Funding scenario in MSMEs – Conventional and Unconventional Sources

MICRO, SMALL & MEDIUM ENTERPRISES

सूक्ष्म, लघु एवं मध्यम उद्यम

A white paper written by

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Abstract

The objective of this paper is to identify and understand the various sources of financing that are available to MSMEs in India. The MSME sector in India is considered to be the backbone of the economy. Thus we should enable the development of a business ecosystem that will enable and continuously support businesses so that they can deliver the right product, the right solution, and the right service at a competitive price, both in domestic and international markets. A major hurdle in the Indian MSME sector is the availability of finance to enterprises due to the high-risk low security nature of the industry. We take a look at the various conventional and unconventional sources of finance that may be utilized by the sector. Starting with the primary source of personal capital and ranging out to various government schemes that have been announced for the growth and development of the sector.

The changes that have been brought by the digital revolution are clearly visible in the various new sources of funding that can be obtained through digital sources making finance ultimately accessible to the entrepreneur.

MSME in India

Micro, Small and Medium Enterprises (MSMEs) are an integral cog of the growth engine of different global economies. They have a great capacity for innovation, competence for advancements and perseverance to face multiple challenges. With around 63.4 million units throughout the geographical expanse of the country, MSMEs contribute around 6.11% of the manufacturing GDP and 24.63% of the GDP from service activities as well as 33.4% of India's manufacturing output. They have been able to provide employment to around 120 million persons and contribute around 45% of the overall exports from India. About 20% of the MSMEs are based out of rural areas, which indicates the deployment of significant rural workforce in the MSME sector and is an exhibit to the importance of these enterprises in promoting sustainable and inclusive development as well as generating large scale employment, especially in the rural areas. The figure in the following page shows the distribution of MSMEs across the nation.

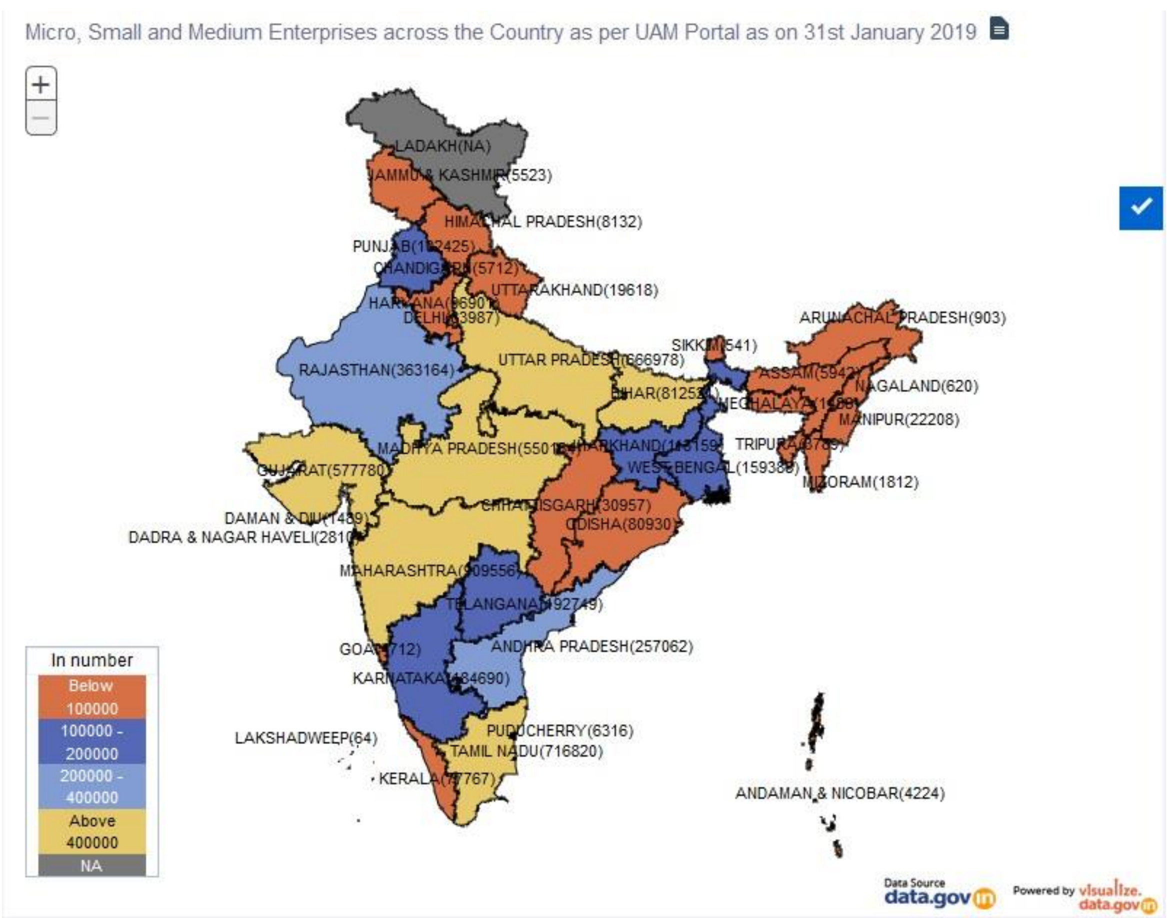
The Micro, Small, and Medium Enterprises (MSMEs) segment is expected to play a significant role in the emergence of the Indian economy. The development of this segment is very much essential to meet the national imperatives of financial inclusion and the generation of significant levels of employment across the country. MSME are defined based on investment and annual turnover as follows:

