

FINANCING MSME SECTOR - GAPS AND CHALLENGES

N. Thangavel* and V. Hariharan**

Abstract: *The Micro, Small and Medium Enterprise (MSME) sector is crucial to India's economy. MSMEs not only play crucial role in providing large employment opportunities at comparatively lower cost capital than large industries but also help in industrialization of rural and backward areas, thereby, reducing regional imbalances, assuring more equitable distribution of National Income and wealth. There are 29.8 million enterprises in various industries in MSME, employing 69 million people. The sector includes 2.2 million women-led enterprises (7.4 percent) and 15.4 million rural enterprises (51.8 percent). In all, the MSME sector accounts for 45 percent of Indian industrial output and 40 percent of exports. Although 94 percent of MSMEs are unregistered, the contribution of the sector to India's GDP has been growing consistently at 11.5 percent a year, which is higher than the overall GDP growth of 8 percent. MSMEs face several challenges and barriers. Poor infrastructure and inadequate market linkages are key factors that have constrained growth of the sector. The lack of adequate and timely access to finance has been the biggest challenge. The financing needs of the sector depend on the size of operation, industry, customer segment, and stage of development. Financial institutions have limited their exposure to the sector due to a higher risk perception and limited access of MSMEs to immovable collateral. The present research paper reveals that there is a substantial amount of gap in the overall finance for the MSME sector.*

Keywords: *MSME, Gap, Financing Challenges, Financial Problems.*

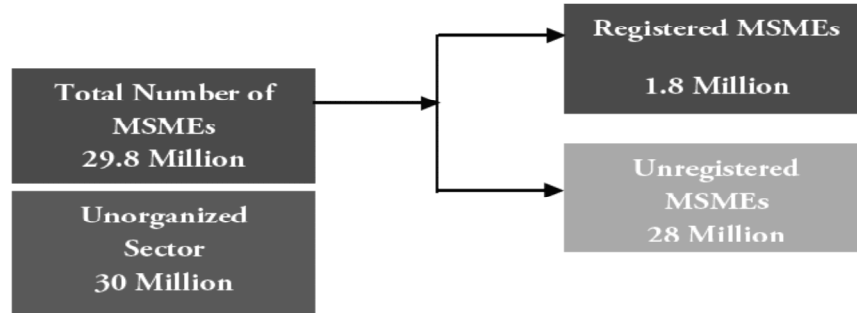
1. INTRODUCTION

MSMEs are defined in different ways in different parts of the world. In some countries, they are defined in terms of assets, while few countries use employment as a parameter for defining MSMEs. The MSME sector is responsible for about 40 per cent of the exports and 45 per cent of the total manufacturing output of the country (MSME Annual Report, 2012). This sector is the nursery of entrepreneurship and has been recognized as the engine of growth. The MSMEs also have a vital role in the dispersal of industries and generation of employment opportunities.

* Professor and Head, DOMS, Jeppiaar Engineering College, Chennai – 600 119

** Research Scholar, Bharathiar University, Coimbatore, E-mail: thangavelraj@gmail.com, harivaaragi@yahoo.co.in

Figure 1



2. DEFINITION OF MSMES

Table 1

Enterprise Size	Employee	Assets	Annual Sales
Medium	<300	USD 15 Million (?INR 750 Million)	USD 15 Million (INR 750 Million)
Small	<50	USD 3 Million (INR 150 Million)	USD 3 Million (INR 150 Million)
Micro	<10	USD 10,000 (INR 500,000)	USD 10,000 (INR 500,000)

3. DEMAND OF CAPITAL IN THE MSME SECTOR

There is a total finance requirement of INR 32.5 trillion (\$650 billion) in the MSME sector, which comprises of INR 26 trillion (\$ 520 Billion) of debt demand and INR 6.5 trillion (\$130 Billion) of equity demand. To estimate the debt demand that Financial Institutions would consider financing in the near term, the study does not take into account the demand from the enterprises that are either not considered commercially viable by formal financial institutions, or those enterprises that voluntarily exclude themselves from formal financial services. Thus, after excluding (a) sick enterprises, (b) new enterprises (those with less than a year in operation), (c) enterprises rejected by financial institutions (d) micro enterprises that prefer finance from the informal sector, the viable and addressable debt demand is estimated to be INR 9.9 trillion (\$198 billion), which is 38 percent of the total debt demand.

