

## Funding Scenarios for MSMEs

The objective of this paper is to identify various challenges faced by MSMEs in their life cycle in the sourcing of finance. The paper is based upon the secondary data collected from a literature review on the MSMEs, and it also explores the limitation of MSMEs in the identification and utilization of sources of finance to ensure the financial awareness of MSMEs and entrepreneurs.

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## ABSTRACT

The Micro, Small and Medium enterprises have been accepted globally as the growth engine of the economy. Many financial institutions provide facilities and various services to invest in the growth and restructuring of the MSMEs. Despite these facts, a huge concern for all the stakeholders of MSMEs, including financial institutions, entrepreneurs, and government organizations, has been the “Finance for MSMEs”. Some significant problems include lack of adequate and timely supply of finance, lack of working capital, training, and awareness about suitable technology. The objective of this paper is to identify various challenges faced by MSMEs in their life cycle in the sourcing of finance. The study is based upon the secondary data collected from a literature review on the MSMEs, and it also explores the limitation of MSMEs in the identification and utilization of sources of finance to ensure the financial awareness of MSMEs and entrepreneurs. The review of literature revealed that the significant problems of MSMEs are how to raise funds from banks and financial institutions, particularly the timely availability of finance. This paper will be beneficial for Entrepreneurs, Community, and other Business Ventures. All these problems may differ from region to region and Business to Business. Recommendations have been proposed based on the main challenges faced by MSMEs in underutilization of formal sources due to the inadequacy of collateral assets and lack of financial awareness of entrepreneurs.



## INTRODUCTION

Micro, small, and medium-sized enterprises (MSMEs) have strategic importance to the economy and the country. Therefore it has gained increased attention in India in recent times, MSMEs play an essential role in generating employment—65 million MSMEs in the country employ 120 million people and 30% of the country’s economic output. Its importance cannot be undervalued as it forms the backbone of the industrial landscape of India. The MSME sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last few decades.

In spite of their remarkable contribution, MSMEs in India face various challenges. Firstly, they need to keep pace with the rapidly changing technologies and risks to become technologically obsolete. They have to face high costs of credit and are unable to identify their key competitive strengths. They often fail to maintain product standards and quality. The studies have identified the availability and accessibility to the sources of finance as the most crucial factors to promote the growth of MSMEs in developing economies. In India, both of these issues pose innate challenges due to less awareness about the government initiated funding schemes among MSME entrepreneurs and the inadequate role of NBFCs, venture capitalists, angel investors, foreign banks, and IPO in financing the MSMEs in India.

Knowing the fact that banks are the major source of finance in India, the RBI includes micro and small enterprises in the list of priority lending sectors. With the analysis of secondary data sources, it became evident that MSMEs have different types of financial and social requirements at different stages of their life cycle. This paper focuses on the sources of finance used by MSMEs during different stages of the enterprise life cycle, and on the awareness of different government schemes for funding of MSMEs.

## SOURCES OF FINANCE FOR MSMEs: AVAILABILITY AND ACCESSIBILITY

### I) Funding in different stages of MSME life cycle

According to a survey by SIDBI on the major financial needs of MSMEs at different stages of their life cycle and the predominant sources of finance used to meet those requirements, we could find that enterprises are not restricted to reporting data for the present scenario of their life cycle, but they could report perceptions and experiences for other stages of their life cycle.

**Start-up stage:** Enterprises in this stage make use of funds from friends and family sources, from personal savings, and from public sources like government-owned banks, mostly for the purpose of working capital. The other highly used source is an institutional source like public banks for collateral financing. This ensures preparedness or risk aversion, or both, for an enterprise in the beginning stage.

**Survival stage:** In the survival stage, enterprises seek financial assistance for primary purposes like working capital, short-term loans, and overdrafts. For working capital, finance is sourced largely from public banks and moneylenders, and shortly by personal funds and private banks. Private Banks are also being reached out to secure short-term loans and for overdraft facilities. Few enterprises also go to moneylenders. In the survival stage, enterprises look to pay off debts, for which they require adequate availability of working capital.

**Growth stage:** In this stage, enterprises require finance for working capital, collateral financing, and short-term loans. They source working capital from public banks, friends and family, and personal sources, and approach private and cooperative banks to a lesser extent. Collateral financing is obtained from public banks, preferably. To obtain short term loans, Private and cooperative banks are being considered.

**Sustenance stage:** Enterprises in sustenance stage, make use of finance from personal funds, cooperative banks, public banks, and private banks to get their working capital. Cooperative banks are used for collateral financing and also to secure short-term loans. At this stage, the enterprise requires working capital, collateral financing, and short-term loans and make use of finance from trustworthy sources.