Existing and Revised Definition of MSMEs

Existing MSME Classification			
Criteria : Investment in Plant & Machinery or Equipment			
Classification	Micro	Small	Medium
Mfg. Enterprises	Investment<Rs. 25 lac	Investment<Rs. 5 cr.	Investment <Rs. 10 cr.
Services Enterprise	Investment<Rs. 10 lac	Investment< Rs. 2 cr.	Investment<Rs. 5 cr.

Revised MSME Classification			
Composite Criteria : Investment And Annual Turnover			
Classification	Micro	Small	Medium
Manufacturing & Services	Investment< Rs. 1 cr. and Turnover < Rs.5 cr.	Investment< Rs. 10 cr. and Turnover < Rs.50 cr.	Investment< Rs. 20 cr. and Turnover < Rs.100 cr.

It is also observed that a majority of the MSMEs in India fail due to lack of availability of funding in crucial stages to allow growth of the unit. Hence, let us take a look at the conventional and unconventional sources of finance for the MSME sector.



Conventional Sources

Project financing

Project financing is the most widespread source of funding generally at the initial stages of an enterprise. This includes the use of own capital and usage of cash generated from existing units. This allows the entrepreneur to maintain complete ownership of the unit thus ensuring complete control over the direction of the company as well as the decision-making process. Initial funding is also obtained from banks through term loans which are usually offered at rates that are 3.5% to 4% higher than the Marginal Cost of funds-based Lending Rate (MCLR).

Working capital

Once the initial funding is obtained, it is invested to acquire fixed assets or directed towards the initial plant setup cost in case of a manufacturing unit. Further liquidity is required to begin and sustain operations. This requirement is known as working capital. Working capital is defined as the capital of a business which is used in its day-to-day trading operations. Ideally, current assets should outweigh current liabilities, leading to a positive number upon completing the working capital equation. A positive working capital indicates that the business can pay off its debts and still afford to purchase inventory and run other business operations. However, if the current liabilities outweigh the current assets, there is a negative working capital and it may be difficult to pay off debts, purchase inventory, and run the business operations. Hence, in addition to the term loan mentioned above, banks also provide Working Capital loans which may be availed by MSMEs. The working capital requirement is calculated by considering the following:

+ Stocking period for raw material, finished goods
+ One-month expenses
+ Receivables
- Less the credit on purchases

Then a further margin of 25% is taken out to calculate working capital limits on loans generally available from banks. There are two types of working capital loans available:

- Fund based for stocks or receivables provide funds to the enterprise to obtain stock via cash purchase
- Non fund-based Letter of Credit to obtain material from suppliers on credit or Letter of Guarantee that acts as performance guarantee to obtain a Bank Guarantee

Working capital loans keep the cash flow running smoothly reducing the risk of a liquidity crunch for daily operations.

