year, the capital markets opened up to SME units. The BSE SME Exchange was launched on March 13, 2012 followed by NSE Emerge, in order to provide SMEs with an opportunity to raise equity capital. Encouragingly enough, during 2012-13, Rs 2.4 billion (3.7% of the total amount mobilised through IPOs) was mobilised through 24 SME IPOs. These belonged to various sectors such as textile (17%), financial services (17%), realty (13%), agro (13%) and engineering (13%) amongst others.

Also, Budget FY14, made an increased allocation for the MSME (Refinance) Fund corpus from Rs 50 billion to Rs 100 billion per year with SIDBI coupled with recommendations on some credit guarantee schemes. Also all non-tax benefits were made available to MSME units even after 3 years of their graduating out of the MSME bracket.

The government has further planned for an aggregate allocation of more than Rs 490 billion towards overall SME sector development in the 12th FYP, along with recommendations on making Rs 1,800 billion of credit guarantees available to MSEs by the end of the 12th Plan period.

Despite such efforts, funding requirements of SMEs are not adequately met and other sources such as venture capital and PE funding need to be made available. Given the protective financial assistance to SMEs by the government, the success of SMEs in open market has not been very clear. Again, the performance of SMEs based on bank financing has been a mixed bag of reasonable to poor credit, rather than strong. In a bid to make the SME sector attractive to lend to, the success of the bank lending is crucial as an example for other avenues to thrive.

Making bank lending to SMEs viable – a win-win situation

The role of banks in enhancing the scope of finance to SMEs is critical. For one, there is need to transform bank lending to SMEs from bad debts to value territory assets i.e. ensure improvement in asset quality in SME sector and secondly, new modes of bank lending to SMEs need to be explored. At the same time, SMEs should be incentivised to access bank funding and not just through the PSL window.

Some proposals are discussed in this section.

On the one hand, the scale of SME units collectively may be leveraged to better funding prospects. In other words, bank credit may be routed through well-institutionalised SME clusters -

1. Loans to SME clusters – it has been observed time and again that individual SME units have limitations in operational and financial management, rendering them less profitable. 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. For this purpose however, SME clusters would have to be given institutional status in order to ensure financial and legal accountability. Lending to SME clusters could also help deal with the problem of collateral that often independent units find difficult to provide to banks against their loans.

2. 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. The provision of credit guarantees to SMEs under the Umbrella Scheme of 12th FYP should facilitate bank lending to SMEs. In an added initiative, SMEs within a cluster can form a mutual guarantee scheme such that the units mutually guarantee each other's bank borrowing against a fund created by regular joint contributions. Also, foreign buyers, Trans-National Corporations (TNCs) and other business linkage makers could be invited as facilitators or guarantors for SME loans.

3. 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 finance companies may be established in the country. Banks could undertake lending to these SME finance companies, which in turn could distribute funds to individual units. Thus, these SME finance companies would function like special purpose vehicles (SPVs) with higher credit ratings, with independent units getting the required amount of funds.

On the other hand, some granular attention needs to be paid to individual SME units as well. The performance of each unit is critical, whether independently or individually and cannot be wished away.

4. Linking lending to ratings – in a recent move State Bank of India decided to link lending rates to corporates, based on their external credit rating. This is a positive step that ends arbitrariness and discretionary policies in the pricing of loans. A similar strategy could be followed in the case of SMEs as well. This allows for transparency in lending regime, inducing confidence in SME units to access bank finance. External credit rating agencies (CRAs) help in bridging the informational gaps and eliminating information asymmetries, whilst providing unbiased credit opinions on borrowers. CRAs are key players in the creation of credit histories for SMEs, a hitherto missing component for banks to take informed lending decisions. The success of SME ratings is noteworthy in this context. CRAs with the help of NSIC are reaching out to the SME market to bring them under the ambit of credit ratings. Additionally, the structural framework has been set in place, with the RBI being proactive here and specifying norms on lending and debt-restructuring for SMEs; very much relevant to major lenders to this sector such as EXIM Bank of India.

5. Acknowledging sound management practices – while lending decisions of banks cannot entirely be based on management practices alone, they may be given due recognition in the pricing of loans. Interest-rate incentives could be linked to financial and operational management practices, skill development and quality control rules of SME units. This may be expected to further competitive spirit amongst SMEs to perform better and secure lower-cost borrowings.

