MSMEs (Micro, Small and Medium Enterprises) Segmentation in India: Towards Need Based Financing

Momina Bushra, Research Scholar, Department of Rural Management, School for Management Studies, Babasaheb Bhimrao Ambedkar University (A Central University), Lucknow

Dr. Kushendra Mishra, Associate Professor, Department of Rural Management, School for Management Studies, Babasaheb Bhimrao Ambedkar University (A Central University), Lucknow

ABSTRACT

MSMEs (Micro, Small and Medium Enterprises) is one of the sectors in India that not only contributes significantly to economic growth but also its contribution is more than the overall GDP growth rate. This sector is thought to be one but actually it is not homogeneous in itself. Apart from operations, MSME sector as a whole is facing a major problem related to financing of its enterprises. When analyzed closely, it is found that funding needs of Micro Enterprises, Small Enterprises and Medium Enterprises are different from each other and therefore the quantum and frequency of fund requirements vary from enterprise to enterprise. This paper depicts the differences that exist in the financing needs of Micro, Small and Medium enterprises in India. As financing problems are different within the sector, it should be dealt differently and different strategies should be adopted to meet their financing needs accordingly. This paper has been prepared on the basis of literatures available in various MSMEs annual reports, journals and articles. The present research paper reveals that as there are considerable differences in the financing needs of different segments of the MSME sector and there is a need to redefine the sector again.

Keywords
Micro Small and Medium Enterprises, Funds, Banks and Financing needs

INTRODUCTION

The Micro Small and Medium enterprises (MSMEs) have been acknowledged as the engine of economic growth and play a crucial role in the equitable economic development of a country. Employment generation potential with low capital cost make this sector more important.

Till 2005, the term SSIs and MSMEs were used interchangeably but from 2nd October 2006, MSME (Micro Small and Medium Enterprises Development) Act, 2006 became operational to give a greater clarity for defining this sector. It replaces the concept of “Industry” with “Enterprises and facilitates the promotion, development and enhances the competitiveness of Micro Small and Medium Enterprises (www.indiansmechamber.com/msmeActs.php).

Fourth all India census of MSME reported that micro enterprises dominate the MSME sector in numbers and employment generation both.

Although, the sector contains highly innovative and high growth potential enterprises, still more than 94 % of MSMEs are unregistered and a large number of them are established in the informal or unorganized sector. (Report of Prime Minister’s task force on Micro, Small and Medium Enterprises, Govt. of India, January, 2010).

<table>
<thead>
<tr>
<th>Type</th>
<th>Number of Enterprises (Lakh)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro Enterprises</td>
<td>14.85</td>
<td>94.94%</td>
</tr>
<tr>
<td>Small Enterprises</td>
<td>0.76</td>
<td>4.89%</td>
</tr>
<tr>
<td>Medium Enterprises</td>
<td>0.03</td>
<td>0.17%</td>
</tr>
</tbody>
</table>

Table 1. MSMEs in India

<table>
<thead>
<tr>
<th>Type</th>
<th>Employment (Lakh)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro Enterprises</td>
<td>65.34</td>
<td>70.19%</td>
</tr>
<tr>
<td>Small Enterprises</td>
<td>23.43</td>
<td>25.17%</td>
</tr>
<tr>
<td>Medium Enterprises</td>
<td>4.32</td>
<td>4.64%</td>
</tr>
</tbody>
</table>

Source: 4th All India Census of MSME

Definition of Registered and Unregistered Enterprises

<table>
<thead>
<tr>
<th>Registered Enterprises</th>
<th>Unregistered Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Those MSMEs which file business information such as nature of operations, investment, and manpower with District Industry Centers (DICs) of the State/Union Territory and if their data on enterprise output performance are not adequately tracked by the government agencies, they are considered as Registered enterprises.</td>
<td>MSMEs that do not file business information with District Industry Centers (DICs) of the State/Union Territory</td>
</tr>
</tbody>
</table>
A part from other problems faced by the MSMEs, Finance is the core issue as most of the MSMEs are not able to acquire financial resources for their fixed as well as for meeting day-to-day expenses. Along with that it restricts their growth potential i.e., when Micro Enterprises want to become small; Small Enterprises to Medium; and Medium to Large. Lack of adequate and timely access to finance at reasonable lending rate is the biggest challenge that has impacted their growth. The financing needs of the sector depend on:

a) The size of operation  
b) Customer segment  
c) Industry, and  
d) Stage of development

