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The MSME Sector – Significance, Constraints and Need for Exploring Alternative Funding Sources

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Abstract:- The Micro, Small and Medium Enterprises (MSME) sector comprises large number of business units involved in various manufacturing and service oriented activities. It has presence in urban and rural areas. Through its contribution to economic growth, employment generation and exports, it has great potential to bring about overall economic development, eliminate regional imbalances, provide employment opportunities and contribute to poverty alleviation. Several concerted efforts were made by the Government aimed at furthering its development and growth. The study examines the size and characteristics of the sector, its significance in terms of its contribution to the growth of the economy, employment generation, policymeasures adopted, constraints to its growth, specific reasons for lack of formal funding in the form of bank finance. While it is necessary to address the specific constraints to low bank credit, it is equally important to explore alternative sources of funding for the sector.

Keywords:- *Bank Credit, Credit Gap, Informal Sources of Finance, Non-Banking Financial Sources, Venture Capital, Private Equity.*

I. INTRODUCTION

The Micro, Small and Medium Enterprises (MSME) sector includes business units which are involved in production of a wide range of products or provision of services. They are heterogeneous and are spread across the length and breadth of the country, employ skilled or unskilled labor, have different capital requirements, cater to urban or rural markets. They have wide disparities in their operations, usage of technology, customer base or market presence. Most of business units are unregistered and tap informal sources of finance while a few of them are registered and have access to institutional finance. The MSME sector is the focus of several policy initiatives by the Government on account of their potential to promote job and employment opportunities, develop entrepreneurial skills, provide regional development, alleviate poverty and contribute to national income and prosperity.

➢ *Definition*

- The MSMED Act, 2006 uses the criteria of investment in Plant and Machinery for a manufacturing unit and investment in Equipment for a service unit as a basis for definition. All business units in manufacturing or service sectors are classified into Micro, Small or Medium sector enterprises.
- "In manufacturing sector, an enterprise is defined as Micro Enterprise if its investment in plant and machinery is less than Rs. 25 lakhs, Small Enterprise if its investment is in the range of Rs. 25 lakhs to Rs. 5 crores, Medium Enterprise if its investment is in the range of Rs. 5 crores to Rs. 10 crores.
- In service sector, an enterprise is defined as Micro Enterprise if its investment in equipment is below Rs. 10 lakhs, Small Enterprise if its investment is in the range of Rs. 10 lakhs to Rs. 2 crores, Medium Enterprise if its investment is in the range of Rs. 2 crores to Rs. 5 crores"[1].
- As per amendment to MSMED Act 2006 approved by the cabinet, the new definition of MSME is proposed on the basis of Annual Turnover. A business unit producing goods or rendering services will be classified as follows: "A Micro Enterprise is a unit whose annual turnover does not exceed Rs. 5 crore. A Small Enterprise is a unit whose annual turnover is between Rs. 5 crore to Rs. 75 crore. A Medium Enterprise is a unit whose annual turnover is between Rs. 75 crore to Rs. 250 crore"[2].

II. OBJECTIVES OF THE STUDY

➢ To understand the size and characteristics of MSME sector
➢ To study the significance of the sector
➢ To study the policy measures adopted for promotion of the sector
➢ To examine the problems faced by the sector
➢ To understand the credit gap and constraints in accessing bank credit
➢ To explore the need for alternative funding sources.

[1]FICCI.*Key to SME Growth*. Report prepared for MSME Finance Summit.
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III. SIZE AND CHARACTERISTICS OF THE SECTOR

The total number of enterprises comprising MSME sector, its classification into micro, small and medium sector, its presence in rural and urban locations, registered and unregistered units, its organization structure are detailed below.

As per National Sample Survey round 73 on unincorporated non-agricultural enterprises, there are 633.88 lakh enterprises in MSME sector in the country during 2015-16. Their distribution is as follows:

Category	Rural (in lakhs)	Urban (in lakhs)	Total (in lakhs)	Percentage share
Manufacturing	114.14	82.5	196.65	31%
Trade	108.71	121.64	230.35	36%
Other Services	102	104.85	206.85	33%
Electricity	0.03	0.01	0.03	0
Total	324.88	309	633.88	100

Table1:- Number of MSMEs category-wise and location-wise during 2015-16
Source: Annual Report of the Ministry of MSME.

