ISSUES AND PERSPECTIVES OF FINANCING SME SECTOR

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ABSTRACT

Small and Medium Enterprises (SMEs) plays a very significant role in the economy in terms of balanced and sustainable growth, employment generation, development of entrepreneurial skills and contribution to export earnings. However despite their importance to the economy, most of the SMEs are not able to stand up to the challenges of globalization, mainly because of difficulties in the area of financing. With the opening up of the Indian economy, it has become necessary to consider measures for smoothening the flow of credit to this sector. This article provides a cross country perspective in this regard and highlights the Indian scenario with reference to SME lending. SMEs make a major contribution to the growth and employment and their ability to grow depends on their potential to invest in technology, restructuring, innovation and human resource development. Access to finance in time and in adequate measure has been made out as a key factor affecting the healthy growth of the sector.

OBJECTIVES

• To know about the various options for financing SMEs
• Issues in lending the SME sector
• Steps for smooth lending SMEs

KEYWORDS: Angel Funds, Equity financing, Hybrid capital, Venture Capital & SMEs

INTRODUCTION TO SMEs

Small and Medium Enterprises (SMEs) have played a significant role world over in the economic development of various countries. Over a period of time, it has been proved that SMEs are
dynamic, innovative and most importantly, the employer of first resort to millions of people in the country. The sector is a breeding ground for entrepreneurship. The importance of SME sector is well-recognized world over owing to its significant contribution in achieving various socio-economic objectives, such as employment generation, contribution to national output and exports, fostering new entrepreneurship and to provide depth to industrial base of the economy.

Small and Medium Enterprises (SMEs) are the backbone of all economies and are a key source of economic growth, dynamism and flexibility in advanced industrialized countries, as well as in emerging and developing economies. SMEs constitute the dominant form of business organization, accounting for over 95% and up to 99% of enterprises depending on the country. They are responsible for between 60-70% net job creations in developing countries. Small businesses are particularly important for bringing innovative products or techniques to the market. SMEs are vital for economic growth and development in both industrialized and developing countries, by playing a key role in creating new jobs. Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities. SME finance is funding of small and medium sized enterprises and represents a major function of the general business finance market. Banks are playing a major role in financing SMEs in India. Nearly 82% of the total SME financing is through banks. And among them the major share is of public sector banks i.e. 57%. Thus it is clear that the most common source of finance for SMEs is Bank Financing. There are number of banks that assist the SMEs for financing. The main channel used by the SMEs via Banks is specialized loans by various banks. The main reason for choosing bank loans by SMEs compared to other sources of financing like venture capital, PE funding etc is that is only interest to be paid no stake is to be diluted thus the whole command of the SME is with the owner only. There are a number of Private as well as Public sector banks who assist SME in financing.

Financing is one of the necessary prerequisites for SMEs development such as legislative, marketing and research requirements. Lack of finance represents a major obstacle to SMEs growth and development. It is undeniable that in both developed and developing countries, SMEs traditionally lacked access to formal credit, particularly long-term finance. This is because SMEs are considered of high risk due to insufficient assets, low capitalization and lack of collateral as well as high vulnerability to market conditions.

Options for Financing SMEs:

1. **Equity Financing:**

   Equity finance (owners or investors) is important for maintaining a sustainable capital structure particularly at the early start-up and expansion stages. Without adequate equity there can be a problem accessing debt financing. Investors will expect a return on their investment commensurate with their risk and they mostly would like to have a say in running the business. Sometimes raising start-up capital requires sharing business ownership among investors who contribute to capital, who may or may not participate in the day to day operations of the business. Equity finance does not put obligation on the firm to pay back to the investors. All that the investors get for their money is the percentage of the business’ net earnings, whether profit or loss, liabilities or assets associated with it. Investors can bring in their experience in running the business and also establish networks that would contribute to the growth of the enterprise.