6. Developing mutually feasible loan structures – SME loans are usually small in quantum and banks can structure them easily in accordance with their asset base to avoid ALM mismatches. For instance, loans could be sanctioned with a specified moratorium, so that SME units break even and do not face repayment pressures from day one. The money due for repayments can be diverted to capacity expansion in initial years to make the business profitable. The aim is to introduce new loan products for SMEs without damaging the banks' asset quality.

7. Educating SMEs on risk management – the comfort for external financing from the perspective of banks as lenders as well as SME units as small borrowers lies in the knowledge of current and potential risks and their management. SME units need to be made aware of the operational, credit and market risks faced by the SME

industry, coupled with unit-specific micro-risks that may arise. This acts as a natural checks-and-balances mechanism, such that SME units get trained to tackle risks and budget or cushion for them in a bid to secure more funds from banks.

Other avenues of financing for SMEs

Although bank financing may be expanded and made attractive, it is not possible for the entire funding requirement of SMEs to be met by banks alone. Other avenues of funding need to be explored; these could include some of the following.

1. Technology development funds – a common pool of funding technological upgradation is essential. This may be initiated by the government and supported by participating SMEs through yearly contributions to the corpus. Disbursements from the corpus may, in some way, be linked to SME performance in terms of production efficiency and improvement in output quality. Here for instance, the New Manufacturing Policy (NMP) has recommended the establishment of a Technology Acquisition and Development Fund (TADF); this could serve as an incentive for SMEs to improve the application and use of appropriate technology and engage in research and development (R&D) activities.

2. Impact Investment – these are investments made into SME companies with a purpose to produce quantifiable social and environmental impact along-side financial returns. Modes of investment could include share (through an Impact Exchange) and/or bonds issued by for-profit Social Enterprises. Thus SME units would obtain a new source of capital to fund expansion. Simultaneously, investors benefit from financial returns through regular interest receipts and eventually receipt of principal when due for repayment. With the country looking at increasing investments in basic amenities such as affordable housing, rural water supply, health and primary education, the scope of impact investment and capital raising thereof is immense.

3. Scope for foreign funding - the SME segment today attracts little foreign investments. It is essential to reverse this trend and boost foreign investments directed towards SMEs, preferably in the form of long-term funds through the FDI route. It may be nascent to introduce FII investments in SMEs at this juncture, given the volatile nature of such funds and recent introduction of SME exchanges that are yet to be fully tapped. However, the government may most definitely promote FDI in SME, just as in the case of FDI in infrastructure, where we have special investment limits. FDI in SME may be viewed as a channel for direct international linkages having benefits of technology and related-investment flows, thereby helping SMEs break-through both technology and financial hindrances in development. Even the ECB route is a viable option, although the risks of currency volatility need to be managed appropriately. Banks could play a vital role in financial advisory for SMEs, given that current financial management skills amongst SMEs are limited.

4. SME finance programmes with multilateral financial institutions – the government may play a proactive role in facilitating interest of multi-lateral lenders to SMEs be it at the global, interregional, regional and sub-regional levels through trade agreements. Greater access to foreign funding through regional co-operation can hold special relevance in such endeavours. Export-related documentation must become more stringent, not in terms of making procedures complex but in terms of improving accuracy. Accessing finance from such multi-lateral finance institutions must ensure adherence to international norms prescribed by WTO, BIS (Basel norms) and other international bodies such as IMF and World Bank as the case may be. This would require implementation of administrative and legal reforms.

5. Promotion of public-private partnership - governments may approach domestic and foreign large corporations to design specialized institutions engaged in the provision of training centres, technology upgrading hubs, research labs and quality check centres. The private sector needs to be attracted to the SME sector, the development of which may not necessarily be profitable for private players (both corporate entities and financial institutions). Along with the much required financial backing, the government needs to efficiently develop and implement strategies in a time-bound fashion to ensure optimal results.

The private sector would, play a critical role here, in terms of providing for technical expertise and effective execution. Viability-gap funding in this context would also be important. Initiatives from domestic and foreign private banks and financial institutions would be limited, unless the government makes an environment conducive to ensure profitable lending activity. While banks' NIMs (net interest margins) and hence profitability might not be very high in the SME sector, it could very well be made viable with reasonable asset quality assurance. Government financial cushioning is important here.

In conclusion, it would definitely not be an overstatement to say that SME financing is a very profitable venture for banks and financial institutions. It is just a matter of time that a strong mutually feasible institutional framework brings SMEs into mainstream financial markets in order to ensure delivery of attractive returns on investments. Given the contribution of this segment to the national economy, funding of its progress is not just a necessity but also a firm commercial proposition for the banking system.