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Financing of Micro Small and Medium Enterprise Sector in India

Aishwarya Nagpal[1] Molly Mondan[2]

[1]Assistant Professor, Department of Commerce, Daulat Ram College, University of Delhi

[2]Guest Lecturer, Department of Commerce, Daulat Ram College, University of Delhi

Abstract – The contribution of Micro-Small and Medium Enterprises (MSMEs) has been growing tremendously in the overall industrial economy of the country. In recent times, the MSME sector has consistently shown a higher growth rate compared to the overall industrial sector. In the Indian market, MSME's rapid growth is shown by the Indian entrepreneurs making remarkable progress in various Industries like Manufacturing, Precision Engineering Design, Food Processing, Pharmaceutical, Textile & Garments, Retail, Agro and Service sector. MSMEs complement and go hand in hand with these large industries as ancillary units and contribute largely to the socioeconomic development of the country. However, although MSME's contribution is phenomenal in the growth of Indian economy, but still; they are facing intense pressure and constraints to sustain their competitiveness in a globalized world. MSMEs in India are facing issues such as the recession, low demand, finance, heavy competition from MNCs etc. But majorly, the availability of external finance for them is a matter of importance for policy makers around the globe.

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1. INTRODUCTION

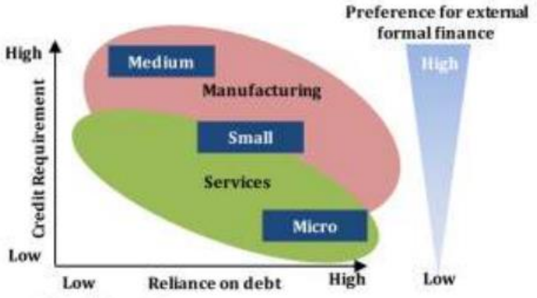
There are 30 million enterprises in various industries, which employ 69 million people. Together, these account for 45% of the industrial output and 40% of the exports. Although 95% of Micro, Small and Medium Enterprise units are informal in nature, the contribution of the sector to India's GDP has been growing consistently at 11% per 3 annum, higher than overall GDP growth of 7-8%. This sector is a very essential sector for achieving the targeted growth rate of our nation. This sector motivates budding entrepreneurs and inspires innovation from its very initial level. A growth in the MSME sector not only provides for industrialisation in backward areas, but also indicates a more equitable Gini coefficient. With the country moving towards a more inclusive growth agenda, a robust MSME sector can accelerate the growth rate, as they do not necessitate huge investments while simultaneously acting as ancillary units to larger industries. Poor infrastructure and inadequate market linkages are among key factors that have constrained the growth of the sector. However, lack of adequate and timely access to finance has continued to be the biggest challenge.

1.1 Differentiated Finance Needs

The financing needs of the sector depend upon size of operation, industry, customer segment, and stage of development (Figure 1). The smaller the entity, greater is the reliance on debt as a primary source of finance.

- Micro enterprises primarily rely on debt for both early and growth-stage financing.
- Micro and small services enterprises primarily transact in cash and tend to keep minimal records.
- Manufacturing enterprises and those with order-driven services tend to need more finance because of longer working capital cycle and higher capital expenditure.

Figure 1: Nature of Finance Demand in Micro, Small and Medium Enterprise Sector



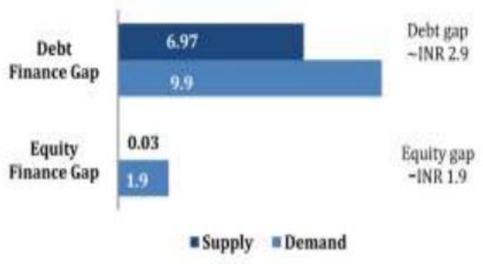
Source: IFC-Intellecap Analysis

1.2 Size of Micro, Small and Medium Enterprise Finance Gap

The total finance gap in the sector, including debt and equity, but excluding entrepreneur's equity contribution, is INR 20.9 Trillion (USD 418 Billion). This is split between Micro (INR 16.25 Trillion; USD 325 Billion), Small (INR 3.9 Trillion; USD 77 Billion) and Medium (INR 0.78 Trillion; USD 15.4 Billion) enterprises. Following the exclusions already highlighted, the debt gap that is immediately addressable by formal financial institutions is estimated at INR 2.9 trillion ($ 58 billion) and the equity gap at INR 1.9 trillion ($ 38 Billion).

