Sucoso Knowledge Exchange: Financing MSME

Financial Engineering Guide for MSME Manufacturing Businesses in India

Rohit Suresh

Foreword

The Micro Small and Medium Enterprise (MSME) sector in India is essential to achieving the targeted growth rate of our nation. This sector nurtures budding entrepreneurs and incubates innovation at its most rudimentary level.

With the country moving towards a more inclusive growth agenda, a robust MSME sector can accelerate the growth rate, as they do not necessitate huge investments while simultaneously acting as ancillary units to larger industries.

Albeit the sector has shown impressive potential, it also faces a number of challenges to its growth story. MSMEs suffer the high cost of credit which does not reach them on time. There is inadequate capital infusion compounded by insufficient data on credit requirement.

To address such issues, various central and state government schemes have been rolled out supported by government bodies, banks and financial institutions to infuse funds in this sector.

This study attempts to document the various schemes and new financing methods available for MSMEs and provide them with a roadmap for optimal use.

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Overview

The Micro, Small & Medium Enterprises (MSME) sector is a critical component of India's growth story, making significant contributions to GDP, employment and exports. MSMEs contributed around 37.5% of India's GDP in 2015-16, a number which has remained steady over the past three years. Of this, around 30% of the GDP is contributed by the services sector and the remaining by the manufacturing sector. This translates to a gross value added of 20.56 lakh crore. Of the aggregate gross value added, 71.2% was contributed by the services sector and 18.8% by the manufacturing sector.

As per the Ministry of MSME's Annual Report for 2014-15, MSMEs account for nearly 44.70% of India's exports and also contribute significantly to the generation of employment in the country, employing nearly 80-100 million people.

It is an acknowledged fact that the MSME sector can help realise the target of the proposed National Manufacturing Policy of raising the share of the manufacturing sector in GDP from 16% at present to 25% by the end of 2022. However, this sector has faced certain impediments to growth, owing to some historical factors discussed below.

Definition of MSME

As per the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, the micro, small and medium enterprises are defined as below:

Table 1: Definition as per MSMED Act, 2006

Categories	Manufacturing (Investment in plant and machinery)	Services (Investment in equipment)
Micro	Does not exceed 25 lakh	Does not exceed 10 lakh
Small	More than 25 lakh but does not exceed 5 crore	More than 10 lakh but does not exceed 2 crore
Medium	More than 5 crore but does not exceed 10 crore	More than 2 crore but does not exceed 5 crore

MSMED (Amendment) Bill, 2015

The Ministry of MSME has released a draft document on the proposed amendments to the MSMED Act, 2006 to incorporate a new section on a change in definition for MSMEs. The Bill proposes to change the definition of MSMEs by raising the capital limits in plant and machinery to the following revised levels:

Table 2: Proposed definition by Ministry of MSME

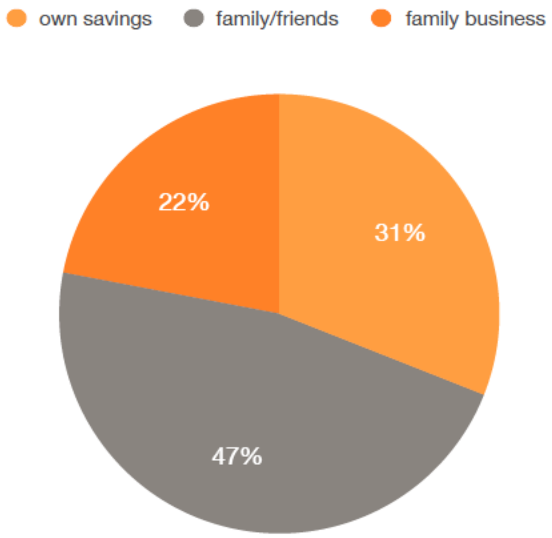
Categories	Manufacturing (Investment in plant and machinery)	Services (Investment in equipment)
Micro	Does not exceed 50 lakh	Does not exceed 20 lakh
Small	More than 50 lakh but does not exceed 10 crore	More than 20 lakh but does not exceed 5 crore
Medium	More than 10 crore but does not exceed 30 crore	More than 5 crore but does not exceed 15 crore

The Ministry of MSME in consultation with other government authorities may take a view on any modifications required to the MSME definitions from time to time. It is suggested that value-based limits such as investment should have a mechanism for automatic indexation linked to an appropriate inflation benchmark.

