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The Financing of MSMEs – Role of Venture Capital

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Abstract:

The Micro, Small and Medium Enterprises (MSMEs) Sector is considered to be crucial to the growth of the economy. It provides large employment opportunities at low cost, helps in industrialization of rural and backward regions, reduces regional imbalances and promotes equitable distribution of income and wealth. The small and ancillary units of MSMEs are complementary to large industries and contribute to the growth of the economy. It is important to provide adequate and timely finance for the growth of MSMEs. However, studies have indicated that the sector faces great difficulty in obtaining adequate and timely finance during its early stages. Venture capital has an important role to play in effectively meeting the early stage requirements as Bank finance is not forthcoming due to various constraints. The study examines the importance of MSMEs, their growth constraints, financial sources, role of venture capital in meeting financial requirements, measures to channelize venture capital funds to MSME sector.

Keywords: MSME, Venture capital, growth constraints, formal and informal funding sources

1. Introduction

The MSME sector includes a large number of Business Units producing a wide variety of products and services. The business units may be organized as Proprietorships, Partnerships, Cooperative Societies, Public or Private Corporations. They may be registered or unregistered. Micro, Small and Medium Enterprises Development Act 2006 defined micro, small and medium organizations based on the amount of investment in Plant and Machinery or Equipment as follows:

If the investment in Plant and Machinery is below Rs. 25 lakhs, it is considered to be Micro, with investment between Rs. 25 lakhs to Rs. 5 crore, it is a Small enterprise and with investment between Rs. 5 crore to Rs. 10 crore, it is considered to be Medium enterprise. In case of enterprises engaged in providing services, it is Micro, if investment in equipment is below Rs. 10 lakhs, it is Small, if investment is between Rs. 10 to Rs. 2 crore and it is Medium, if investment is between Rs. 2 crore to Rs. 5 crore.

2. Objectives of the Study

1. To examine the role and importance of MSMEs
2. To Study their problems and growth constraints
3. To identify sources of finance and their effectiveness
4. To examine the suitability of Venture Capital finance as a source of finance
5. To suggest measures to channelize more venture funds to MSME sector

3. Methodology

The Study is based on secondary sources of data collected from MSME Annual reports published by the Ministry of MSME Sector, report by International Finance Corporation on MSME finance and Joint report by CII-PWC on the Financing of MSMEs the East side story.

4. Role of MSMEs Sector in Indian Economy

Recent statistics reveals that MSME Sector is an important constituent in the growth of the economy. It contributes 45% of manufacturing output and 40% of exports. Its growth rate is over 10% in the last 5 years. Its contribution to GDP is 11.5% and provides employment to about 70 million people. The sector is highly heterogeneous in terms of the type of products produced or services provided. In 2009-10, there were over 29.8 million registered and unregistered enterprises manufacturing more than 6000 products¹.

¹IFC. (2012). Micro, Small and Medium Enterprise Finance market in India, IFC Intellectap Report, page 3.

Features of MSMEs:

- Around 95% of MSMEs are Micro organizations. Small organizations constitute 4.7% and Medium organization 0.3%. Micro enterprises are too small in size and are mostly organized as proprietorships. 94.5% of MSMEs are organized as Sole Proprietorships, 1.2% as Partnerships, 0.8% as Public and Private Corporations and 3.5% as Cooperatives. Their ownership structure prevents infusion of external equity and hence they rely heavily on debt as a source of finance. 77% are in Manufacturing of products, while 23% are providing services².
- Because of their small size, high risk is associated with them in terms of their ability to withstand adverse situations.
- Most of them are unregistered and unorganized. They do not maintain proper records and transact mainly in cash. This makes it difficult to secure bank credit.
- They have inadequate market linkages. They use outdated technology due to lack of awareness.
- They do not have adequate assets which can be used as collateral for raising loans from commercial banks. This is especially in case of units involved in information technology, services.

5. Challenges Faced by MSMEs

The report of Prime Minister taskforce on MSME, 2010 identified the following growth constraints:

Financial Constraints:

- Non availability of adequate and timely funding on account of high cost of credit, collateral requirements, limited access to equity capital.
- Lack of access to institutional credit forcing them to borrow funds from unregulated lenders at high cost of interest.

Non-Financial Constraints:

- Problems in procuring raw materials, difficulty in storage, designing and packaging.
- Lack of access to skilled manpower, global markets, infrastructural facilities, modern technology³.