The viable and addressable equity demand is estimated to be INR 0.67 trillion (\$13.4 billion), after excluding: (a) entrepreneurs' equity contribution to enterprises estimated at INR 4.6 trillion (\$92 billion) and (b) equity demand from micro and small enterprises that are structured as proprietorship or partnership[7], and are unable to absorb equity from external sources. The second is estimated to be worth INR 1.23 trillion (\$24.6 billion), Flow of Finance to the MSME Sector. This study shows that of the overall finance demand of INR 32.5 trillion [8] (\$650 billion), 78 percent, or INR 25.5 trillion (\$510 billion) is either self-financed or from informal sources. Formal sources cater to only 22 percent or INR 7 trillion (\$140 billion) of the total MSME debt financing. Within the formal financial sector, banks account for nearly 85 percent of

debt supply to the MSME sector, with Scheduled Commercial Banks comprising INR 5.9 Trillion (USD 118 Billion). Non-Banking Finance Companies and smaller banks such as Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and government financial institutions (including State Financial Corporation and State Industrial Development Corporations) constitute the rest of the formal MSME debt flow. Despite the significant contributions of the MSME sector, the sector continues to face certain constraints like, as pointed out in PM's Task Force Report, 2010, availability of adequate and timely credit, high cost of credit, collateral requirements, access to equity capital and rehabilitation of sick enterprises, etc. It thus emerges that adequate, timely and affordable credit is one of the bigger issues for the MSME sector.

4. REVIEW OF LITERATURE

A brief review of literature pertaining to the objectives of the present study has been done to plan it on a systematic line and avoid duplication if any. The review of relevant literature is given below. The issue of small business finance has been receiving increasing attention over the recent decade in the extant literature. There have been studies on various branches of small businesses: two of these branches are namely 'financial management practices of small businesses' and 'implications of financial management strategies on the survival and growth of small businesses' have been polarized by **Berger and Udell (2002)**. Contemporary studies have tested the hypotheses for financial variables for other developing countries. There have been numerous studies that analyze the financial obstacles affecting the growth and survival of MSMEs. These studies are both quantitative and qualitative in nature.

Jain (1956) in his study looked at the total performance of various institutional financing agencies, using secondary data only. The study reveals that the assistance to small scale industrial sector has been grossly inadequate. Secondly, the agencies have developed a preference of investing their funds in the medium and large scale units and the bigger ones among the small scale units. **Stiglitz & Weiss (1981)** stated that the exclusion of SMEs from credit markets in the region is chiefly due to three sets of factors. First, their inherent lack of transparency, absence of suitable collateral and poor track record exacerbate information asymmetries, resulting in acute credit rationing.

Nagaraj (1985) reported important findings, based on two all-India sample surveys, one conducted by the Reserve Bank of India (RBI) and other by National Small Industries Corporation (NSIC). RBI's conducted survey during 1976-77, covered only those units assisted by commercial banks and left out from its purview registered units not receiving bank finances as well as unregistered units. **Gibb and Lyapunov (1996)** suggested that an entrepreneurial culture needs to be nurtured to support MSMEs in areas such as values, beliefs, attitudes and behavioural norms. Gibb also argues that a personal network based on social value constitutes an important variable that influences transactions between firms and customers, marketing channels,

suppliers, employees, family, regulatory authorities, banks, accountants, and competitors.

Hallberg (2001) argued that financing for the SME sector has emerged popularly in the recent few years and it has become a debatable topic for the economists as well as policymakers. This has become immensely important because SMEs account for the majority of units of a country and play a key role in employment generation. **Rani and Rao (2008)** conducted a research that Small and Medium Enterprise sector is a vibrant and dynamic one, and an engine of growth for the present millennium. Financing of micro, small enterprises, which is the part of SME sector, has been given special attention by bank and financial institution, and is included in priority sector lending. In spite of the special efforts, only 14.3% of registered small enterprises have availed themselves of institutional credit, as per the 3rd All Indian Census of small scale industries of 2001-02. From 2000-2004, institutional credit for MSMEs has shown disturbing trends, despite the high level of liquidity in the banking system and the initiatives taken by union government and Reserve Bank of India (RBI).