Financing of MSMEs

MSMEs require timely and adequate capital infusion through term loans and working capital loans, particularly during the early and growth stages. Historically the MSMEs have relied on following sources for financing their needs:

- Retained earnings, funding through sale of assets
- Ancestral capital, personal savings, loans from relatives, loans from unregulated market
- Institutional financing from scheduled commercial banks
- Venture capital funds/ seed funds



The number of new MSMEs has been consistently increasing across the nation. Financial support can be attributed as a reason for this. This has been possible through various debt instruments, limited equity capital and a slew of government schemes.

Financial support from public sector banks

Public sector banks have been pioneers in providing financial assistance to several MSMEs which can approach the banks for loans under various schemes. The government of India has shown strong commitment to double the credit flow to this sector. The RBI has mandated scheduled commercial banks to achieve 20% year-on-year credit growth to the MSME sector. MSMEs needing financial assistance can approach the banks for aid as per the specific schemes constituted for different types of financial aid. These schemes offered by multiple banks are expanded below. Also, certain public sector banks provide MSMEs with various bank-specific schemes which have been expanded below.

1. SME Credit Card (up to 10 lakh INR)

Loans are for the micro enterprises including SSI units, small business enterprises, professional and self-employed persons, small retail traders, transport operators etc. for meeting any kind of credit requirement including purchase of shops, maximum limit being 10 lakh INR including term loan and working capital loan. The loan will be sanctioned for three years with an annual review.

2. SME Smart Score (up to 50 lakh INR)

The loan product is for manufacturing trade and services segments to meet working capital needs and for acquisition of fixed assets. A simplified appraisal model has been developed to standardise the appraisal process for loans up to 50 lakhs INR in SSI sector and up to 25 lakh INR for trade and services sector available with attractive interest rates. The loan will be sanctioned for two years with an annual review.

3. SBI SMILE (interest free loan as equity)

The scheme provides interest free loan as equity assistance towards part of margin requirements of the project, to assist eligible professional and technically qualified entrepreneurs setting up new micro and small enterprises and units covered under the bank's project uptake for technology upgradation. Equity assistance is up to a maximum of 10 lakh INR. The interest free loan is repayable in three years with a moratorium period of 5-7 years.

4. General Purpose Term Loan for SSI sector (up to 50 lakh INR)

This product is for existing borrowers for any general commercial purpose such as shoring up of net working capital, substitution of high cost debt, R&D, ISO certification, etc. subject to disbursement being made in line with the specific purpose approved. The maximum loan available is 50 lakh INR repayable in maximum period of five years.

5. Open Term Loan (up to 2.5 crore INR)

This is a pre-sanctioned term loan with limit up to 2.5 crore INR for existing or new corporate or non-corporate customers in manufacturing sector and up to 1 crore INR for hotels, hospitals, educational institutions in service sector. The sanctioned limit is valid for a year. Margin requirement is 10%. The borrower can utilise pre-approved sanction to plan capital expenditure and negotiate with suppliers of machinery and finalise best possible contract.

6. Corporate Loan (from 25 lakh INR up to 10 crore INR)

The scheme provides term loan for all existing customers and established non customers (subject to takeover norms of the bank) in manufacturing sector. Quantum of finance is minimum 25 lakh INR and maximum 10 crore INR for non-corporate and no cap for corporate borrowers. No margins are required under the scheme. A maximum of three corporate loans can be outstanding per borrower at any point of time.

7. SME Credit Plus

For existing and new borrowers this scheme provides a clean cash credit facility to meet contingencies. Under the scheme 20% of aggregate WC or max 25 lakh INR fund based limit can be availed. Margins are not required and interest rate will be same as applicable to cash credit limit. The facility is repayable in two months and can be availed for 12 times a year.