These constraints limit their ability to raise funds, increase sales, retain the customer base and compete with large organizations.

6. Sources of Funding and Their Limitations

Credit availability at affordable cost is identified as one of the critical factors for the growth of MSMEs. To unlock their growth potential, it is necessary to provide timely and adequate amount of funds to meet working capital and long term requirements. The following are the funding sources for MSMEs:

1. Informal sources such as Personal Savings, Loans from Family, Friends, Chit Funds and Money Lenders costs anywhere between 25% to 60%⁴ which makes it unviable for many of the businesses. Around two-thirds of MSMEs depend on such informal sources of funding.
2. Formal sources of credit such as loans given by Scheduled Commercial Banks, Regional Rural Banks, Non-Banking Financial Institutions, etc. 80% of the Institutional Credit is provided by Commercial Banks in the form of loans. The rate of interest is anywhere between 13% to 16%. Only one-third of MSMEs have access to bank finance⁵. The reasons cited for low exposure to bank credit are lack of collateral against which banks lend, lack of credit information about MSMEs and low risk appetite of banks as a result of which they lend only to satisfy the priority sector lending norms fixed by the Reserve Bank of India. Credit Guarantee Scheme of the Central Government promotes collateral free lending. However, this remained largely unutilized as the banking sector is affected by a major portion of non-performing assets.
3. Other formal source of funding is from Venture Capital Funds or Seed Funds which provide equity finance to growth oriented MSMEs. They are different from institutional and informal sources of credit as they provide several value added services along with supply of ownership capital in order to enable the enterprises to realize their growth potential. Their exposure to MSME sector has been quite low so far.

Total demand for finance for MSME sector in 2009-10 is estimated to be INR 32.5 trillion of which requirement for Debt is INR 26 trillion and that of equity is INR 6.5 trillion. The share of formal sources in the total demand is 22% or INR 7 trillion. The rest of the demand is met by informal sources. The share of micro units in the total demand is 79%, while that of small units is 17% and medium units is 3%⁶. The funding gap is more severe in case of micro units and less severe in case of medium enterprises. Various studies have indicated that firms in the seed stage and early stages of their development find it more difficult to raise funds rather than firms in the later stages of their growth. In the seed stage, funds are required for developing prototypes, testing their commercial viability, investing in research and development activities. In the early stages, the firm is already in business and sometimes making profits but do not have a track record for raising bank funds and may not have generated sufficient assets which can be used as collateral. Hence finds it difficult to raise funds for meeting growth requirements.

² KPMG-ICC. (2013) Indian Banking-The engine for sustaining India's growth agenda, page 11.

³ Biswas Abhijeet. (2014). Financing constraints for MSME sector, International Journal of Interdisciplinary & Multidisciplinary Studies, Vol.1, No.5, 60-68.

⁴ IFC. (2012) Micro, Small and Medium Enterprise Finance market in India, IFC Intellectap Report, page 5

⁵ Ibid, page 3.

⁶ Ibid

To reduce the funding gap it is necessary to promote alternative sources of finance which specialize in meeting the early stage funding requirements of small and micro units. Venture Capital Funds are widely recognized as a means of providing early stage funding requirements of enterprises.

7. Venture Capital as a Source of Finance: Suitability and Constraints

Venture Capital Fund is a pooled investment vehicle where by funds are pooled from foreign institutional investors, development funds, high networth individuals, insurance companies, banks, etc. The funds so raised are managed by an asset management company consisting of a group of professionals with investment experience. Such funds are invested after a thorough due diligence in enterprises with high growth prospects. They intend to earn high returns from their investments usually in the form of capital gains. Following are the advantages of Venture Capital Funding to MSME sector:

1. It provides medium term or long term finance. Technology based companies require a long gestation period before their operations start generating sustainable revenues. Funds needed for product development, initial marketing, working capital needs and other requirements can be met by venture capital funds.
2. Funds are provided in the form of Equity which strengthens the capital structure of the business and provides a strong financial base for raising debt or further equity in future.
3. Venture capital fund acts as a business partner and provides strategic advice and guidance based on past experience with other companies in similar situations.
4. Apart from finance, several value added services are provided by venture capital funds in order to enable the company to reach its expected growth potential. Some of the value added services provided by venture capital funds include raising additional funds, networking with suppliers, customers, recruiting key personnel, co-investments with other venture capital funds and exploring new markets.
5. Venture capital funds share the risks and rewards of ownership. Venture capital funds lose the capital if the business fails but makes substantial capital gains if the business succeeds.