Enterprises in manufacturing sector are 196.65 lakhs, in trade 230.35 lakhs, in service 206.85 lakhs. There are around 324.88 lakh units in rural areas and 309 lakh units in urban areas. In terms of business activities, they are evenly distributed across manufacturing, trade and other services. Location-wise, manufacturing units are concentrated more in rural areas while trade and other services units are more in urban areas.

The micro sector constitutes 99.46% of the total with around 630.52 lakh units. The share of small sector and medium sector is 0.54% with around 3.31 lakh and 0.05 lakh units respectively. The aggregate growth rate was 6% in the decade of 2006-07 to 2015-16[3].

Registered	8.5	15%
Unregistered	47.6	85%

Table 2:- Number of MSMEs in terms of registration(in Million)
Source: Ministry of MSME-UdyogAadhar, World Bank Group-Intellecap Analysis[4].

Majority of the MSME units are unregistered. Registration is not compulsory under MSMED Act, 2006.

Business structure	Percentage
Sole Proprietorship	93.38
Partnership	1.53
Private Company	0.23
Public Company	0.04
Cooperatives	0.13
Others	4.24

Table 3:- Organization Structure Adopted
Source: MSME Annual Report, 2017, World Bank Group-Intellecap Analysis[5].

Majority of them are organized as Sole Proprietorship units.

IV. SIGNIFICANCE OF MSME SECTOR

The significance of the sector is examined in terms of its contribution to economic growth and employment generation.

[3]Ministry of Micro, Small & Medium Enterprises.(2018). *2017-18 Annual Report.*Ministry of MSME, Govt. of India
[4]IFC (2018).Financing India's MSME's – Estimation of Debt Requirements of MSMEs in India.IFC. Org. November, 2018

[5] IBID.

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Year	MSME GVA	Total GVA (at current price)	Share of MSME in GVA (%)	Total GDP (at current price)	Share of MSME in GDP (%)
2011-12	2583263	8106946	31.86	8736329	29.57
2012-13	2977623	9202692	32.36	9944013	29.94
2013-14	3343009	10363153	32.26	11233522	29.76
2014-15	3658196	11481794	31.86	12445128	29.39
2015-16	3936788	12458642	31.60	13682035	28.77

Table 4:- Contribution to Economic parameters (in Rs. Crores adjusted at current prices)
Source: Annual Report of the Ministry of MSME.

The MSME sector has contributed around 31 percent to Gross Value Add (GVA) and 28 to 29 percent to total Gross Domestic Product (GDP). Its contribution has remained constant over the period of five years from 2011-12 to 2015-16. Contribution of service sector MSME to GDP is in the range of 27.4% to 30.5% during 2006-07 to 2012-13, while that of manufacturing sector MSME is in the range of 7.73% to 7.04% for the same period[6].

It promotes manufacturing through more than 6000 products, contributes about 45% to manufacturing output and about 40% of exports[7].

Category	Rural (in lakhs)	Urban (in lakhs)	Total (in lakhs)	Percentage share
Manufacturing	186.56	173.86	360.41	32%
Trade	160.64	226.54	387.18	35%
Other Services	150.53	211.69	362.22	33%
Electricity	0.06	0.02	0.07	0
Total	497.78	612.1	1109.81	100

Table 5:- Employment Generation by MSME Category-Wise (in lakhs)
Source: National Sample Survey (NSS) 73rd Round, 2015-16[8].

The share of micro sector in total employment is 97%, while that of small and medium sector is 2.88% and 1.75% respectively. In quantitative terms, Micro sector provides employment to 1076.59 lakh employees. Small and Medium sector provides jobs to 31.95 lakh and 1.75 lakh employees[9].

MSME is the second largest employment generator in the country, next only to agriculture. It provides 80 percent of the jobs in the industry with only 20 percent of investment[10]. More jobs are provided in urban areas than in rural areas. Employment opportunities are more or less evenly divided over different categories of MSMEs.

V. INSTITUTIONAL SUPPORT AND POLICY MEASURES

The following section details the institutions involved and policy measures adopted for promotion of the sector:

❖ *Institutions Involved:*

The Ministry of MSME, Government of India, formulates policies aimed at facilitating overall growth and development of the MSME sector. It has formulated MSMED Act in 2006. Prior to that, several regulations were in place, indicating their significance in promoting economic growth.