The Census of MSME found that only 14.26% of the registered units availed bank finance, while only 3.09% of the unregistered units had access to bank finance. This means that 97% of the smaller among the Small Enterprises were deprived of the institutional credit.

<table>
<thead>
<tr>
<th>Enterprises by Source of Finance: (Lakh)</th>
<th>Source of Finance</th>
<th>Amount in Lakh</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Finance/Self Finance</td>
<td>13.64</td>
<td>(87.23%)</td>
<td></td>
</tr>
<tr>
<td>Finance through Institutional Sources</td>
<td>1.70</td>
<td>(10.87%)</td>
<td></td>
</tr>
<tr>
<td>Finance through Non-Institutional Sources</td>
<td>0.16</td>
<td>(1.05%)</td>
<td></td>
</tr>
<tr>
<td>Finance through both Institutional and Non-Institutional Sources</td>
<td>0.13</td>
<td>(0.84%)</td>
<td></td>
</tr>
</tbody>
</table>

Source: 4th All India Census of MSME

Financing constraints are magnified when firms are informal or unregistered, which tend to be small in size, and although often less productive than formal enterprises, contribute significantly to economic activity and employment. The Ministry of Micro, Small and Medium Enterprises (MSME) has various well-funded programs like Credit Guarantee Scheme (CGS), Credit Linked Subsidy Scheme (CLCSS), Performance and Credit Rating Scheme and initiatives to support this sector. It is estimated in the 12th plan (April 2012-March 2017) that the credit gap for the MSME sector will increase from ₹10, 15,614 crore (April 2012) to ₹ 11, 37,151 crore (March 2017). Beginning of the 12th Plan period shows the estimated outstanding credit gap for the MSME sector was 62 % but it is expected to fall to 43 % by March 2017 as government advises the banks to increase lending in this sector. The current credit information system used by banks and other financial institutions in the country is not very encouraging for MSMEs and in spite of all efforts done by government and RBI an efficient credit information system is missing, most banks require a lot of documentation and collateral from MSME loan applicants, which is a tiring exercise for both the bank and the applicant.

OBJECTIVE

1. To find out whether financing needs of Micro, Small and Medium Enterprises are different from each other in India.
2. To find out how MSME segments are fulfilling their financial needs.

LITERATURE REVIEW

World Economic Forum (WEF) in collaboration with Boston Consulting Group (BCG) prepared a report on Small and Medium Enterprises (SMEs) financing which described SMEs financing as one of the three most significant opportunities (consumer financial services, SMEs financing, and corporate bonds) for financial services firms in emerging markets.

Ayyagari et al., 2007 pointed out that on an average 50% of GDP in high income countries are contributed by SMEs and 60% on average of formal employment in the manufacturing sector of the developed and developing economies are contributed by SMEs. As compared to lending made by the banks of the developed countries, SMEs of developing countries are lagging behind in getting access of funds through banks. Therefore access to funds is becoming a challenge that affects SMEs disproportionately more than large firms as banks charge high interest rates and fees due to high risk.

Bebczuk, 2004; Slotty, 2009; Balling et al. 2009; Irving & Scott, 2010; Yongqian et al., 2012 found that SMEs are facing financial constraints in both developed and developing economies, therefore it is a Global concern.

Beck et al., 2005; Beck et al., 2006, 2008; Fatoki & Assah, 2011, Kira & He, Beck et al., 2012 have revealed in their studies that financing is a major constraint that restrict the SMEs to grow than for larger firms in the developing economies.