2. **Hybrid Capital:**
Hybrid capital invariably refers to a combination of equity and debt with capacity to convert as equity at a particular growth stage of the company. In India, several SMEs took this route as it provides comfort for the investor in terms of the debt provider doing the due diligence and project appraisal to assure safe investment and the debt provider derives the comfort of having to look to provision of the required equity from the venture at the beginning. Sometimes, during the growth of the company, the financing institution may suggest ways of raising equity and provide comfort to the equity provider over the safety of the investment.

3. Venture Capital:

Venture capital refers to independently managed and dedicated pools of capital that decides to put in an equity-linked investments in privately held, high growth companies; it generally expects a high return for the risk it takes. Venture capital is generally synonymous with private equity. Venture capitals may obtain some income from dividends from the companies they invest in but they obtain most of their earnings from capital gain from their investments. Venture capitalists would not generally take part in day-to-day running of the company, although provision of management and technical expertise can often be a condition of Venture capital funding. They commonly acts as mentors and a business partners to see that the company grows and succeeds, which is in the best interests of all concerned, including the venture capitalist. Several IT, Biotech and Pharmaceutical companies have used VC funds very successfully in their initial years. They seek to exit within a period of five to seven years. Exit strategies can differ and may include being bought out by the company’s principals, a public listing, or sales of the VC’s shares to a third party at a premium. The strategy needs to be negotiated at the beginning of the VC investment. Most VCs have a portfolio of investments to spread their risks evenly.

4. Angel Funds:

Angels pool money and invest in larger deals; they diversify across multiple investments; they leverage network contacts and investments expertise (such as screening, valuation and monitoring); and add follow-on rounds to existing investments unlike the VCs. Angel funds have entered retail markets, real estate ventures, information technology and biotech industry.

5. Debt Financing:

Smaller firms often find it more difficult to access debt financing than the larger firms for the simple reason that they do not have acceptable collateral of adequate value. Some of the common difficulties associated with lending to SMEs include:

- Low levels of equity.
- Under-capitalization and lack of financial strength.
- Insufficient plough-back of profits.
- Poor reporting systems.
- Poor understanding of financial data.
ISSUES OF FINANCING SME SECTOR:

There are a number of issues in lending to the SME sector, which banks generally face. The key issues among them are outlined below:

(a) Information Asymmetry:

Accurate information about the borrower is a critical input for decision-making by banks in the lending process. Where information asymmetry (a situation where business owners or managers know more about the prospects for, and risks facing their business than their lenders) exists, lenders may respond by increasing lending margins to levels in excess of that which the inherent risks would require. However, the sheer ticket size of SME lending makes it viable for banks to invest in development of information systems about SME borrowers. In such situations, banks may also curtail the extent of lending even when SMEs are willing to pay a fair risk adjusted cost of capital. The implication of raising interest rates and/or curtailing lending is that banks will not be able to finance as many projects as otherwise would have been the case.

(b) Granularity:

This refers to a situation where the risk grading system at banks does not have the requisite capability to discriminate between good and bad risks. The consequence is tightening of credit terms, or an increase in prices, or both. From the borrower’s perspective, this leads to an outcome where the bank is over-pricing good risks and under-pricing bad risks. The fact that most banks in India have not developed adequate expertise in SME lending risk assessment exercises leads to the problem of granularity when it comes to SME lending.

(c) Pecking Order Theory:

Pecking order theory flows from the above two issues, which makes SME lending highly difficult for banks. Under this hypothesis, SMEs, which face a cost of lending that is above the true risk-adjusted cost, will have incentives to seek out alternative sources of funding. Evidence suggests that in such situations SMEs prefer to utilize retained earnings instead of raising loans from banks.

(d) Moral Hazard:

Even when loans are made to SMEs, it may so happen that the owners of these SMEs take higher risks than they otherwise would without lending support from the banks. One reason for this situation is that the owner of the firm benefits fully from any additional returns but does not suffer disproportionately if the firm is liquidated. This is referred to as the moral hazard problem, which can be viewed as creating a situation of over-investment. The moral hazard problem may, thus, result in SME lending turning bad in a short period of time, a situation that all banks would like to avoid.