8. Standby Line of Credit

For existing units including export units, an additional working capital(fund based and non-fund based) limit by way of cash credit, packing credit and bills discounting against stock, receivables to meet contingencies such as bunching of orders, delay in shipment, sudden increase in raw material prices, mismatch in cash flows. Under this 15% of aggregate working capital or max 5 crore INR can be availed. Margins are as applicable to original limit.

9. SME Collateral Free Loan (SMECFL)

Collateral free loan for viable projects of micro and small enterprises in manufacturing and service sector with maximum guarantee cover up to 1crore INR under the CGTMSE guarantee scheme for working capital and term loan (FB+NFB) facilities.

10. Traders Easy Loan

Easy loan for specific business needs of traders, self-employed, small business enterprises, agents engaged in purchase and sale of food grains etc. Loan can be availed for normal day to day business requirements or for purchase of equipment/ fixed assets. Loan is available up to 5 crore INR with very competitive rate of interest.

11. SME Construction Equipment Loan

Maximum loan available is up to 25 crore INR with minimum margin applicable up to 15%. Tenure of loan can be extended up to maximum of four years. Term loan for purchase of construction equipments viz. loaders, excavators, cranes etc. For contractors and firms engaged in construction activity.

Some of the bank specific schemes are outlined below.

Table 3: Bank Specific MSME Financing Schemes

Bank	Schemes
State Bank of India	Commodity backed warehouse receipt financing, SSI loans, Traders easy loan scheme, Open term loan, Business current accounts, Retail Trade, SBI Shoppe, SME Petro Credit, Small business credit card, Paryatan Plus, Swarojgar credit card, etc.
Bank of Baroda	Baroda SME Gold Card, Baroda Vidyasthali Loan, KVIC-ISEC, Scheme for Financing Energy Efficiency Projects, Baroda Overdraft Against Land and Building, Baroda SME Loan Pack, Baroda Arogyadham Loan etc.
Export Import Bank of India	Agri Finance, Several Debt Restructuring schemes for Small and Medium Enterprises (SMEs) etc.
United Bank of India	United Doctor Plus, United Medical Plus, United Mahila Udhyami Yojana, United Shilpi Card, United Udyogshree Yojana etc.
IDBI	Entrepreneurial development fund, Dealer finance program, SME hosiery A/C etc.
Vijay Bank	Liquidity Finance To MSEs, Technology Upgradation Fund Scheme For MSE, Vijaya Kisan Card, Credit Guarantee Fund Scheme To MSE, etc.
Union Bank of India	Union high pride, Union support, Union transport, Union Cyber etc.
PNB	PNB vikash udyami, PNB SME sahayog scheme etc.
ICICI Bank Ltd	The ICICI bank edge, vendor bill discounting, SME dialogue etc.
HDFC Bank Ltd	Working capital finance, construction equipment loan, commercial vehicle finance, Credit substitute, Export credit etc.
Axis Bank	Financing to Non-Priority Sector Entities, Overdraft against Property, Financing to Priority Sector Entities, Term Loan against Property, Lease Rent Discounting, Business Loan for Property (BLFP) etc.

Government institutes and schemes

The following captures in brief the nodal government bodies looking after MSME development and some of the central government financing schemes available.

1. National Small Industries Corporation (NSIC)

This agency provides financial and marketing assistance to the small scale unit supplying requisite machinery on hire purchase and leasehold basis.

2. Credit Linked Capital Subsidy Scheme (CLCSS)

This scheme facilitates technology upgradation of micro and small enterprises. The scheme provides 15% capital subsidy on institutional finance availed by them for induction of well-established and improved technology in approved sub-sector products. The maximum limit of loan for calculation of capital subsidy under the scheme is 100 lakh INR with a maximum subsidy of 15 lakh INR.