Government Schemes

Apart from the above-mentioned methods, traditionally in the MSME sector, the government also provides certain financing schemes which may be availed by the enterprises to meet their funding needs. The following outline a few of the schemes and regulations which were launched by the government of India.

Credit guarantee fund scheme for MSE

It was identified that among all the problems faced by the MSEs, non-availability of timely and adequate credit at reasonable interest rate is one of the most important. The major cause for non-availability of bank loans is due to perceived high-risk nature of the MSME units, most of which are unable to provide adequate collateral to obtain the required funds in loans. Hence, the Government of India launched the credit guarantee fund scheme for MSE. Under this scheme, the bank loans upto an amount of INR 1 Crore may be allotted without requirement of collateral or guarantee. A guarantee commission is required to be paid in the tune of 1% - 1.5% p.a. on these loans. A portal has been launched for the disbursal of such loans under 59 minutes to enable easy access to credit for MSMEs.

Standup India scheme

Standup India scheme was launched with the objective of facilitating bank loans from INR 10 Lakhs to 1 Crore to at least one SC/ST or woman entrepreneur per bank branch. Under this scheme, a composite loan (Term loan + Working Capital) may be obtained upto 75% of project cost. Hence, 25% of the project cost is to be borne by entrepreneur or obtained through other schemes which are available to support MSME development.

The following funds have been setup for the benefit of MSME sector:

<u>Prime Minister's Employment Generation Programme (PMEGP):</u> Margin money assistance of Rs,4735.93 crores provided to 1,93,818 MSME units

<u>Credit Linked Capital Subsidy Scheme (CLCSS):</u> Subsidy worth Rs. 1169.03 crore disbursed to 20,385 MSEs

<u>Credit Guarantee Trust Fund for Micro and Small Enterprises (CGTMSE):</u> Credit Guarantee cover of Rs. 80221.59 crore approved for 16,32,722 MSEs

Listing on SME Exchange (EMERGE - NSE / BSE - SME)

Apart from personal funds and bank loans, MSMEs may also be financed by the masses through the process of getting listed on MSME platforms such as EMERGE on the NSE board and BSE SME on the BSE board. To be listed, the enterprise must fulfil certain eligibility criteria.

- Post issue paid up capital should not be more than INR 25 Crore and not less than INR 3 Crore
- Track record of atleast three years of either the individual, promoter, or the company in the same line of business

- The company/entity should have positive cash accruals (earnings before depreciation and tax) from operations for atleast two financial years preceding the application and its net-worth should be positive
- Issue lot purchase of Rs. 1 Lakh to 2 Lakh
- No petition for winding up is admitted by a Court of competent jurisdiction against the applicant Company

So far, over 200 companies have been listed on the EMERGE platform, of which, 30 companies have migrated to the main board. With the implementation of GST, majority of the units in MSME sector have been formalized following the due process of registration. Thus, there may be an uptick in the number of companies that apply to be listed on the platform with increasing awareness in the community.

Unconventional Sources

Equity funding

Equity financing is the process of raising capital through the sale of shares. Equity funding is obtained from venture capitalists and angel investing firms. In most cases, they also provide mentoring support and other value addition in the form of expertise and experience that enable the funded company to achieve quick growth while maintaining a competitive edge in the market. This is because the financing firms have a stake in the company and growth of the company yields returns for their investment.

Obtaining equity faces the challenges of lengthy and cumbersome sector-specific processes, reluctance to cede control, mismatch in valuation expectations and most importantly – the lack of capacity to absorb the capital.