(e) Switching Costs:

SMEs may find it harder to switch banks, when countered with any issue. It is a known fact that the smaller the business, the more significant the switching costs are likely to be and, therefore, it is less likely that the benefits of switching outweigh the costs involved. This situation results in SME lending becoming a seller’s market, which may not be attractive to SME borrowers.
Steps for Smooth SME Lending

In order to ensure that the above issues do not stand between SMEs and Bank Finance, the following steps could be taken as remedial measures:

(a) Collateral:

Existence of collateral that can be offered to banks by SMEs could be one effective way of mitigating risk. Banks could, therefore, look at collateral when pursuing the question of SME lending. It can also be stated that a borrower’s willingness to accept a collateralized loan contract offering lower interest (relative to unsecured loans) will be inversely related to its default risk. However, not all SMEs would be able to offer collateral to banks. Hence, Reserve Bank of India (RBI) allows banks, with a good track record and financial position on SSI units, to dispense with collateral requirements for loans up to Rs. 25 lakhs.

(b) Relationships:

The length of the relationship between a bank and its SME customers is also an important factor in reducing information asymmetry, as an established relationship helps to create economies of scale in information production. A relationship between a SME and a bank of considerable duration allows the bank to build up a good picture of the SME, the industry within which it operates and the caliber of the people running the business. The closer the relationship, the better are the signals received by the bank regarding managerial attributes and business prospects.

(c) Quality of Information:

SMEs are required to provide accurate and qualitative information to the banks for them to undertake a reliable risk assessment. Accurate risk assessments obviously rely upon good information regarding the SME and its prospects. Hence, it is suggested that banks should make efforts to encourage SMEs to improve the quality of information provided.

(d) Customer Consideration:

The SME markets is somewhat different to the corporate market in that corporate customers generally have a wide range of financing options to choose from and are not as dependent on bank financing as is the case with SMEs. The extent to which SMEs can take necessary steps, with the aid of public initiatives, to easily switch to another bank is another factor that can influence the level of competitive pressure on banks in the case of SME lending.

Role of Government and Banking Regulator in SME Lending

As is apparent, the above factors are only idealistic solutions and may not be practical for SMEs to follow because they are faced with several problems such as weak financial strength, inability to provide adequate collateral and other factors. Hence, the Government and banking supervisors should take a holistic view of the SME Sector while considering SME financing, taking into account the risks faced by banks and the problems faced by SMEs. In this regard, the initiatives taken up by the Government and Banking Regulators across various countries and in India are as follows:
(a) Cross-country perspectives:

Increased competition in financial markets in developed countries has led several Governments and Banking Regulators to encourage banks and other financial institutions to launch a number of initiatives to serve the financing needs of SMEs effectively. Some of these initiatives (along with necessary government and regulatory support) include the promotion of venture capital; receivables financing; leasing finance; soft loans, grants, and guarantees for entry into public tenders; setting up of special financing companies with state participation; micro-finance programmes, etc. For instance, New Zealand has introduced a scheme called ‘BIZ Investment Ready’, which targets innovative businesses and entrepreneurs seeking funds to expand, diversify or commercialize a new concept. The European Union has devised a scheme to facilitate contacts between SMEs and banks and other financial institutions, by developing a ‘code of good practice’ for SME lending. The Philippines has instituted a financing programme called SME Force (SME Financing for Organizationally Competent and Excellent Franchise Businesses), which is a franchise development financing facility that will be implemented with the participation of franchiser organization.

(b) Indian scenario – Government initiatives:

Even in India, the financing of the SME sector has received some attention since independence. Some of the initiatives taken by the Government in this regard are as follows:

- Setting up of the Small Industries Development Bank of India (SIDBI), as the apex refinance institution in India for the purpose of channeling of finance to Small Scale Industries (SSIs) and SMEs in an organized manner.

- SIDBI has proposed two fund based initiatives for improving credit flow to the SME sector as follows:
  
  - A contribution of Rs. 100 crore to the Rs. 500 crore corpus of the SME Growth Fund (SGF), which shall make primarily equity/equity related capital investments in accordance with SEBI guidelines in SMEs operating in various growth sectors such as the life sciences, biotechnology, etc.
  