The Reserve Bank of India (RBI) regulates formal credit through Banks and Non-Banking Financial Companies. Banking sector includes Scheduled Commercial Banks such as Public Sector Banks, Private Sector Banks, State Financial Corporations, Regional Rural Banks, Cooperative Banks, Small Finance Banks. Non-Banking Finance Companies includes Micro Finance Institutions and Other Non –Banking Finance Companies. RBI formulates policies which have direct impact on access of bank and non-bank credit to MSME sector. Some of the Banking institutions involved in providing funds for the sector are:

- State Financial Corporations (SFC)were set up with the objective of providing long term loans and equity support to Small Scale Industries (SSI). Its focus is to grant loans for acquisition of fixed assets, provide financial assistance to units whose capital does not exceed Rs. 3 crore. Overtime, the role and significance of SFC has reduced on account of high Non Performing Assets (NPA) and emergence of other lenders such as Non-Banking Financial Corporations (NBFC), private lenders, etc.
- Regional Rural Banks were established in 1975 to meet the credit requirements of units in rural areas.
- The Self Help Group (SHG) bank linkage programme was launched in 1992 in order to extend bank finance to the member of the SHG members. SHG is a self -

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regulated group whereby members pool their savings and borrow among themselves to meet their requirements for business and social purposes.

- Small Finance Banks were set up in September 2015, in order to provide a means of saving and credit to small and micro business units, marginal farmers, entities operating in unorganized sector[11].

Small Industries Development Bank of India (SIDBI) is the apex financial institution which provides refinance facilities to institutions engaged in lending funds to the sector. It also provides direct lending, equity support, etc. It has set up a Credit Rating Agency (ACUITE Rating Research), Venture Capital Company (SVCL), MUDRA, a Technology Company (ISTSL), a Lending Platform (PSB loans in 59 minutes), etc. It takes active involvement in supporting startups with a view to encouraging entrepreneurship[12]. The Micro Units Development & Refinancing Agency (MUDRA), set up with a corpus of Rs. 20,000 crores, provides refinance to micro units with an aim to ease the credit availability and provide them liquidity[13].

The Securities Exchange Board of India (SEBI) regulated institutions providing capital are Small and Medium Enterprises (SME) Exchange, Angel Investors, Venture Capital and Private Equity. It has formulated the Alternative Investment Fund (AIF) Regulations Act 2012, replacing the SEBI Venture Capital Fund Regulations 1996.

❖ *Policy Measures:*

- The scheme “Entrepreneurial and Managerial Development of SMEs through Incubators” promoted in 2008, to provide support for entrepreneurial development.
- The MSME Technology Centers provides high end skill training to the youth.
- The Make in India Programme of MSME in 2015, promotes innovation, rural industry and entrepreneurship. It aims to set up technology and incubation centers to accelerate and promote startups for innovation and entrepreneurship in agro industry. The scheme identifies 25 sectors for financing small enterprises in MSME sector.
- The Atal Innovation Mission (AIM) by NITI Aayog, aims to promote Research and Development, Innovation and Scientific research through collaborations between academia, industry and research.
- The Self Employment and Talent Utilization (SETU) scheme set up by NITI Aayog provides technical and financial support, incubation for promotion of all aspects of startup businesses.
- The Electronics Development Fund launched by the Ministry of Communications and Information Technology, provides support for innovation in the field of Information Technology (IT) and associated sectors.
- Digital India Programme was launched to provide broadband connectivity in rural and urban areas.
- The India Aspiration Fund (IAF) launched by SIDBI in 2015 with a corpus of Rs. 2,000 crore aims to invest in various venture capital funds which provides startup capital to MSMEs.
- The SIDBI Make in India Loan for Small Enterprises (SMILE) scheme was set up with a corpus of Rs. 10,000 crores to make equity investments in MSMEs[14].
- The Priority Sector Lending (PSL) norms of RBI were in operation since 1960s. Under PSL norms, banks are required to lend 40% of Adjusted Net Bank Credit or Credit Equivalent amount of Off Balance Sheet Exposure, whichever is higher, to few specified sectors in MSME. MSMEs engaged in manufacture of goods specified in the first schedule of Industries (Development and Regulation) Act 1951, MSMEs engaged in service sector are eligible for obtaining finance under PSL norms.
- Credit Guarantee Scheme was formulated in 2000 to provide collateral free credit to micro and small enterprises.
- Under PSB Loans Scheme in 59 Minutes, launched in 2018, banks give in-principal approval for loans up to Rs. 1 crore by examining data points such as GST data, IT returns, Bank /statements, etc, online. Business unit is required to submit physical documents only after getting in-principal approval. However, all in-principal approvals have not been converted to sanction of loans. Rejection rate was observed to be quite high[15].