### Sources of Funding Not Used by Enterprises in Different Stages

From SIDBI's report, we could find out a number of sources of finance that are not used by enterprises in different stages of the life cycle. It is quite evident that enterprises from the four stages do not avail financing from angel investors, other entrepreneurs, pawnbrokers, foreign banks, initial public offerings, and venture capitalists Refer to the table below:

Source of Finance	Start-Up	Survival	Growth	Sustenance
Angel investors	X	X	X	X
Another entrepreneur	X	X	X	X
Cooperative banks	✓	X	✓	✓
Family wealth	✓	X	✓	✓
Foreign banks	X	X	X	X
Initial public offering	X	X	X	X
Microfinance institutions	✓	X	X	✓
Money borrowed from friends	✓	X	X	✓
Money borrowed from relatives	✓	X	X	✓
Pawnbrokers	X	X	X	X
SIDBI	X	X	✓	X
Venture capitalists	X	X	X	X

✓ – used, X – not used.

SIDBI – Small Industries Development Bank of India.

## II) Challenges faced by MSMEs in Accessing Funding

**Start-up stage:** The major challenges in accessing funding by enterprises in the start-up stage includes (ordered):

- Difficulty in providing collateral or a guarantee
- Processing time for loan applications
- Lack of knowledge about available schemes
- Procedural complication

High service fees for loan requests and difficulty in completing the required documentation are also considered challenging by enterprises.

**Survival stage:** The major challenges encountered by enterprises to attain funding in the survival stage is similar to the difficulties in the start-up stage, the order is different:

- Difficulty in providing collateral or a guarantee and procedural complications were jointly rated the highest
- Issues of lengthy processing time, lack of knowledge about available schemes, high service fees for processing loan requests, and difficulty in completing the required documentation are equally challenging

In this stage, enterprises usually look to break even with regard to investments made at start-up and also like to grow in their markets. They, therefore, need working capital to meet their day-to-day needs. They lack knowledge of available financial assistance schemes by the government and other banks.

**Growth stage:** Major challenges reported by enterprises to bring funding in growth stage include:

- Lack of knowledge about available schemes
- High service fees for processing loan requests
- Difficulty in the provision of collateral or guarantee

- High rates of interest
- Difficulty in completing the required documentation

As mentioned in the above section, there would be a requirement of working capital and short-term loan for enterprises in this stage. It requires knowledge regarding specific schemes for making the most appropriate choice of financing for their enterprise. To seek formal financial assistance, high service fees, and high rates of interest prove to be a deterrent. Enterprises in this stage are in a state of rapid transition, and therefore, the need to provide documentation for securing assistance in funding acts as a deterrent.

**Sustenance stage:** Common challenges to access funding in this stage includes:

- Difficulty in the provision of collateral or a guarantee
- Procedural complications
- Lack of knowledge about available schemes
- Lengthy processing time for loan applications
- High service fees for processing loan requests
- Difficulty in completing required documentation

Many enterprises have reported high rates of interest being a challenge to funding. The entrepreneurs are more concerned about the requirement to have collateral or security to attain funding deals, suggesting that banks or lending institutions should be more realistic about lending funds to MSMEs that have already established themselves in the market.

To summarize these challenges faced by MSMEs in different stages of their life cycle, we have created this table (using data from a report by SIDBI). Enterprises in the survival stage, do not feel infrastructure, labor, labor law compliance, or enterprise registration to be a challenge in accessing finance. They have access to adequate labor and infrastructure. Though, enterprises in the sustenance stage are more likely to have active current accounts, and therefore they do not take it to be a challenge.

**Challenges Faced by MSMEs in Accessing Finance**

Challenges	Start-Up	Survival	Growth	Sustenance
Difficulty in collateral/guarantee	✓	✓	✓	✓
High rates of lending	✓	✓	✓	✓
Procedural complications	✓	✓	✓	✓
Lack of knowledge about available schemes	✓	✓	✓	✓
Lengthy processing time for the loan application	✓	✓	✓	✓
High service fees for processing loan requests	✓	✓	✓	✓
Difficulty in procuring/completing the required documentation	✓	✓	✓	✓
Lack of available infrastructure	✓	X	✓	✓
Lack of availability of skilled labor	✓	X	✓	✓
Absence of current account (active for 6 months)	✓	✓	✓	X
No formal accounting system	✓	✓	✓	✓
Tax compliance issues	✓	✓	✓	✓
Labor law compliance issues	✓	X	✓	✓
Registration of enterprise	✓	X	✓	✓

✓ – challenging, X – not challenging.

MSMEs – micro, small, and medium-sized enterprises.

