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Micro Small and Medium Enterprise Sector in Indian Context

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Abstract

MSMEs sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades. The projected contribution of Micro, Small and Medium Enterprises (MSME) sector, including service segment, to the country's GDP during 2012-13 was 37.54 per cent; while the total employment in the sector is 805.24 lakh; and the share of MSMEs in India's total export for the year 2014-15 was 44.70 per cent. There are around 13.2 MSMEs in India out of which about 55% are in rural areas and balance in urban areas. This sector is extensive and diversified producing as many as 6000 products, contributing to 40% of the manufacturing output and 35% the direct exports. This paper descriptively explains the major information drawn on multiple sources of data including the Ministry of MSME, Government of India, Reserve Bank of India (RBI), Small Industries Development Bank of India (SIDBI), existing research literature, IFC publications, industry publications, other government publications and interviews with various stakeholders to size the market opportunity of MSME finance in India. The major source of information for the estimation of finance demand is the Fourth All India Census on MSME 2007 (MSME Census), Annual Reports of Ministry of MSME, SIDBI MSME Database 2010, National Accounts Statistics (NAS) Ministry Of Statistics and Program Implementation (MOSPI).

Key Words: Micro, Small and Medium Enterprises, Finance, Economic Growth and India.

1.1 Introduction

Micro Small and Medium Enterprises (MSMEs) sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades. The MSME sector has the potential to spread industrial growth across the country and can be a major partner in the process of inclusive growth. As per the estimates of 4th All-India Census of MSME Sector, "There are 29.8 million enterprises in various industries and this sector produces more than 6,000 products contributes about 8% to GDP besides 45% to the total manufacturing output and 40% to the exports from the country and this Sector consisting of 36 million units, as of today provide employment to over 80 million persons across the country". The State-wise distribution of MSMEs show that more than 55% of these enterprises are in 6 States, namely, Uttar Pradesh, Maharashtra, Tamil Nadu, West Bengal, Andhra Pradesh and Karnataka. The MSME sector is a nursery of entrepreneurship and often being driven by individual creativity and innovation. The MSME sector in India is highly heterogeneous in terms of the size of the enterprises, variety of products and services produced and the levels of technology employed (Chandrasekhar, 2003). Indian government have enacted a separate act "The Micro, Small and Medium Enterprises Development (MSMED) Act" which was notified in 2006 to address policy issues affecting MSMEs as well as the coverage and investment ceiling of the sector. The sector is classified into Micro, Small and Medium based on the size of the enterprise, as defined in Table 1.

Table.1 Definition to MSMEs in India

Category of Enterprises	**Type of Business**	
	Manufacturing	**Service**
	Ceiling for Investment in Plant & Machinery	**Ceiling for Investment in Equipment**
Micro Enterprise	Upto Rs.25 lakh	Less than Rs10 lakh
Small Enterprise	Above Rs.25 lakh & Upto Rs.5 crore	Less than Rs.2 crore

Medium Enterprise	Above Rs.5 crore & Upto Rs.10 crore	Less than Rs.5 crore

1.2 Economic Contribution of MSME

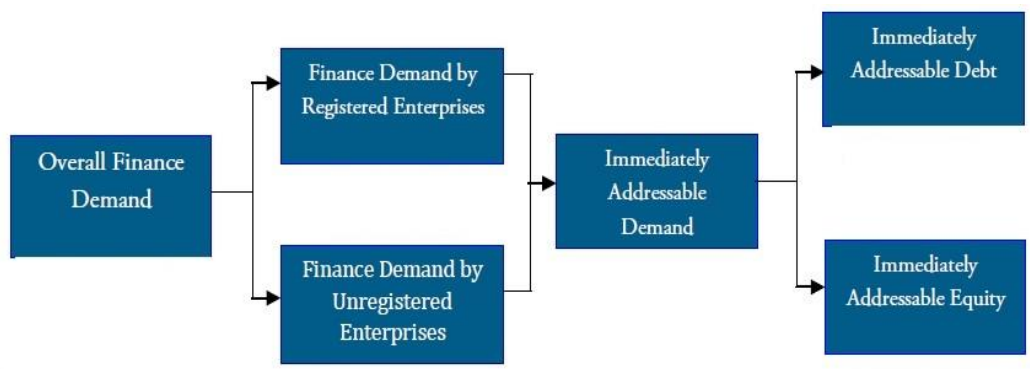
There are around 13.2 MSMEs in India out of which about 55% are in rural areas and balance in urban areas. This sector is extensive and diversified producing as many as 6000 products, contributing to 40% of the manufacturing output and 35% the direct exports. It also provides vital component and accessories to large scale sector. District Industries Centres across the country was 1.73 lakh which increased to 1.93, 2.13, 2.39, 2.84 and 3.23 lakh during 2008-09, 2009- 10, 2010-11, 2011-12 and 2012-13 respectively. This sector is a second largest employment provider next only to agriculture. It is breeding ground for business ideas and main driver of innovations. This sector has registered higher growth then overall industrial growth.