Sonia and Kansai Rajeev (2009) analyzed how far the globalization has had an impact on the MSMEs. They considered the period of study from 1973-74 to 2008-09. They analyzed the scenario before the liberalization era and as well as after the liberalization era. They analyzed the MSMEs on the basis of growth in the number of units, total production, employment generated by this sector and total contribution in exports. Their study concluded that the MSME sector has shown a better growth rate in all these parameters in the pre liberalization era as compared to post liberalization era.

Rao & Ganesh (2011) found that reluctance by banks to extend credit to women, inability to provide adequate security and margin money, tight repayment schedule are the main problems being faced by the MSME sector. **Shiralashetti (2012)** stressed that absence of adequate and timely supply of bank finance, limited capital and knowledge, lack of power, low quality inputs, low return, non availability of suitable technology, low production capacity; ineffective marketing strategies are the main problems of MSMEs in India.

5. OBJECTIVES OF THE STUDY

1. To identify and analysis the various problems that faced by MSMEs.
2. To identify constraints and analysis the gap in financing to MSME Sector.
3. To provide some important recommendations for owners/mangers of MSMEs and government policy makers so that the growth and survival of MSMEs in the manufacturing sector of India can be secured.

6. RESEARCH METHODOLOGY

The study is primarily based on qualitative literature survey method. It facilitates in depth analysis of the issues related to financing challenges for the MSMEs. Extensive

review of the literature provided useful insight about the major challenges that the MSMEs are facing today in availing credit facilities from banks and other financial institutions. The study is based on secondary data, which has been collected from various MSME Annual Reports, International Finance Corporation Report on MSME Finance in India, and credit rating agency reports.

7. MSME FINANCE GAP IN THE SECTOR

Despite the increase in financing to MSMEs in recent years, there is still a considerable institutional finance gap of INR 20.9 trillion (\$418 billion). After exclusions in the debt demand (62 percent of the overall demand) and the equity demand (from MSMEs that are structured as proprietorship or partnership), there is still a demand-supply gap of INR 3.57 trillion (\$ 71.4 billion), which formal financial institutions can viably finance in the near term. This is the demand-supply gap for approximately 11.3 million enterprises. While a large number of these already receive some form of formal finance, they are significantly underserved with only 40-70 percent of their demand currently being met. With appropriate policy interventions and support to the MSME sector, a considerable part of the currently excluded demand can be made financially viable for the formal financial sector. Of the viable and addressable demand-supply gap, the debt gap is INR 2.93 trillion (\$58.6 billion) and the equity gap is INR 0.64 trillion (\$12.8 billion).

The micro, small, and medium enterprise segments respectively account for INR 2.25 trillion (\$45 billion), INR 0.5 trillion (\$10 billion) and INR 0.18 trillion (\$3.6 billion), of the debt gap that is viable and can be addressed by financial institutions in the near term. Micro and small enterprises together account for 97 percent of the viable debt gap and can be addressed by financial institutions in the near term. Available data and primary interviews indicate that medium enterprises in India are relatively well financed. The equity gap in the sector is a combined result of demand-side challenges such as the legal structures of enterprises, as well as supply-side gaps, such as a lack of investment funds focused on MSMEs. The equity requirements for the MSME sector are concentrated in the growth-stage enterprises (70 percent).

8. MAJOR CHALLENGES FACED BY MSMEs

8.1. Credit Availability

This perhaps is the biggest problem for MSMEs. Availability of adequate and timely credit is critical for MSMEs. Banks and Financial Institutions usually are a bit reluctant in sanctioning credit to MSMEs because of their poor accounting practices.

8.2. Capital Structure

Usually MSMEs lack capital. The owners don't have much of an equity capital to setup a large facility with heavy machineries. This in turn affects the balance sheet and with lack of equity banks are hesitant to extend credit with larger values.

8.3. Technology Innovation

MSMEs are technological savvy and methods used are not very efficient and effective. There is a lack of technical know-how, since in most of the cases the owners of the units are not very well qualified. They are not very keen on investing in technology due to shortage of capital and banks are not intent to finance for the same.

8.4. Cost of Capital

MSMEs usually don't maintain a proper balance sheet and IT returns. Their mode of operation is opaque. It is difficult for a lender like banks or financial institutions to analyze the credit worthiness of MSMEs. Since it is difficult to ascertain the pay IRR and ROI of MSMEs. The banks are charging a risk premium for the inherent risk in lending to MSME sector.