Crowdfunding

Crowdfunding is the emergence of peer-to-peer lending through online platforms for short-term loans or equity / product investments without the involvement of formal institutions. Crowdfunding may also take the form of donation in case of certain social causes. It basically brings together individual borrowers and lenders on a single platform to enable transactions. There are some 30 P2P platforms in India, with many of them in the micro lending space. Some examples include, Faircent, i2i, among others.

With the plethora of platforms that are available, it is important to conduct a thorough research before choosing a certain platform to raise funds. Basically, the business seeking funding should be able to withstand the burden of interest and the timely repayment of capital. It would be worthwhile to engage a professional who would help evaluate the various financing opportunities before the final decisions are taken.

Venture Debt

Venture debt is short term capital acquired from venture capital firms. This form of funding helps MSME achieve accelerated growth without letting go of any equity or ceding control of the firm. Venture debt is usually structured similar to a term loan with customizations being offered in terms of tenure and repayment schedule as per the requirement of the borrowing firm. These debts are generally scheduled for a term of up to three years and incur higher interest rates in the range of 18% to 24% since they are not secured.

Factoring

Factoring is a form of receivables finance in which the company obtaining finance sells or assigns its accounts receivables (i.e. invoices) to a finance company (a factor) at a discount in exchange for immediate money. This form of financing keeps liquidity going to manage working capital requirements. However, the challenge lies in obtaining the validation of customers by the factoring agencies. Hence, it becomes important to finance only reliable and trustworthy customers.

Supply Chain Finance

Supply chain finance is similar to factoring in that the business may utilize existing resources in the form of supply chain to generate liquidity. Supply chain finance can prove to be another route to facilitate SMEs' access to enhanced working capital from bank and non-bank sources. This mode of financing enables businesses from SME suppliers up to large OEMs to receive short-term credit against the volume supplied during the payment receivable period. Hence, it is important to ensure supplies are regular in order to be a favored entity to receive the financing.

Digital Lending Platforms

Growing awareness of the digital revolution in India has also led to innovations in the fintech sector. Several digital lending platforms that cater to MSMEs have popped up recently. These platforms provide ease of access and ease of use to the entrepreneurs by facilitating online processing of the entire loan process so that funds are transferred immediately. They make use of machine learning to streamline and automate the process of loan approvals. As the awareness and digital education of small business owners increases with the push towards digital transactions, more and more emerging entrepreneurs are attracted to such offerings. Similar to venture debt, these digital lending platforms also provide customized offerings that match the needs of the enterprise. Some examples of such services are MoneyTap, FlexiLoans, LenDenClub, NeoGrowth, Vivriti Capital, Ziploan, Shubh Loans, Lendbox, CoinTribe, Happy Loans etc...

Loan Sharks

Another unconventional source of liquidity for small businesses comes in the form of local loan sharks who lend money off the books at a high interest rate with little or no security. These types of loans are the most accessible to small businessmen commonly in rural settings. Entrepreneurs tend to turn to such sources when they are not eligible for the various schemes made available by the government most commonly due to non-registration of the enterprise. Further, small business owners are also reluctant to approach traditional sources of finance due to the perceived complexity of the process of registration, application for loan and other schemes. As such, loan sharks are the largest source of funding currently in rural areas, however, this may change with the improving nature of rapid digitalization in the industry.

Conclusion

After observing the various sources of finance that are available to MSME in India, it may be noted that the traditional sources that have been listed in this paper are available at a lower cost to the enterprise. Although this requires formalization of the enterprises through registration for any enterprise to be eligible for most of the benefits that have been made available. Further education of the entrepreneur regarding the benefits of accurate reporting of finances would encourage more enterprises to register themselves and maintain clear accounts and financial books. Further analysis of such financial statements would allow the enterprises to identify the pain points that lead to sickness and address them to foster growth. This kind of education may also lead to a change in the behavior of the entrepreneur thus leading to wider acceptance of financing modes such as equity financing that would allow a faster and more sustainable growth trajectory for the enterprise.

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