- The gap in debt finance is primarily due to un-served micro enterprises and underserved small enterprises
- Gap to demand ratio for equity is ~100%, particularly for small and medium enterprises that are constrained for both early-stage and growth capital. (Figure 2)

Figure 2 : Immediately Addressable Finance Gap (INR trillion)



Source: MSME Census, SIDBI, Primary Research, IFC-Intellecap Analysis

1.2.1 Micro Enterprises Debt Gap - INR 2.3 trillion ($ 46 Billion)

- Micro enterprises tend to be too large for microfinance institutions and too small for large commercial banks.
- Cost of acquiring and maintaining accounts is very high
- Banks have limited information on micro enterprises and no access to alternative tools for assessment
- Micro-entrepreneurs lack adequate collateral

1.2.2 Small Enterprises Debt Gap - INR 0.5 trillion ($ 10 billion)

- Insufficient short-term financing Use of industry averages to determine financing requirements, not taking into account working capital cycles of specific industries and service enterprises.

1.2.3 Medium Enterprises Debt gap - INR 0.1 trillion ($ 2b billion)

- 'Mid-corporate' debt needs are well served, and hence they have been excluded from priority sector lending targets
- Policy efforts are now focused on reinforcing the flow of equity to the sector through the SME stock exchange.

2. FINANCIAL MANAGEMENT IN MSMES

Finance is the key input of production, distribution & development. The financial investment of these small units comes mainly from within; most of them invest their own funds or borrowed funds. Much less comes from banks & government channels. Small-scale entrepreneurs face a lot of problems, while availing loan facility from commercial banks and Government agencies. Financial institutions ask for a lot of information & data, state financial corporation takes several months to take decision on extending term loans small-scale sector are not in a position to offer guarantee required by the banking sector. Even when small loans are raised from Government agencies, the procedure is so cumbersome that most of the entrepreneurs who either illiterate or semiliterate, hesitate to make use of these facilities. This makes matters very difficult for the small industrialist, particularly when he is new to this way of life and he has to deal with both state financial corporation as well as banks. The conceptual framework to which most of the current research literature adheres has been quite helpful in understanding the institutions and markets that provide funds to MSMEs in developed and developing nations. This framework has also provided insights into the effects of policies that affect access to funding by creditworthy MSMEs in these nations. However, the current framework is oversimplified, and neglects key elements of the financial system that affect MSME credit availability. Information is a key input that goes into the credit decision of banks and one of the challenges for banks is to acquire information about the credit risk of the borrower, as borrowers have more information than the lender about the projects. This fundamental information problem is a key concern that needs to be addressed in the allocation of loans; the absence of a mechanism to bridge the information asymmetry between the borrower and the lender would lead to a failure to allocate loans efficiently.

2.1. Type of Industrial Finance

Depending upon the type of activity, entrepreneur requires three types of Finance

- Short-term finance: For the period of less than one year, it is usually required to meet variable, seasonal or temporary working capital needs.

- Medium-Term finance: For the period of 1-5 years, it is usually required for permanent working capital, small expansions, replacements, modifications etc.

- Long-Term Finance: For the period exceeding 5 years, Long-term finance is usually required for procuring fixed assets, for the establishment of a new business, for substantial expansion of existing business, modernization.