3. PMEGP Training Programme

Beneficiaries can set up micro enterprises by availing of margin money subsidy of 25% (35% for special categories) of the project cost in rural areas. The maximum cost of the projects assisted under PMEGP is 25 lakh INR in the manufacturing sector and 10 lakh INR in the service sector.

4. Small Industry Development Bank of India (SIDBI)

This agency works towards promotion, financing and development of the small scale sector, and coordination of the functions of the institutions engaged in the promotion and financing or developing industry in the small scale sector. SIDBI also re finances institutions such as state financial corporations (SFCs), state industrial development corporations (SIDCs), and commercial banks against loans granted to the small-scale sector. SIDBI also acts as financier for small-scale projects directly on a selective basis.

Products and services offered by SIDBI may be broadly classified:

SIDBI Venture Capital Fund Ltd (SVCL) manages two funds set up by SIDBI at the national level.

- The National Venture Capital Fund for Software and IT Industry (NFSIT) is worth 100 crore INR, established with the focus of supporting incubation projects of small-scale units in the IT and related business.
- The SME Growth Fund has a corpus of 500 crore INR which targets growth-oriented businesses in the areas of life sciences, retailing, light engineering, food processing, IT, infrastructure related services, healthcare, logistics and distribution, for making primary equity and equity related investments.

5. National Bank of Agriculture (NABARD)

This agency provides assistance and refinance to farm and rural development agro processing sector.

6. Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)

CGTMSE, established jointly by SIDBI and the government of India, extends credit facilities to the micro and small enterprises sector. The mandate is: Credit facilities, including term loans, fund and non-fund based working capital facilities up to 1 crore INR extended to micro and small enterprises are guaranteed up to 80% of the amount in default, subject to a maximum of 65 lakh INR. With regard to loans up to 5 lakh INR to micro units, the coverage is 85%. Loans guaranteed under the scheme carry zero percent risk weight and provision for the lending institution for the guaranteed portion. The scheme also facilitates lending institutions by the evaluation of the credit proposals on the basis of intrinsic merits of the projects, rather than merely on adequacy of collaterals.

7. Reserve Bank of India Rural Planning and Credit Department

This agency works towards providing finance to nationalised banks and financial institutions in the industry sector and framing of policy decision in the working of banks.

8. TUF

TUF facilitates those SMEs that look to improvise their technological skills. It provides 15% margin money subsidy for the SSI textile and jute sector in lieu of 5% interest reimbursement on investment in TUF compatible specified machinery subject to a capital ceiling of 200 lakh INR and ceiling on margin money subsidy 15 lakh INR. A minimum of 15% equity contribution from beneficiaries is ensured.

9. CLCSS

Under CLCSS, tiny units with investment in plant and machinery of less than 10 lakh INR are eligible for a loan support of up to 8 lakh INR. Tiny units with investment in plant and machinery between 10 lakh INR to 25 lakh INR are eligible for a loan support of up to 20 lakh INR. Small units with investment in plant and machinery of above 25 lakh INR are eligible for a loan support of upto 40 lakh INR.

10. Interest subsidy scheme of IPR

The interest subsidy scheme helps in dispensation for labour-intensive industry by extending the facility of 2% interest subvention for handlooms, handicrafts, carpets and small and medium enterprises (SMEs).

SME exchanges

There is a general lack of awareness among SMEs about equity capital, stock markets and funding options, other than banks. So far, there have been only debt- financing options, without any access to alternative equity options. The small and medium exchanges for SMEs listing norms unlike the regular listing on a SME platform through an IPO are a major introduction. Meant for SMEs with a paid-up capital of less than 25 crore INR, it empowers them to tap into the capital markets by getting listed on the exchange without having to make any initial public offering. To enable SMEs to get over the liquidity crisis that they continue facing, regulators have mandated market making in the SME Exchange platform, to ensure that liquidity is generated.

Moreover, the sector is highly unorganised and fragmented, and the new SME exchange will facilitate the creation of a financial ecosystem for SMEs in India.

