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LISTING OF SMES - A SOLUTION TO THE GORDIAN KNOTS OF THE MSME INDUSTRY

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Abstract

This paper seeks to examine the Gordian knots of the Indian MSME sector and address them through the new model of listing of SME via the BSE SME a joint initiative of The SEBI and BSE. Problems of the erstwhile MSMEs that got resolved in the current set up of SME listing has been taken as the criterion. The major ones amongst them are Capital availability, Investor draw, Sub division and consolidation of ownership interest, Business valuation, Distribution of risk, Equity financing through venture capital financing, Premium valuation, Unlocking/ benchmarking value, Good governance, Tax exemptions, Public awareness, Attracting new talents, Credit management, Reputation management, Migration to main board exchange. However, betterment comes at a cost only. Listing entails few procedural compliances and drawbacks as well. This paper also makes an attempt to throw light at the various critical areas and drawbacks of listing end tailing a broader picture of listing of SMEs.

Key Words: SME, MSME, Net worth, Credit funding, RBI, NPAs.

Introduction

With India becoming a hub for start-ups, the small and medium enterprises or companies have seen a boom in the last few years. To support the growing number of small and medium companies, the government in 2012 initiated the SME exchange platform under the Bombay Stock Exchange along with support from SEBI.

The small and medium enterprises are said to become the major contributors to the Indian economy over the coming few years. There is no denying that SMEs play a vital role in the growth of an economy both, as a job creator and a contributor to the national income. However, it is often seen that these small companies fail in procuring sufficient funding and technological advancement due to the lack of funds to compete in the market and gain visibility for selling their products and services. By listing under the small and medium enterprise exchange, a company can ensure better opportunities to allow itself time and convenience to grow. Listing a company on the stock market is one of the best moves in order to raise capital. This is valid for SMEs (Small and Medium Enterprises) and also for start-ups and funds for development are needed all the time.

Running a business on a right scale exploring the right scaling opportunities requires alignment of various business opportunities with various skills and strengths of the business houses. While the law of land bestows certain advantages of taxation, other factors such as scale, information availability, market approach, exit possibilities amongst a lot of others influence the growth and placement of the business house in the market. This further influences the trade and statistics in the economy as a whole by contributing to various factors and indices like employment creation, credit cycles, GDP etc.

It is a fact that the Indian economy has been doing exceptionally well despite the bear trends an depressed world economy only because of the strength and diversification, she has got in the vastly spread MSME sector. Yet the growth potential of the same has not been fully unleashed owing to various shortcomings and inherent lacunae.

This paper seeks to examine the Gordian knots of the Indian MSME sector and address them through the new model of listing of SME via the BSE SME, a joint initiative of The SEBI and BSE. Problems of the erstwhile MSMEs that got resolved in the current set up of SME listing have been taken as the criterion. The major ones amongst them are Capital availability, Investor draw, Sub division and consolidation of ownership interest, Business valuation, Distribution of risk, Equity financing through venture capital financing, Premium valuation, Unlocking/benchmarking value, Good governance, Tax exemptions, Public awareness, Attracting new talents, Credit management, Reputation management, Migration to main board exchange. However, betterment comes at a cost only. Listing entails few procedural compliances and drawbacks as well. This paper also makes an attempt to throw light at the various critical areas and drawbacks of listing end tailing a broader picture of listing of SMEs.

Objective of the Study

This study mainly focuses on suggesting a solution in listing of SMEs to the various bottlenecks and Gordon knots faced by MSMEs in the Indian economy while critically examining the listing requirements

Methodology

All the information required for this study has been collected and compiled from secondary sources (Registrar of Companies and BSE-SME platform) as the subject matter comprises only listed SME companies. BSE SME is a trading platform floated by The Bombay Stock Exchange under the guidelines of SEBI. Further operation of various frameworks like SEBI guidelines, ROC (Registrar of Companies) filings, application of SCRA (Securities Contracts Regulation Act) Companies Act 2013 etc., make the secondary data most reliable and accurate fit for research purposes.

Capital Availability

The ace problem for any MSME in India is the availability of capital. Traditionally business can be run from two sources of funds – credit and own capital. It is obvious that own sources of capital are negligible effectively explaining the scale of operations. To make it big in the trade or service sector, availability of funds has become a very critical success factor besides having a feasible business idea and opportunity. As own sources are meager, the next go to option left with the sector is to root in for credit funding. But the same has been over years very unattractive and has high risk profile from the lender's perspective. The comparison of key statistics related to loans given by Indian Banking industry is presented in Table 1.

Comparison of Key statistics related to loans to MSME sector by Indian Banking industry

Criterion	2016-17	2017-18
Loan default margin	8,249 Cr	16,118 Cr
NPAs / Bad loans	82,382 Cr	98,500 Cr
Percentage of total loan defaults	66.61%	65.32%
Outstanding advances to MSME	9,93,655 Cr	10,49,796 Cr

Source – Reserve Bank of India

A careful analysis of the above data shows that the MSME sector has been a bad performing sector for the lender. Hence interest rates (being a risky sector) and collateral requirements are always on the rise.

Observations in respect of issues related to access to capital by fresh infusion are

It is a fact that credit availing avenues have been restricted and controlled over years from the organized sector and the semi organized and unorganized sources of credit take away the risk taking flair in conducting business from the entrepreneur's perspective. Working on the capital building is a more feasible solution than pondering on credit which bears with it a constant risk and requirement of mandatory accumulating cost of funding.

Though capital can be raised even by the unlisted SMEs, believability factor and market appeal go for a toss in respect of the same. Listing provides access to capital by equity infusion which is a direct growth driver.