2.2. Financial Sources of MSMEs

Usually the commercial banks provide short-term credit to MSMEs. The institutions like State Financial Corporations (SFCs), Small Industries Development Corporations (SIDCs), National Small Industries Corporation (NSIC) and National Bank for Agriculture and Rural Development (NABARD) provide short-term loans. The financial assistance in the form of supply of machinery on hire purchase basis, from NSIC and to some extent from SIDCs is available. The Small sized units and tiny units also get some short-term loans from commercial banks along with working capital in the form of composite loans.

The Small Industries Development Bank of India (SIDBI) provides refinance to these institutions. This kind of refinance includes, assistance provided to State Financial Corporation Bills, Finance Scheme, Special Capital/Seed Capital Scheme, new debt instruments and to the National Small Industries Corporation. In the small scale industrial units, long-term loans are provided by SFCs mainly through Single Window Scheme and National Equity Fund and direct assistance provided to State Financial Corporations in the form of refinance. State Financial Corporations provide some part of working capital for pre-operative expenses of Small Scale Industrial Units under the Single Window Scheme.

2.3. Own Financial Resources for Innovation

The financing experiences of MSMEs around the world suggest that smaller firms typically depend on internal finance for initial capital and external finance for liquidity, and studies have noted that banks are the major source of external finance.

2.4. Difficulty in Access to Finance

MSMEs face a lot of problems while availing loan facility from commercial banks as well as Government agencies. Financial institutions ask for a lot of information & data, state financial corporation takes several months to take decision on extending term loans small scale sector are not in a position to offer guarantee required by the banking sector. Even when small loans can be raised from Government agencies the procedure is so cumbersome that most of the entrepreneurs, who either are illiterate or semiliterate, hesitate to make use of these facilities.

When MSMEs have been offered to external finance, they will be charged with high rates of interest as smaller enterprises provided to be more risky & more likely to fail than larger firms. The lack of financial resources hinders many MSMEs from initiating or – even worse - completing their innovative ideas. MSMEs had abounded innovation activities. They have problems to acquire loans because financial institutions are often reluctant to (co-)finance risky innovation projects. Another financial constraint refers to the problem of getting access to public funding for innovative ideas and bureaucratic application procedures associated with them. Further, it was pointed out that innovation projects must be delayed owing to regulatory reasons until the application has been approved.

2.5. Government Policies

Government aid is paramount in the case of small scale manufacturing organizations. Government can assist organizations in several ways, such as through collaborative training programs, R&D programs among government-funded research centers, universities for specific sectors of the manufacturing industry. Government can encourage networking, promote growth ambitions and encourage new product development by making them aware that it is a risky option to continue with their existing products/customers regardless of market changes. Government can provide sector specific specialist advice within the manufacturing industry and provide more financial and tax incentives.

It can support programs to build infrastructure as well as the incentives (such as tax incentives) and special start up programs to develop private sector. Increase in technological innovation demands that government should enhance spending on R&D.

CONCLUSION

Industries from the backbone for national development and are one of the important components for the growth of national economy and the growth of the MSMEs sector at a healthy rate is crucial for overall growth of the industry. However, lack of proper financial facilities is the barrier of better performance. There are not many financial resources available for innovation activities within the MSMEs.

It is found that the MSMEs depended much of their initial capital on internal sources as they have accessibility problems in getting external debt or equity financing. Even if they are offered with debts, they will be charged with high rates of interest as smaller enterprises are perceived to be more risky and more likely to fail than larger firms are. This problem is shared by the MSMEs around the world, irrespective of the differences in the countries' financial infrastructure.

In this study, an attempt has been made to identify the factor affecting financial management of MSMEs. The present work presents four key issues under financial management. These include Shortage of own financial resources for innovation, Difficulty in access to finance via bank loans, Government subsidies etc., Slow process for loan applications, Lack of Government policies like subsidies, relief in taxes etc. Effective management of these issues can lead to the better performance of MSMEs in the competitive environment faced by them.

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