The projected contribution of Micro, Small and Medium Enterprises (MSME) sector, including service segment, to the country's GDP during 2012-13 was 37.54 per cent; while the total employment in the sector is 805.24 lakh; and the share of MSMEs in India's total export for the year 2014-15 was 44.70 per cent, the Parliament was informed and is growing at a rate higher than the projected GDP growth rate. Approximately there are 46 million Micro, Small and Medium Enterprise sector enterprises across various industries, employing 106 million people. The MSME sector in India has a minimum of 95% of industrial units, which accounts for almost 40 % of the gross industrial value-added in the Indian economy, exports and provision of direct employment to 20 million persons in around 3.6 million registered MSME units MSMEs are now exposed to greater opportunities than ever for expansion and diversification across the sectors. Indian market is growing rapidly and Indian entrepreneurs are making remarkable progress in various Industries like Manufacturing, Precision Engineering Design, Food Processing, Pharmaceutical, Textile & Garments, Retail, IT and ITES, Agro and Service sector.

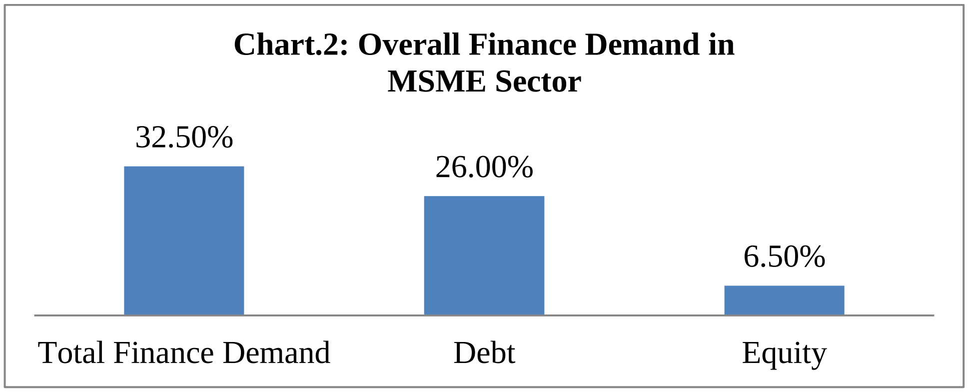
1.3 Overall demand for finance in MSME sector

Although the MSME sector has been growing at a faster rate than the overall industrial sector, MSMEs experience multiple constraints that threaten to derail the sector's growth trajectory. As per "R H Patil Committee" (2005) the following are the key Growth Constraints for MSMEs (i) Inadequate market linkages, (ii) Lack of infrastructure, (iii) Inadequate finance, (iv) Lack of managerial competence, (v) Obsolete technology. In that inadequate finance plays a major role in constraining the growth of MSMEs. The Report of Working Group on Rehabilitation of Sick MSMEs by RBI also finds lack of adequate and timely access to working capital finance is one of the key reasons for sickness in the sector. The 2007 MSME Census indicated that only 5 Percent of enterprises in the sector had access to some form of formal finance, while over 92 Percent of the units lacked access to any form of institutional finance