VI. CHALLENGES FACED BY MSME SECTOR

Though the sector is one of the major contributors to the growth of the economy, it suffers from several constraints. There is no credible data about most of the business units as they are unregistered, do not maintain proper accounting records, adopt cash based operations, are outside the reach of institutional sources of finance. Policy initiatives and benefits under various schemes do not reach them on account of lack of awareness and illiteracy.

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The Constraints / challenges identified by the Prime Ministers Task Force in 2010 were as follows:

- Finance related constraints: lack of adequate and timely credit, high cost of credit, collateral requirements, limited access to equity capital.
- Operations related: non availability of cost efficient supply of raw materials, problems of storage, designing, packaging, product display
- Legal and tax related: multiplicity and complexity of tax laws, no mechanism for quick revival of sick units
- Infrastructural and technology related: lack of access to global market, modern technology, inadequate infrastructure, lack of skilled man power.
- Out of all these challenges, availability of credit at affordable cost, adequate and timely supply of credit is considered to be the most important constraint. Smaller firms find it more difficult to access credit compared to larger firms[16].

➢ *Sources of Finance:*

The following are the main sources of finance:

- Informal sources **-** Personal funds, funds from friends and family, money lenders.
- Internal financing **-** Profits retained from the business.
- Debt based financing – Term loans, Overdrafts from Commercial Banks, usually provided against some collateral.
- Equity based financing – Funds provided in exchange of ownership share such as by Business Angels / Venture Capital / Private Equity / Initial Public Offer.
- Non-collateral debt products – Asset based financing such as Factoring, Leasing, Invoice Discounting.
- Government Grants, Subsidies, Guarantees – Provided through Commercial Financial Institutions.

Micro and Small business units use informal and internal sources of finance[17].A business needs to tap various sources at different stages in its life cycle. MSMEs in startup phase are considered to be highly risky as they do not have the financial capacity to meet demand supply or inflow outflow mismatches. Inability to raise working capital funds quickly would put them at the risk of liquidation. As business grows and reaches the growth and maturity stage, funds would be required for investment in production capacities[18]. As per MSME census of 2006-07, 92% of the MSME business units did not have access to institutional sources and depend heavily upon personal sources, friends, money lenders for their financial needs[19]. This is due to lack of credit information, improper accounting, small ticket size, high transaction cost, lack of collateral and so on.

VII. TOTAL DEBT FINANCING TO MSMES AND CREDIT GAP

The study conducted by International Finance Corporation (IFC) revealed the following statistics.

Denomination	Banking Institutions	NBFCs	Total Formal Sources	Total Informal Sources	Total Credit Supply
Rs. (Trillion)	9.4	1.5	10.9	58.4	69.3
US $ (Billion)	144.3	24	168.3	898	1066.3

Table 6:- Debt supply
Source : IFC Report.

Informal Sources such as Moneylenders, Chit Funds account for 84% of total debt financing while the formal sources constitute mere 16%. Out of formal sources, Banks constitute 86% of total debt financing.

Huge demand and supply mismatch exists in the issue of credit. The total addressable demand for external credit is estimated to be Rs. 36.7 Trillion (US $ 565 Billion), while the overall supply of credit from formal sources is Rs. 10.9 Trillion (US $ 168.3 Billion). Therefore, addressable credit gap in MSME sector is estimated to be Rs. 25.8 Trillion (US $ 396.7 Billion). Almost 75% of the addressable credit demand from Micro enterprises and 80% of addressable credit demand from Small enterprises is currently unmet by formal financial sources[20].

VIII. CONSTRAINTS IN ACCESSING BANK FINANCE

Banks are the primary lending institutions among formal sources but they are faced with several constraints in meeting the financial requirements of MSMEs. Most of the MSMEs are unregistered and outside the reach of financial institutions. Comprehensive data is not available about such unregistered businesses. As a result, focused measures cannot be undertaken by the regulatory authorities for providing financial, technical or other support. Registered MSMEs constitute a minority, though their number is increasing. Both registered and unregistered MSMEs face

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several demand and supply side constraints, which limit their ability to access funds.