  - The SME Fund of Rs. 10,000 crore to give an impetus to the flow of funds to the SME sector. This fund has begun operations with effect from April 2004. Under the Fund, assistance is provided to SMEs at affordable rates of interest, and direct finance is extended to SMEs through SIDBI’s network of branches. Further, refinance to State Financial Corporation’s (SFCs) has also been made attractive in terms of low rates of interest.

- The Government of India has launched the Credit Linked Capital Subsidy Scheme (CLCSS), which aims at facilitating technology upgradation of SMEs in specified products/sub-sectors.

- SIDBI has recently negotiated a line of credit with the World Bank for financing and development of SMEs in India, with a view to upscale the credit flow to the sector and raising resources for the SME Fund.
(c) **Indian scenario – RBI initiatives:**

The RBI, from time to time, has formed several committees and working groups to study the flow of credit to the SME sector in a comprehensive manner, and has issued detailed guidelines in this regard. Recently it has constituted an Internal Group under the Chairmanship of Shri C. S. Murthy to, *interalia*, consider the relaxation and liberalization of credit lending norms that are applicable to the SME sector. The Group has submitted its report on June 6, 2005.

The Internal Group, with reference to financing of SMEs, has recommended:

- Constitution of empowered committees at the regional offices of the Reserve Bank to periodically review the progress in SME financing and also to coordinate with other banks/financial institutions and the state governments in removing bottlenecks, if any, to ensure smooth flow of credit to the sector.

- Opening of specialized SME branches in identified clusters/centers with preponderance of SME units to enable entrepreneurs to have easy access to bank credit and to equip bank personnel to develop the requisite expertise.

- Empowerment of the boards of banks to formulate policies relating to restructuring of accounts of SME units subject to certain guidelines.

- Restructuring of accounts of corporate SME borrowers having credit limits aggregating Rs.10 crore or more under multiple banking arrangements to be covered under the revised CDR mechanism. Appropriate authorities are currently examining the above recommendations of the Internal Group.

**ISSUES IN SME FINANCING**

The development literature focuses a good deal of attention on issues faced by SME in accessing finance. Traditionally, the focus is on obstacles created by commercial banks or equity funds, or on imperfections in the broader institutional environment. However, SME also make decisions about financing and display attitudes that have an important bearing on financing decisions. Therefore, constraints may also appear on the ‘demand side’ of the financing marketplace.

**Obstacles to SME Financing**

The economics literature on enterprise financing has identified three main obstacles that may prevent SME from obtaining adequate financing which are as follows:

- The existence of marked *informational asymmetries* between small businesses and lenders, or outside investors;
- The intrinsic *higher risk* associated with small scale activities;
- The existence of sizeable *transactions costs* in handling SME financing.

In developing countries, these problems are often exacerbated by *institutional factors*. These aspects are briefly dealt with below:

**Informational Asymmetries**

Informational asymmetries are always present in enterprise financing transactions. Entrepreneurs typically possess privileged information on their businesses that cannot be easily accessed—or cannot be accessed at all—by prospective lenders or outside investors. This leads to two
problems. First, the lender/investor may not be able to differentiate adequately between ‘high quality’ and ‘low quality’ companies and projects. In that case, price variables (i.e. interest rates) may not work well as a screening device, because high interests may lead to an excessively risky portfolio (the ‘adverse selection’ problem). Second, once the lenders/investors have supplied the funding, they may not be able to assess whether the enterprise is utilizing the funds in an appropriate way (the ‘moral hazard’ problem). To mitigate these problems, bankers and outside investors may adopt precautionary measures, such as requiring that financing be collateralized. Ultimately, they may simply turn down the request financing (‘credit rationing’). Informational asymmetries tend to pose more severe problems for SME, than for larger business. The information that SME can realistically provide to external financiers (in the form of financial accounts, business plans, feasibility studies, etc.) often lacks detail and rigor. This problem is often aggravated by the low level of education of small entrepreneurs, who may not be in the position to adequately articulate their case.