EBRD 2004; Hossain 1998 found that external financing has become costly for SMEs and that compelled them to avoid looking for funds from external sources. A absence of external financing not only hampers their growth but also it restricts them to exploit various investment opportunities that are available to them. Finance is an essential factor for all firms and for SMEs it’s a crucial issue as they have to maintain their working capital requirements, realize long-term investment opportunities and to achieve development targets. Due to poorly developed banking sectors SMEs are unable to get access of loan which proved to be a bottleneck in most developing and transition economies.
Ayyagari et al., 2010a; Ayyagari et al., 2010b Financing constraints are also magnified for informal firms, which tend to be small in size, and although often less productive than formal enterprises, contribute significantly to economic activity and employment. Unregistered firms rely mostly on informal ways of financing which on one hand facilitating access to finance but on other hand associated with lower firm growth and increased firm illegality. Along with that due to a higher risk perception and limited access of MSMEs to immovable collateral financial institutions (FIs) have limited their exposure to this sector.

METHODOLOGY

The study is primarily based on qualitative literature review method. It facilitates in depth analysis of the various financing needs of the MSMEs segments. This study is based on secondary data collected from various MSME Annual Reports, Report on MSME Finance in India, and SIDBI Annual Reports, Prime Minister Task Force Report, RBI master circulars, journals and articles.

MICRO ENTERPRISES- NEED FOR ACCESS TO FUNDS

According to Prime Minister Task Force Report, most of the Micro Enterprises are unregistered and unorganized. Micro Enterprises require significant working capital demand to meet their short term needs for starting a sustaining enterprises. These enterprises are mostly run by entrepreneurs or first generation entrepreneurs alone with their own savings and private assets, who mostly operate in order-driven industries like tailoring, carpentry, handlooms, dairy, animal husbandry, retail trade, repair & maintenance etc., which makes them risk susceptible. They rely on funds from the informal sources of funding include family, friends, and family businesses while institutional sources consist of moneylenders, chit funds and expensive private fund providers that charge interest rates varying between 36% to 200% per annum. Thus, they are unable to make big investments such as acquiring modern machinery and equipment and expansion of their businesses. The problem of lack of access to finance to Micro Enterprises is serious and big in magnitude because the absolute size of ‘microenterprise’ segment within MSE sector is quite big.

Micro Enterprises are not only proved to be costly but the units are vulnerable to even minor income shocks as entrepreneurs have limited training in resource planning like:

Capital management: Most of these enterprises largely transact in cash therefore they do not have accurately recorded financials which makes it difficult for financial institutions to assess their credit defaults. Large proportions of Micro Enterprises operate out of houses or small leased premises. They have problems related to procurement of raw materials at a competitive cost. They face designing, packaging and storage related problems. Inadequate infrastructure, use of low technology levels and lack of access to modern technology lead to low level of mechanization and often use outdated technologies that ultimately make it difficult for these enterprises to sustain and earn profits.

Labor management: In the absence of proper labor management these enterprises lack in skilled manpower and their labor cost increase due to multiplicity of labor laws and complicated procedures related with compliance of such laws.

Lack of awareness pertinent to potential financing avenues: Most enterprises do not have bank account and usually bank account is in the name of owner of the enterprise. Growth of these enterprises is inhibited by poor book-keeping and a limited knowledge of formal financial institutions due to lack of managerial competence. Most of the units prefer to avoid registration and other regulatory compliances to avoid compliance related costs, taxes and in this way they themselves self-exclude from procuring funds through formal sources.

Micro finance has emerged as a major tool to reduce poverty in many countries as it helped in the creation and expansion of micro enterprises by vulnerable communities. Most of the Micro Financial Institutions (MFIs) are adopting strategies to deliver micro-finance in sustainable manner but still are dependent on concessional funding for carrying out their operations. Government of India launched the Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGMSE) to make available collateral-free credit to these enterprises. This scheme covered both the new and existing enterprises. The Ministry of Micro, Small and Medium Enterprises and Small Industries Development Bank of India (SIDBI), established a Trust named Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) to implement the Credit Guarantee Fund Scheme. It was formally launched on August 30, 2000 and became operational from 1st January 2000.