➢ *Supply Side Constraints:*

- High transaction costs
- Low ticket sizes
- High risk of Non-Performing Assets.
- Lack of collaterals, especially in respect of business unit in its early stages of development
- Lack of stable turnover and cash flows
- Poor financial performance and improper books of accounts
- Low credit worthiness
- Lack of transparency
- Asymmetry of information

High risk of lending to the sector is on account of their inability to repay loans. This is due to their low capacity to mitigate business risk such as changes in market demand, delayed payment from borrowings, etc. Assessing creditworthiness becomes difficult in the absence of information about the financial performance of business units. Low equity base, absence of collateral further reduces the ticket size of loans.

➢ *Demand Side Constraints:*

For MSMEs the constraints in accessing bank finance are the following:

- High interest rates
- Complex and Time consuming loan disbursal procedures
- Difficulty in securing loans for working capital requirements
- Lack of awareness of various schemes
- Lack of technical, managerial skills to take business forward[21].

➢ *Reasons for Low Bank Credit:*

Multitude of factors is responsible for low bank credit such as:

- As many as 85% of MSME s are unregistered. Information relating to their cash flows, track record of the promoter not available.
- Lending norms from banks and financial institutions require collateral based lending. Many MSMEs were unable to provide collateral for debt financing.
- There is a high risk of default on lending to MSME. Most of such loans turn out to be NPAs for banks.
- The growth rate of micro and small firms is low.
- Many of the MSMEs follow informal business practices, do not keep proper records. Hence, it becomes difficult to ascertain their credit and repayment capacity.
- Due to lack of documentation relating to accounts, income and business transactions, loans are provided on the basis of collaterals and not on the basis of assessment of their business potential.
- Even promising businesses require heavy upfront investment in working capital. Lack of positive cash flows limits the capacity of banks to provide for funds.
- Relatively high processing costs as the loans required are of smaller denomination
- Lack of transparency due to poor reporting of firm data.
- Cost of making and monitoring small loans to large number of MSMEs is greater compared to large size loans to few large businesses. Transaction costs are large due to longer due diligence process, information asymmetry or lack of credit information about the borrowing entities[22].

IX. NEED FOR ALTERNATIVE SOURCES OF FINANCE

Lack of adequate bank finance necessitates exploring alternative sources of finance for the sector. Equity finance is relevant for innovative, high growth oriented businesses with high risk return profile.

Alternative source of equity financing for an enterprise are:

➢ Private Equity – Business Angels and Venture Capital Funds,

➢ Public listing of securities on an SME platform

Business Angels/Angel Funds are high net worth individuals who invest their own money in companies at very early stages of their development as seed money for firm creation and development. Business angels support new enterprises by providing funding and their own expertise as former entrepreneurs. They usually exit by selling their stake to Venture capitalists. A well-developed network of business angels create investment opportunities and deal flow for venture capitalists.

Venture capitalists invest in companies that have already received some rounds of funding from business angels. They usually concentrate on a small pool of companies with high commitment from the entrepreneur, having strong management team, strong market potential for high growth in a short span of time, high research and development spending. Exit possibilities in the form of a well-developed Initial Public Offering (IPO) market and Mergers & Acquisitions (M&A) market are preconditions for venture investment.

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SME Exchanges provide opportunities for raising equity finance by providing for listing of securities through primary and secondary issues[23].

X. CONCLUSION

The MSME sector has a huge potential for economic development, balanced regional growth, industrial growth, employment generation, etc. Their potential can be unlocked if efforts are made to mitigate the constraints limiting their growth. Among other things, their growth is hampered by lack of access to adequate finance at low cost. Many policy initiatives were introduced in recent times for the promotion of the sector. However, 85% of the enterprises are unregistered and outside the reach of formal institutions. The benefits of various Government schemes do not reach them. Majority of the business units are in the category of micro sector, a very small percentage are in small and medium sector. 84% of their financial needs are serviced by informal sources such as money lenders and chit funds. Formal sources of finance constitute only 16%. Finance from commercial banks is 86% of the formal sources. There is a huge credit gap as many of the enterprises face unmet credit demand on account of their small size, high transaction costs, high risks, informal nature of businesses, etc. Hence, while efforts should be made to overcome the constraints involving disbursal of credit through commercial banks, it is desirable to make efforts to tap alternative sources of financing as well.

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