Venture Capital Funds broadly meet early stage and late stage financial requirements of the recipient companies. Early stage finance is provided to companies in the initial stages of their development. The typical investment size is between US Dollars 1 to 3million⁷. Late stage finance is provided to mature companies for meeting their growth and expansion requirements. The financial requirements of MSMEs fall in the category of early stage finance.

Year	Early stage finance (USD million)	Late stage finance (USD million)
2000	257	760
2001	60	441
2002	31	1240
2003	61	432
2004	86	2314
2005	281	2208
2006	1153	5344
2007	514	5344
2008	1444	7580
2009	132	4077
2010	290	3391
2011	691	4462
2012	1221	3655
2013	339	2115
2014	245	2544

*Table: Early Stage and Late Stage Funding by Venture Capital Funds
Source: India PE Report, 2014, Bain & Co., IVCA.*

From the details given in the above table, it is obvious that the early stage funding of the MSMEs is below par. Early stage investment in India is inadequate on account of the following reasons:

1. 90% of the Venture Capital Funds are promoted by foreign investors rather than domestic investors. There are regulatory hurdles on investment by large domestic investors such as pension funds, insurance and provident funds.
2. Angel investment which usually precedes venture capital is at a nascent stage in India. In 2011, Business Angels invested only about Rs.100 crore in around 50 deals compared to Rs. 2,000 crore invested in Canada⁸. Angel investors provide seed capital and mentor the enterprises in the very early stages of its development and play an important role in scaling up the operations.

⁷ ADB SME Finance Monitor, 2013 p.no. 72.

⁸ Planning Commission Report on Angel Investment and Early Stage VC, Creating a Vibrant Entrepreneurial Ecosystem in India, 2012, New Delhi.

3. Most of the Micro and Small business enterprises are promoted as family businesses. The founding families are generally not willing to relinquish control in favour of outside investors. There is a fear of unnecessary interference by venture capitalists in day to day affairs of the business.
4. Majority of Micro and Small enterprises are organized as Sole Proprietorships or Partnerships. These forms of business organizations are not eligible for venture capital funding as they invest only in the form of equity which could be provided only to businesses which are organized as limited liability corporations.
5. Difficulty in making exits is another constraint to venture capital finance. They usually look for exits via Initial Public Offerings (IPOs), Strategic or Secondary sales. Exit or divestment provides effective recycle of funds for further investments.
6. Venture capitalists expect high returns from their investments. If Micro and Small businesses do not provide potential for high growth, they remain unattractive for venture capital investment.

8. Measures to Channelize More Venture Finance to MSMEs

1. Promote Business Angel network through public private partnerships so as to improve the deal flow for venture capital funding. High Networth Individuals should be encouraged to provide incubation facilities and also act as Business Angels for enterprises at seed and very early stages. They help in determining commercial viability of new businesses and also facilitate venture funding.
2. Improve exit prospects of venture capital funds through IPOs, the Government should promote Stock Exchanges which specialize in securities of small companies. Such exchanges also help companies to raise additional capital. A beginning is made in this direction through SME exchange promoted in recent times. However, it is yet to show the results.
3. Promoters of Micro and Small enterprises should be trained in drafting business propositions, presenting their requirements effectively for venture funding through workshops and seminars.
4. Ease investment norms for large domestic investors such as pension funds, provident funds and insurance companies.
5. To encourage early stage funding, Government may consider providing fiscal incentives to investors in venture capital funds by providing tax exemptions on capital gains arising on sale of their holding in MSMEs.

9. Conclusion

In spite of the importance of MSME sector to the growth of the economy, the sector faces severe constraints which are both financial as well as non-financial. Banks and other institutional sources do not provide adequate credit forcing them to rely on informal sources of credit which leads to high exploitation. Medium enterprises fare better than micro and small enterprises in terms of raising funds. There is a need to promote alternative sources of funds such as venture capital funds which provide early stage finance and also nurture them to realize their growth potentialities. Their risk taking ability makes them to be an ideal source of finance but their proportion of providing early stage finance is low over the years on account of some limitations. To address such limitations, Government should take measures such as promotion of SME exchanges to provide better exit environment, relaxation of regulatory norms, fiscal incentives and promote development of business angel networks through public private participation.

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