Chart.1: Demand for Finance in MSME sector



Financial institutions have traditionally limited their exposure to the sector due to the perception that these businesses carry high risk and high cost of delivery, and have limited access to immovable collateral. A large number of micro services enterprises such as small retail trade and repair prefer informal sources to the formal financial. Small enterprises require higher capital investments and tend to operate in value-add manufacturing and knowledge-based service industries. Entrepreneurs who run small enterprises have a relatively better knowledge of external sources of finance. 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. Businesses in the segment are typically structured as limited companies that allow for infusion of alternative forms of capital such as equity. the manufacturing sector accounts for a smaller share of enterprises, operations are more capital-intensive, as a result of which working capital requirement tends to be higher in the manufacturing sector than that in the services sector. Service industries such as retail trade, repair and maintenance, and restaurants are typically cash businesses with shorter turnaround, because of which their overall external capital requirements tend to be low on an average.



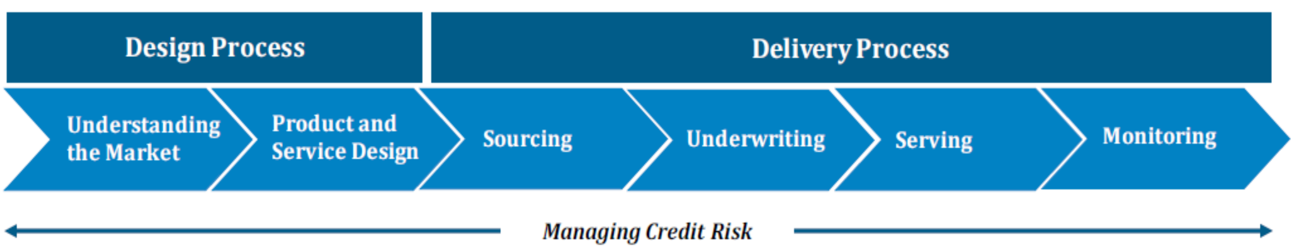
Source: MSME Census, SIDBI, Primary Research, IFC-Intellecap Analysis

1.4 Overall Flow of Finance to the MSME Sector

The flow of finance to the MSME sector comprises informal finance, self-finance and finance from the formal financial sector. The Institutional informal sources for flow of finance for MSME sector are registered trade credit, chit funds and moneylenders channel etc. Entrepreneurs are estimated self-equity contributions also leverage personal resources and contribute equity to the enterprise. The flows of MSME debt finance from the formal financial sector are from banking and non-banking institutions and government financing agencies. Public Banks have a better access to MSMEs, and take the lead in lending to the sector, as compared to private and foreign Banks. Public banks have considerable empirical knowledge of the MSME sector, and with the increased use of core banking technology, they are able to analyse historical data on MSMEs to develop targeted products and better risk management techniques. NBFCs provide an estimated INR 0.57 trillion ($11.4 billion) of debt finance to the MSME (IFC-Intellecap Analysis).

Microfinance institutions are often incorporated as NBFC-MFIs, and are mostly active in the unregistered and unorganized microenterprise segment. MFIs are gradually scaling up from providing individual loans to providing business loans for micro enterprises. The current flow of debt finance is uniformly distributed across Micro Small and Medium Enterprises. Based on the analysis of the data from RBI and other financial institutions, debt channelled to micro, small, and medium enterprise segments respectively is estimated to be INR 2.15 trillion ($43 billion), INR 2.4 trillion ($48 billion) and INR 2.42 trillion ($48.4 billion). Although the process of providing debt and equity capital for financing the MSME segment is not a lot different from that followed for other segments, yet investors need to have differentiated product and marketing strategies for the sector. This is to factor in the heterogeneity and risk inherent in the MSME sector. The process for debt finance to the MSME segment comprises the following: (a) understanding the market (b) product and service design (c) sourcing (d) underwriting (e) serving and (f) monitoring.

Chart.3: MSME Sector Finance Process



Financial institutions can use several parameters such as area of operation, industry segment, vintage, legal structure, cluster operations to identify sub-segments that can be effectively served by leveraging institutional strengths. In some cases financial institutions identify enterprises in the vicinity of branches and use rule-of-thumb to address the financial needs of micro and small enterprises.