## ANALYSIS OF FINANCIAL AWARENESS

Many institutions capture the data of awareness amongst enterprises about the well-known financial schemes for MSMEs, and the level of financial awareness is measured by analyzing this data. Few schemes have been explained below:

### **Credit-Linked Capital Subsidy Scheme for Technology Upgradation**

This scheme provides help with financing technological up-gradation for small businesses. Technological up-gradation relates to various processes for an enterprise, such as manufacturing, marketing, supply chain etc. Through this scheme, the government helps MSMEs to reduce their cost of production of goods and services, thus allowing them to remain price competitive in local and international markets. The CLCSS scheme is run by the Ministry of Small-Scale Industries. It offers an up-front capital subsidy of 15% for eligible businesses with a cap set at ₹ 15 lakhs as the maximum amount that can be availed as a subsidy under the scheme. Sole proprietorships, partnership firms, private and public limited companies, and cooperatives, come under this scheme.

### **Credit Guarantee Fund Scheme for Micro and Small Enterprises**

This scheme offers collateral-free credit for both new and existing enterprises satisfying eligibility criteria. Under this scheme enterprises can avail working capital loans up to ₹ 10 lakhs and that can be done easily without any collateral. However, above ₹ 10 lakhs and up to ₹ 1 crore it requires primary security or mortgage of land and building associated with the building. This type of eligible enterprise accounts are covered under Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE). The loans under this scheme are financed by various public and private sector banks covered under the scheme.

### **Prime Minister's Employment Generation Programme (PMEGP)**

This scheme is a credit linked subsidy program integrated with two other government schemes, namely, Prime Minister's Rojgar Yojana (PMRY) and the Rural Employment Generation Programme (REGP). The PMEGP helps to generate employment among the educated youth of the country. Under this scheme, the beneficiary has to invest around 5 to 10% of his project cost and the government grants a subsidy of 15-35% of the project. The participating banks offer the rest of the funds as "Term loans" to the business owners.

### **MUDRA Loans**

Micro-units Development and Refinance Agency (MUDRA) is an organisation established by the government of India to provide business finance to micro-business units on a concept of low-credit financing. The loans under this scheme are given on the pretext of 'funding the unfunded'. MUDRA Loans are referred as "refinanced business loans" that are approved and disbursed via public sector banks, private sector banks, small banks, scheduled commercial banks, co-operative societies, and rural banks that come under this scheme. The loans under MUDRA are generally given to MSMEs operating in the manufacturing, trading and services sector. The structure of MUDRA Loans is:

- Sishu Loans: Loan up to Rs. 50,000/-

- Kishor Loans: Loan above Rs. 50,000/- and below Rs. 5,00,000/-
- Tarun Loans: Loan above Rs. 5,00,000/- and below Rs. 10,00,000/-

### **National Small Industries Corporation Subsidy**

This scheme offers two kinds of financial benefits for SMEs – Raw Material Assistance and Marketing Assistance. Under the Raw Material Assistance scheme, both indigenous and imported raw materials are covered. Under the Marketing Assistance scheme of NSIC, funds are given to SMEs for helping them enhance their competitiveness and upgrade the market value of their products and services. The NSIC mainly focuses on funding SMEs who want to improve their manufacturing quality and quantity.

### **Awareness of Schemes**

The awareness score indicates the number of MSME financing schemes that the enterprise could recognize. The results of a survey by “” presents that more than 50% of the MSMEs surveyed, were not aware of any schemes, while nearly all of the other enterprises were aware of 1 to 4 schemes. In each educational category, high proportion of entrepreneurs were not aware of any schemes. Though, enterprise owners with a bachelor’s degree have greater awareness than those with a lower level of education.

## **RECOMMENDATIONS**

The stakeholders in the development of the MSME sector are: government, enterprises, and financial institutions.

### **a. Recommendations for the Government**

- Enhance financial awareness
- Reduce documentation
- Ease legal requirements
- Enhance sensitivity in lending institutions
- Ensure that tax policies are fully implemented
- Support credit enhancement
- Enforce rules for delayed payment

### **b. Recommendations for Financial Institutions**

- Realign approach toward MSMEs
- Promote financial awareness
- Relax the need for collateral
- Expand financial schemes for MSMEs
- Reduce documentation requirements

### **c. Recommendations for Entrepreneurs**

- Use proper accounting practices
- Register the enterprise
- Create prototypes and obtain patents
- Develop networks and markets

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## APPENDIX

### Classification of MSMEs In India

Classification	Manufacturing Enterprises (Investment Limit in Plant and Machinery)	Service Enterprises (Investment Limit in Equipment)
Microenterprise	Rs2.5 million	Rs1 million
Small enterprise	Rs50 million	Rs20 million
Medium-sized enterprise	Rs100 million	Rs50 million

Source: Government of India, Ministry of Micro, Small and Medium Enterprises