This problem is particularly acute in developing countries. The information supplied to bankers and outside investors by family-owned SME is often not fully accurate and realistic, and opaque behavior may prevail. Under these conditions, outside financiers tend to adopt a very cautious attitude towards SME, and either reduce the amount of financing sought or refuse it altogether.

Risk Profile

Another approach ascribes the difficulties faced by SME in accessing finance to their higher risk profile. Suppliers of external funds regard SME as riskier enterprises for a number of reasons. Firstly, SME face a more uncertain competitive environment than larger companies they experience more variable rates of return and higher rates of failure. Secondly, SME are comparatively less equipped in terms of both human and capital resources to withstand economic adversities. Thirdly, there is the problem of inadequate accounting systems, which undermines the accessibility and reliability of information concerning profitability and repayment capacity. In developing countries, there is the added problem of a more volatile operating environment, which has a negative impact on the security of transactions. There is a greater risk that lenders/investors will not get paid, or that assets will not be properly registered.

Transaction Costs

Irrespective of risk profile considerations, the handling of SME financing is an expensive business. The cost of appraising a loan application or of conducting a due diligence exercise in view of a possible equity investment is largely independent from the size of the financing under consideration. For all practical purposes, the following costs are fixed: (i) administrative costs; (ii) legal fees; and (iii) costs related to the acquisition of information, such as the purchase of a credit profile from a specialized agency. In the case of smaller loans or investments, it is more difficult to recoup these costs. Similar considerations apply to the costs that outside financiers must incur after disbursement, when conducting field inspections, or attending board meetings. Again, the problem is more severe in developing countries for the following reasons:

(i) The lack of adequate management information systems in financial institutions;
(ii) The undeveloped state of the economic information industry; and
(iii) The poor state of certain public services, such as the registration of property titles and collaterals.
(iv) To some extent, the problem can be solved by raising the cost of financing through a higher interest rate or closing fee. This is indeed the approach adopted by many micro lending schemes, but it is possible only up to a certain point.
Lack of Collateral

In the case of debt financing, lenders typically request collateral in order to mitigate the risks associated with the ‘moral hazard’. The lack of collateral is probably the most widely cited obstacle encountered by SME in accessing finance. The amount of collateral required in relation to the loan size is a measure frequently adapted to empirically assess the severity of the financing gap. In some cases, the enterprise may be unable to provide sufficient collateral because it is too new and it is not firmly enough established. That problem is closely related to the ‘higher risk’. In some cases, the lender may deem the collateral insufficient in view of the size of the loan requested. In other words, the proposed expansion project may be too large in comparison with the current size of the firm. Again, this is an issue related to the ‘higher risk.’ In other cases, the collateral may be insufficient simply because the managers-owners tend to siphon off resources from the company for personal or other purposes. Again, this is closely related to the risk profile and the moral hazard issues. Lack of collateral can be viewed more as a symptom than as a direct cause of the difficult relations between SME and providers of finance. Whatever the sequence of causes and effects, it is widely acknowledged that in developing countries the issue of collateral is comparatively much more severe. The following section examines how the undeveloped state of institutional and legal frameworks, prevents the possibility of pledging the owned assets as collaterals.

Institutional and Legal Factors

In the case of many developing countries, the above mentioned obstacles to SME financing are exacerbated by institutional and legal factors.

Firstly, many developing countries still have highly concentrated and uncompetitive banking sectors. This is often the result of restrictive government regulations. This reinforces the tendency to adopt very conservative lending policies or to charge high interest rates. If banks can thrive with a stable pool of well-established clients, they have no real incentive to improve the range of financial products and, in particular, no incentive to go down market, to meet the needs of small businesses. The same is true if banks can make hefty profits simply by buying government debt as is often the case in Latin American countries which results in the ‘crowding out’ of small-scale lending.

Secondly, insufficiently developed legal systems effectively prevent the development of certain financing instruments, including the use of collateral as a risk-mitigating element. For instance, legal provisions regarding security interests (how the collateral is protected, how the collateral priority is determined, etc.) are of crucial importance in determining the efficacy of collaterals. Likewise, if company laws offer only limited protection to minority shareholders, the development of venture capital and angel financing is inevitably negatively affected. These problems were particularly severe at the beginning of the transition period in former socialist countries, when even the memories of certain fundamental market institutions had disappeared.