1.5 Finance Gap in the MSME Sector

The lack of adequate and timely access to finance has been the biggest challenge. Financial institutions have limited their exposure to the sector due to a higher risk perception and limited access of MSMEs to immovable collateral. According to 4th MSME Census the finance gap in micro, small and medium enterprise segments is estimated to be INR 16.2 trillion ($324 billion), INR 3.9 ($78 billion) and INR 0.8 trillion ($16 billion), respectively. The gap in debt is largely because of unserved micro enterprises and underserved small enterprises. Micro enterprises mostly operate in the service sector, and most entrepreneurs do not have access to immovable collateral to secure finance or get the sanctioned limits to be raised. Entrepreneurs have limited internal resources to capitalize (equity) the business and limited managerial experience, both of which make accessing debt capital from formal sources challenging. As a result, an enterprise is vulnerable to working capital strain.

The debt gap in the sector is attributed largely to a shortfall in working capital finance. Enterprises in the segment tend to have longer working capital cycles due to delayed realization of payments from buyers – median debtor days in the segment are estimated to be 90-100 days.

1.6 Environment for Growth of Finance to the MSME Sector

Growth of MSMEs needs to be reinforced by holistic fiscal support and enabling policies. The three main pillars of the enabling environment that the study has analysed are (a) legal and regulatory framework (b) government support (c) financial infrastructure support. Given the importance of the MSME sector for economic growth, the government and regulators have instituted several policies to facilitate the growth of the sector and encourage participation by financial institutions. The Micro, Small, Medium Enterprise Development Act, 2006 (MSMED Act) defines the micro, small and medium enterprise segments, and promotes focused and coordinated development of policy for the sector. The government has enacted the Credit Information Companies (Regulation) Act 2005 (CIC Act) to facilitate the formation of credit bureaus and strengthen the finance information infrastructure. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI

Act) is a legal framework that protects creditor rights and facilitates recovery of non-performing assets without the intervention of the judicial system.

The Act is applicable to all loan assets created by a commercial bank, and broadly provides three alternative methods of recovering non-performing assets, namely, (a) securitization (b) asset reconstruction and (c) enforcement of security. Recognizing the importance of the MSME sector, the government has instituted various schemes and funding facilities for the development of the sector. Government interventions are aimed at improving the competitiveness and financial health of MSMEs.

Among the programs that are seen to have impacted access to finance are those for skill development, market linkage, technology adoption, cluster development and finance availability. The government has appointed National Small Industries Corporation Limited (NSIC) as the key implementation agency to manage electronic platforms that will foster business-to-business market linkages for MSMEs. The MSME sector is characterized by low adoption of technology, which impacts the sector's competitiveness. In order to encourage enterprises to invest in technology, the government also provides Credit-Linked Capital Subsidies (CLCS) for technology investments. The government leverages the credit infrastructure of the public sector banking network to make the subsidy available to MSMEs. A cluster is a location-based agglomeration of micro, small and medium enterprises that are faced with similar opportunities and challenges. Clusters tend to provide an ecosystem support.

1.7 Conclusion

The development of this sector came about primarily due to the vision of our late Prime Minister Jawaharlal Nehru who sought to develop core industry and have a supporting sector in the form of small scale enterprises. MSMEs sector has emerged as a dynamic and vibrant sector of the economy.

The Indian economy is expected to grow by over 8 per cent per annum until 2020 and can become the second largest in the world, ahead of the United States, by 2050, and the third largest after China and the United States by 2032. In this context it is very important to examine the role of MSMEs for economic growth of India. The ministry of Micro, Small, and Medium Enterprises in its vision envisages a vibrant MSME sector in the country exhibiting healthy growth through the setting up of new enterprises and up-scaling of the existing ones. Further, the contribution of MSMEs to the country's GDP is vital and efforts are being made to ensure that the MSMEs are focused on constituting a healthy proportion of the country's GDP. To achieve the ministry's objective and to have a healthy MSME sector in the country, it is crucial to remove all roadblocks to the growth of the sector. The Government's 'Make in India' program, with its focus on skill formation and innovation could be utilised for achieving MSME growth by directed efforts towards innovating ways of removing roadblocks and enabling a greater thrust to the overall growth and development of the MSMEs in India.

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