8.5. Security and Guarantee

Bank extends loan facilities to the MSME but they required a collateral or a third party guarantee. This becomes a difficult for the MSME's. Banks are not keen a sanctioning unsecured loan to MSME's

8.6. Availability of Equity Capital

MSMs have constraints to avail equity capital due size and capital limitations. it's very difficult for MSMEs to get listed on secondary market due to resource availability. Investors find this sector as a very risky one to make investment.

8.7. Finance from Banks and NBFC

The banks are not willing to sanction the adequate amount of loan to the MSMEs. The owners of the MSME'S has to produce different types of documents to prove their worthiness. The banks are providing on an average 50% total capital employed in fixed assets and not very keen on working capital requirements. The cost of capital is also very high.

9. CONCLUSION

- MSME Sector has grown as one of the important sectors in our economy. Their contribution to Indian economy has been increasing. To stabilize and improve the availability of finance, the government has drafted various schemes and policies, programs for this sector.
- Government launched several programs to promote MSME units. Despite government initiative, this sector still needs support from banks and financial institutions to have timely and adequate amount of credit requirement.
- Today, there is a total finance requirement of INR 32.5 trillion by the MSME sector in India but out of this; government is hardly able to meet the demand of INR 12

trillion. There is still a finance gap of approximately 20 trillion for the MSME sector. The gap is huge for the government to fill.

- Banks generally can lend only the prescribed amount to this sector as mentioned under priority sector lending obligations but not the full amount.
- Another major problem that MSMEs face in accessing credit from banks is absence of collateral security. Banks generally require collateral security for MSME lending and it becomes a big hurdle for MSMEs in securing credit from banks.
- MSMEs also face the problem of having good skilled managerial personnel required to manage a firm efficiently. Non availability of skilled man power is another major issue that hinders the growth of MSME sector.
- Apart from this, MSMEs face several other problems such as problem of marketing their products. Once the product is ready, it becomes imperative for the owner/manager to sell it into the market. Generally, MSMEs are unable to make use of proper intermediaries for the marketing of their products.
- To sum it up, it can be concluded that MSMEs face several obstacles and hindrances in accessing finance from the banks and other financial institutions. Though a lot of efforts have already been made by the government to make the flow of credit easy to this sector but still a lot of work needs to be done to meet the actual finance requirements of the MSME sector in India.

References

- A Report on Micro, Small and Medium Enterprises (MSMEs) for 12th Plane (Ministry of MSME, New Delhi, India, 2012), *www.msme.gov.in*.
- Berger, A.N., and Udell, G.F, Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure, *the Economic Journal*, 2002, 112 (477).
- Berger, A.N., Klapper, L.F., and Udell, G.F., the Ability of Banks to Lend to Informational Opaque Small Businesses, *Journal of Banking and Finance*, Vol. 25, No. 12, 2001, 56-64.
- Thevaruban, J.S., Small Scale Industries and its Financial Problems in Sri Lanka, *Journal of Asia Entrepreneurship and Sustainability*, I, 2009, 66-74.
- Ganesan, S., Management of Small Construction Firms: A Case Study of Sri Lanka, Singapore, Hong Kong, Thailand, the Philippines and Japan. Japan: Asian Productivity Organization. 1982.
- Gunatilaka, R., The Problems and Prospects of Sri Lanka's Handloom Industry, Institute of Policy Studies, Sri Lanka: Colombo, 1997.
- Laxmi, M. N., and Kumar. S, Industrial Development (New Delhi: Discovery Publishing House, 1999).
- Baldacchino, G., Small Business from Small Islands: A Case Study from India, *Journal of Small Business Management*, 1995.
- Abdullah and M.I.B. Baker (Eds.), Small and Medium Enterprises in Asian Pacific Countries (New York: Nova Science Publishers, 2000).

- Bracker, J.S., Keats, B.W., and Pearson, J.N, Planning and Financial Performance Among Small Firms in a Growth Industry, *Strategic Management Journal*, Vol. 9, 2006, pp. 6-10.
- Hossain, N. (1998), Constraints to SME Development in Bangladesh. Paper Prepared for Job Opportunities and Business Support Program, Mimeo.