The trend in this sector has been of over leveraging debts for lack of opportunity to raise equity capital. The revised ecosystem therefore has to justify opportunities of raising equity capital, balancing the debt equity ratios of companies and facilitate these enterprises to sustain a healthy balance sheet. The need for Indian SMEs to acquire capital at low cost to compete at a global level is one of the key factors behind the creation of this revised framework.

The newly introduced SME exchange will acknowledge the expansion aspirations of these SMEs and help them find solutions to their financial requirement. Companies will be high on the valuation matrix, once they get listed on the exchange. The tax benefits are immense as well. By remaining unlisted, any company attracts a 15% long- term capital gains tax on the sale of shares, while a listed company attracts none.

The listing will also hopefully bring about a sea change in transparency and corporate governance in the listed firms and ensure better visibility among investors.

Compliance norms have also been simplified to the advantage of the SMEs. They need to submit half-yearly financial results instead of quarterly ones. SMEs can send the abridged version of the annual report with the details of the profit-and-loss account and balance sheet to the shareholders, instead of a full annual report. They can make the soft copy of the annual report available on their website. They can send the soft copy to the Exchange, regulators and the ROC also. This will bring down the recurrent cost of compliance substantially for listed companies on the SME Exchange.

The SMEs listed on the SME exchange can migrate to the BSE main board without bringing a fresh IPO, if the paid-up capital of the listed SME is above 10 crore INR and the non- promoter shareholders approve the migration by a two-third majority.

Securitisation of SME credit SME credit could be converted into loan pools or securitised assets and sold to investors interested in investing in such asset classes. The RBI had issued new guidelines for the securitisation of standard assets in order to enable creation of a true securitisation market in India.

These guidelines have numerous safeguards embedded in them to enhance the quality of the pass-through certificates (PTCs) issued in any securitisation transaction.

Asset Reconstruction Company for SME

- SIDBI has promoted the India SME Asset Reconstruction Company Limited (ISARC) to assist commercial banks in managing liquidation of non-performing assets. As non-performing assets management can be cumbersome, commercial banks seek the support of special entities such as the asset reconstruction companies to facilitate this process. This initiative is in partnership with 12 public sector banks, three state financial corporations, the Life Insurance Corporation of India and APITCO Limited.

- The objective of ISARC-like initiatives is to minimise the cost of managing non-performing assets. ISARC plans to acquire, manage and recover illiquid or non-performing portfolios of scheduled commercial banks and financial institutions.

Alternative financing Options

- **Factoring**

Factoring is a form of receivables finance whereby a business sells or assigns its accounts receivables (i.e. invoices) to a finance company (a factor) at a discount in exchange for immediate money with which to finance continued business. The delayed payment cycle by the large scale customers of SMEs have an adverse effect on their operational facets and fund recycling efforts.

Factoring is capable of providing SMEs with the liquidity needed against their receivables and can be efficient alternate source of working capital. Factors buy the right to collect on invoices raised against any sales by the SME and releases 80-90% of the invoice value to the firm. It is on account of its superior conversion time of receivables into cash, absence of geographical restraints, non-requirement collateral security etc makes it a much preferred and superior product than bank finance.

- **Supply Chain**

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 SME suppliers to large OEMS to receive short-term credit against the volume supplied during the payment receivable period.

- **Angel funds or venture capital funds**

SMEs involved in commercialising innovations and high-end technologies need to be able to access venture or risk capital fund effectively. These firms need finance during the initial stages of conceptualising their product offerings (seed phase) and during development and marketing phase. These concept and ideas generally need an incubation period before they can be utilised for generating revenue or profit. This is where venture capital comes in to provide them with funds required to enter new markets and attain accelerated growth.

Role of credit rating in financing

One of the most important procedures taken by financial institutes that offer credit to MSMEs is to scrutinise their credit rating status in order to get a clear picture of the creditworthiness of the enterprises. Credit rating is done by the credit rating agency (CRA) which assigns credit ratings for issuers of certain types of debt obligations as well as the debt instruments themselves to form a basis to prove the authenticity of the new firms who seek financial help from different organisations for their business. Hence, credit ratings are used by investors, issuers, investment banks, broker-dealers, and governments.