For Micro Enterprises, the main concern is not the cost of financing as they are already paying high rate of interest to the fund providers to make their businesses run smoothly and maximum proportion of Micro Enterprises in MSE sector shows that they have growth potential and interest of people (entrepreneurs, financiers and customers) in this segment. The financing need of Micro Enterprises is the access of funds. All they want is access of funds to start up their businesses and to fulfill their continuous working capital needs.
SMALL ENTERPRISES: NEED FOR ADEQUACY OF CAPITAL

Like Micro Enterprises, Small Enterprises are also largely comprised of first-generation entrepreneurs. These enterprises are small in size and have low capital base. They are involved in the businesses like Brick-kilns, grocery stores and small restaurants etc. Small Enterprises require higher capital investments than micro enterprises and tend to operate in value-add manufacturing and knowledge-based service industries. Small Enterprises need finance to for working capital requirements like purchase of raw materials, procurement of stock, payment of wages etc. and to support expansion plans. Small Enterprises access finance from both formal and informal sources. When using formal sources, they are dependent on one to two financial institutions for their funding needs. Mature small enterprises particularly knowledge-based enterprises tend to use bank instruments for most of their business transactions, cash continues to be preferred across the overall small segment as entrepreneur have limited incentive to maintain financial records. Lack of financial documentation further increases the challenge of accessing finance from formal financial institutions (FIs). The average credit requirement of a Small Enterprise across manufacturing and services industries is estimated to be ₹ 4 million to ₹4.5 Million. With limited access to immovable collateral or assets, Small Enterprises especially in knowledge-based industries find it difficult to access adequate debt from formal financial institutions. The key to financing any enterprise lies in the ability of the financier to evaluate and manage such business risks.

<table>
<thead>
<tr>
<th>Business Risk</th>
<th>Idiosyncratic Risk</th>
<th>Systemic Risk</th>
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<tbody>
<tr>
<td>Idiosyncratic risks are specific to an enterprise like location of business, talent or skill of the entrepreneur, strikes, technology etc.</td>
<td>Systemic risks are beyond the control of any enterprise. Such risks make up the environment in which a business operates. Risks due to change in preference of customers, natural calamities, economic, political and legal changes etc., are all examples of systemic risks.</td>
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</table>

A financier analyses the business to establish that the business has a current and future ability to pay back loans, even in an uncertain business environment.

Small Enterprises are surrounded with all the factors that cause systematic risks and the assessment of which is very difficult. Banks or Financial Institutions asks them to go to private equities, when they are uncertain about an enterprise performance in the condition of economic downturn. Traditional equity is not sufficient in getting adequate funds when the viability of the project, collateral requirements and making timely repayment of loans is not according to the banks compliances. Small Enterprises do not keep valid bills and have absence of known buyers therefore do not find a place among the preferred clients of the banks. To mitigate such credit risk, banks typically look for enhanced collateral or traditional equity and both of them are constraints for Small entrepreneurs. Small size and their local presence limitation enhance the transaction costs of financing. In a situation where banks' or FIs' (that charge 10-20 % interest rate) reluctant to lend, these enterprises are forced to resort to high cost (36-70 % interest rate) non-continuous financing from money lenders and other informal sources or continue to operate at low level for survival. Despite the efforts of Ministry of SMEs, support from the RBI by inclusion under priority sector and efforts from SIDBI, there is a huge demand-supply mismatch in small enterprise financing. The government has mandated that banks should reserve a certain portion of their overall lending for the MSME sector but they are also asked to keep banks non-performing assets (NPA)s under control.

Small Enterprises have access to funds and their financing need mostly thrive for adequate fund to run their business hassle free for long term.