Thirdly, even when adequate legislation is available, there are often problems with enforcement. Today, transitional and developing economies often have cadastres and registers of movable assets. Nevertheless, their functioning is often less than ideal. Records are frequently missing or misplaced. There are lengthy procedures for filing mortgages and pledges, and for ascertaining the status of certain assets. There are often cases of corruption among personnel.
Fourthly, the “information infrastructure” is still largely undeveloped. There is a lack of credit bureaus and other mechanisms for collecting and exchanging information on payment performance. This inevitably exacerbates the informational asymmetries between enterprises and lenders/ investors. While some of the above institutional constraints apply to all enterprises, it is clear that small businesses are likely to suffer disproportionately from their presence.

The Critical Challenge of Funding

Flexibility as well as low start-up and operating costs have enabled SMEs to spring up, to reposition and adjust themselves quickly in response to market and economic changes. Moreover, they easily expand or contract in a short time. SMEs have not only survived the impact of big enterprises and the law of economies of scale but have carved out niches for themselves, which enable them to coexist with big enterprises. However, the most common problems for SMEs are the lack of access to market information and technology, the low quality of human resources and the lack of access to capital. Despite efforts by financial institutions and public-sector bodies to close funding gaps, SMEs continue to experience difficulty in obtaining risk capital. These funding gaps relate to firm size, risk, knowledge, and flexibility. SME borrowing requirements are small and frequently do not appeal to financial institutions. More collateral may be required than SMEs can pledge. Financial institutions may lack expertise in understanding small and medium knowledge-based business. The flexibility in terms and conditions of financing that SMEs require may not be available.

SME Funding from Capital Markets

Statements have demanded as much detailed information and forecasting. The increasing pressure for continuous disclosure places great pressure on small management teams. Small business markets have not attracted investors; the costs of listing and ongoing compliance costs combined with requirements for continuing disclosure have been a disincentive to small growing companies with limited management skills. The high-risk nature of these small businesses and the limited information they can provide has not attracted support from the broking community. Disclosure is essential for confidence in public securities markets. Best business practice is crucial to underpin disclosure. Track record is important when investors are comparing options. At the start-up stage, growth and the revenue are important – the demands of listing too soon may inhibit growth.

The Role of Government

Government can affect the supply of funding for SMEs. It can do so by introducing rules and regulations to encourage banks, venture capitalists and capital markets to create uniquely tailored programs, for example, directing venture capital to seed firms in growth sectors and supporting pension funds participation in venture capital funds and tax incentives. Impacts of globalization such as global competition, rapid changes in technology and the evolving market conditions add to the high risk of funding fast-growing small businesses. R&D costs are rising. Strategic alliances are increasing, particularly, cross-border alliances. Mergers and acquisitions cross borders. Information networks are becoming more sophisticated, for example, through development of clusters.
Policy Recommendations

The following recommendations have emerged from the Finance Forum discussion of the issue of how to finance the growth of SMEs in the region:

- Promote a flexible environment for the venture capital specific to SMEs to flourish;
- Tailor credit in banks and other similar institutions to the need of small firms;
- Give a greater emphasis on training programs to help banks’ staff understand the unique requirements of SMEs better;
- Harmonization of the financial policy framework across economies will promote cross-border strategic alliances including SMEs and facilitate transfer of experiences between the regional economies.

CONCLUSION

Without adequate bank finance, SMEs cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms. Similarly, banks cannot consider the financing of SMEs as a viable option unless their priorities are addressed by SMEs. In this regard, SMEs should be assisted largely by public initiatives involving participation of the banking industry. In India, however, the various public initiatives for promoting finance to SMEs have not been as successful as envisaged because there has been some overlapping of regional and national initiatives. Efforts to harmonize the standards and practices, therefore, need to be properly coordinated to facilitate SME finance further.

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