Credit rating is done on the basis of credit scores that are numerical values assigned to the MSMEs based on a statistical analysis to notify their credit worthiness. These scores are often evaluated on the basis of the credit reputation of a company, commonly known as a credit report, available from the Credit Bureau of India.

The government of India also operates a specialised rating agency known as the SME Rating Agency of India Limited (SMERA), which is a third-party rating agency exclusively set up for micro, small and medium enterprises in India for ratings on creditworthiness. It provides ratings which enable only MSME units to raise bank loans at competitive rates of interest. SMERA's MSME rating scale consists of two parts, a composite appraisal/condition indicator and a size indicator. SMERA rating categorises MSMEs based on size, so as to enable fair evaluation of each MSME amongst its peers.

Some of the important credit rating agencies working in India are CRISIL, CARE, ICRA, FITCH RATING, NDIA and ONICRA. A scheme for performance and credit rating mechanism for SSIs has been formulated by the government of India in consultation with the Indian Banks' Association (IBA) and various rating agencies. The National Small Industries Corporation (NSIC) has been appointed the nodal agency for implementation of this scheme. Under the scheme, the NSIC provides subsidy in the rating fees to the small scale industrial units (SSIs) obtaining credit ratings from the agencies which are empanelled by them.

Guide to better credit worthiness

There are several guidelines laid down by the United Nations, the RBI and many others to safeguard the working of MSMEs. The most common teething problem faced by MSMEs is getting access to credit. One of the best ways to ensure credit worthiness, as recommended by many organisations, is to go for credit rating by a third party. Some others include the following:

- Credit rating not only ensures the credibility of the SME, but also helps them to get interest relaxation against credit from banks even in future credit applications

- Credit rating assists the MSMEs in building their business credibility and hence, reduces the perceived risk of default from the banks' perspective.

- Credit worthiness may be further improved by increasing the level of transparency and process rigour in record keeping and financial reporting. Most micro enterprises are weak in this aspect and this may be greatly improved through rating. Rating involves analysis for which the starting point is the financial statement of the firm. Hence, this process also increases the level of discipline and record keeping standards in MSMEs.

- Financing institutes also apply qualitative parameters extensively in gauging the credit worthiness of an MSME applicant since the financial statements furnished may not reflect the correct business strength. Such parameters would include typically organisation structure, background check of promoters (and family), management strength, resilience of the firm, quality of product, supplier and client network, trade relationships, previous credit defaults (by any director or kin), etc. Hence, maintaining transparency is of utmost importance in building credit worthiness. The other aspect is of having well defined processes and adhering to them that would ensure quality of product, consistency of delivery, etc.

- Credit rating also helps an MSME by getting more financial support as banks may increase their credit limits due to higher comfort factor in transacting with a well rated MSME. The rating also allows the MSMEs to expand their market base, get new contracts from export markets.

CONCLUSION

With the government of India putting the development of the MSME sector as top priority, and the state governments aligning themselves to this objective through implementation of various schemes, the future for MSMEs is brightening up. The MSME companies need to be aware of the schemes and financial aids being offered through various banking and non-banking channels to fund their innovation. With increasing participation of SMEs in the innovative exchange platform, along with their active opt-in for third party credit ratings, access to capital, both equity and debt, should no longer be a bottleneck for growth and expansion. These financial aids and processes will not only give the MSMEs a much needed reprieve from their liquidity crunch, but also help them in instilling the rigour of process, transparency and quality.

Contact

Capability Center for Cyber Innovation and Engineering
Sucoso Services Private Limited
connect@sucoso.com

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Sucoso® is a trusted advisory services platform for top-floor to shop-floor business integration. As a part of our MSME manufacturing capability building initiative, we have setup the Cyber Manufacturing Innovation & Engineering capability center to support technology lead manufacturing excellence programmes including Zero Defect Zero Effect Manufacturing, Automation and GST Supply Chain Optimization. To learn more about the Sucoso Capability Center for Cyber Innovation and Engineering, please visit: https://www.sucoso.com/innovation.php.