MEDIUM ENTERPRISES: NEED FOR FUNDS AT FAST AND REASONABLE RATE

Unlike Micro and Small Enterprises, Medium Enterprises exhibit a more predictable demand for debt and these units are able to access multiple sources of capital. Predictable cash flows and a formal structure allow Medium Enterprises to choose formal financial institutions as their preferred financiers. Medium-sized enterprises are professionally managed and hence depend a lot less on the entrepreneur for management of day-to-day operations, allowing him/her to explore broader aspects like financing from multiple sources. Coupled with high average value of financial transactions, these enterprises are able to access financial services more easily, forming financial relationships with multiple financial institutions. The financial history of these enterprises tends to be traceable. Usually, banks demand a registered or equitable mortgage even though they are mandated to lend without any collateral or security, up to a certain limit. There is no system to provide identification to a particular movable. This can be done only through referrals. Businesses in the segment are typically structured as limited companies are allowed for infusion of alternative forms of capital such as equity but promoters of medium sized companies are unable to generate equity to raise debt capital in India.
According to the master circular issued by the Reserve Bank of India (2013), banks in India are mandatorily required to issue loans of up to ₹10 lakh without accepting any collateral or security. For a financially sound unit with a good track record disbursement to a maximum of ₹25 lakh may be allowed by banks after obtaining the required approvals. Also, banks have been mandated to issue collateral-free loans of up to ₹10 lakh to entities financed under the Prime Minister Employment Generation Program. [RBI, Master Circular - Lending to Micro, Small & Medium Enterprises (MSME) Sector, 2013]. RBI has asked banks to give credit to productive sectors of the economy but there is not much progress. Even SIDBI acts offer finance which is limited to units smaller than medium enterprises.

Medium enterprises need not just to get access or adequacy of funds. They require funds that enable them to grow and compete in the national and international market. They require speedy funding facility at a reasonable price or lending rate. Although, there are myriad financial instruments in the market but getting them is not an easy task for Medium Enterprises due to high compliance.

CONCLUSION

Despite various policy initiatives of Government and guidelines by RBI, there still exists demand-supply mismatch in the availability of finance for the MSMEs. Absence of timely and adequate credit have always been constraints for the MSMEs. Micro Enterprises are characterized with limited access to both immovable and movable collateral, while the majority of financial institutions prefer collateral-based financing as a risk mitigation. Credit requirement per unit is small in amount which is not financially attractive for banks. There is always difficulty in ascertaining cash flows and profits. Absence of a suitable mechanism which enables the quick revival of viable sick enterprises and allows unviable entities to close down speedily. Non-availability of funds is not the problem, the actual problem is lack of awareness related to the credit facility. The share of Micro Enterprises in the total number of MSMEs in India is disproportionately high. The capacity building is therefore extremely vital for these firms to become more competitive, productive and viable. The strengthening of the sector cannot happen if these firms remain starved of financing opportunities. India is witnessing the emergence of small but innovative firms which need proper financing. There has to be continuous focus on the development of innovative financial instruments to suit the varied requirements of these firms considering the diverse set of firms that constitute this sector. As a valued partner of larger enterprises in the supply chain, many of medium enterprises have also undertaken modernization initiatives to keep pace with the changing time. The contribution of these firms demands that the bottlenecks in getting credit be removed. It is true that a large number of enterprises becoming sick units that increase risk perception of the lenders. It is important to increase the level of awareness of MSMEs about the policy measures and institutional measures aimed to facilitate credit flow to the sector. The MSME sector can evolve to be more competitive and contribute more significantly towards India’s goal of sustainable and inclusive growth with the greater access to finance. There is a need to develop a framework to differentiate informal sector firms between those firms willing and not willing to register, as well as firms that have and do not have the capacity to formalize. Different financial instrument should be there to deal with the different financing needs. Government, RBI and SIDBI all are trying to focus on Micro and Small Enterprises as they require access and adequacy of funds and don’t focus on their growth while less attention is given to Medium Enterprises as their main focus is to grow and expand. There is a need to redefine the MSME sector and the funding requirement of each of enterprises should be met in a way that their objective becomes broader i.e., from self-sustenance to growth.

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