The funds so raised are company's own and the company is at complete liberty to utilize it for any purpose such as expansion, diversification, acquisition or even loan repayment, all of which leads to a healthy balance sheet. Once listed, these companies are now well equipped to exploit other avenues of raising capital such as rights issue, preferential issues, qualified institutions placements (QIP) and other international fund-raising instruments, such as FCCBs, ADRs and GDRs etc.

Investor Draw

A business can fund its idea and operations from different sources. Majority of them are

- Own capital infusion
- Credit capital
- Government grants and subsidies
- Public issue of shares
- Venture capital financing
- Angel investment
- Business incubators

While traditional business modes like sole proprietor, Hindu Undivided Family (HUF), Partnership firms etc., get access to only three of the above sources and are devoid of availing the other sources of funding and pursuing a business idea.3 It is noticed that a listed entity either on the SME exchange or on the main platform are monitored by various independent parties/organisations such as Registrar of Companies (ROC), SEBI, Stock Exchange, Independent directors, Statutory auditors etc., revealing trustworthy, reliable and verified information to the market and the prospective investors who are at liberty to explore or study the business models and judge on the future viability of the business as an investment profile, thus attracting more investment in other forms like public deposits, debentures etc., besides issue of shares, venture capital financing, angel investment, business incubators etc. Listing also increases the confidence of investors as they have the liberty to enter and exit the listed company as per their convenience.

Subdivision and Consolidation of Ownesrship Interest

Traditionally, ownership interest is absolute and part exit or realisation is not possible in more traditional business formats like sole proprietor and HUFs. This, added with the legal restriction of unlimited personal liability to the debts of the business makes risk-taking a caution worthy exercise often leading in to pessimistic attitude towards business with over caution. Also lack of exit possibilities make the presence felt in operational and strategic decision making activities.

It is observed that stock exchange bye-laws provide for explicit rules for sub division and consolidation of securities as desired by the investors. There are special trading sessions in the exchange for conversion of odd lots into market lots arranged by financial and institutional investors. Thus, listing helps to provide flexibility to investors in the subdivision and consolidation of their holdings with speed and earnestness.

Business Valuation

Business valuation in MSME sector has been a major setback in the Indian context. Earlier definition of MSME was on the self declared investment in plant and machinery and business assets by the owner. Though the same is shifted to turnover based definition in the union budget 2018, the self declaration part is still holding well on the flip side. In the existing set up, there are no measures to verify and validate the turnovers as disclosed by the MSME units.

Lack of independent surveillance and exclusive regulatory mechanism with strict annual disclosure requirements have been forcing the market to cross verify information from various allied sources like income tax filing reports, GST filing reports, PF reports etc. Hence due to lack of information, business valuations have been more often restricted to traditional methods based on cost4

The observations reveal that listing on the SME platform, the valuation of the company increases as investors are drawn towards listed companies. Also presence of independent regulators, industry watch and market watch provide for the trust factor and oversight which are long overdue and are an immediate necessity.

Distribution of Risk

It is a fact that MSMEs contribute to 6.11% of India's manufacturing GDP11 and 24.63% of Services GDP in the previous fiscal. Yet they face a plethora of risks both operational, market-driven and informational. More often the risk has to be borne by the promoter on. Scope for diversification on risk and mitigation has been historically very low which explains the shift in entrepreneur mindset to employment mindset.

As per a news article published on May 07 2017 in The Hindu Business Line, 90% of Indian start ups fail12 because of business associated risks of lack of innovation and allied risks. As per Forbes listing, over 77% of venture capital financiers feel that Indian business models and ideas lack innovation. This can be traced to lack of financial capability to hire quality resources for feasible MSME business ideas.5

Hence it can be resolved that listing of SMEs can contribute to an effective method of distribution of risk in the developing capital market. It is an effective system of sustaining capital flow through the investment of excess which can lead to higher payoffs. Sustainable capital flow will ensure capability to hire quality resources, both human and technical, on a steady basis to cater the needs of ever demanding and dynamic global markets thereby optimizing risk appetite of the business models.

Equity Financing Through Venture Capital

Listing provides an incentive for Venture Capital Funds by creating an Exit Route and thus reducing their lock-in period. Thus more venture capital financing may look in to the Indian SME sector which provided shorter investment periods and availability of huge domestic market to cater to unlike the other contemporary investment opportunities.

Premium Valuation

Valuation of a company is

determined by various factors one of which is class of company – listed or closely-held. The value discounting by investors of an unlisted entity can be avoided, if the shares are listed on a nation-wide exchange platform including SME Exchange.

Unlocking / Benchmarking Value

The fair value of an unlisted company may not be benchmarked appropriately, in absence of a market-driven mechanism. The companies listed on a stock exchange are traded and the market forces are expected to establish their fair value or near-fair value. This leads to unlocking or benchmarking of fair value of the SME businesses.

Good Governance

Benefits accrue at the time of listing as the companies prepare themselves for this event and also throughout the life of the company. Regulatory supervision and governance controls in the form of routine compliances become a part of the company's day-to-day existence. Timely disclosure of material information not only leads to improved governance but also protects investors' interest.

Tax Exemptions

The Income Tax Act offers various benefits to companies that are listed on recognized stock exchanges which include the small and medium enterprises. Some of the major tax benefits include

- Depending upon the assessee's income tax slab and applicable tax rate transfer of unlisted shares attracts a tax of 20% on long-term capital gains and tax of up to 30% on short-term capital gains. However, if the company is listed then there is zero tax on long-term capital gains and only 15% tax on short-term capital gains. By listing on SME exchange, a company can avail this tax benefit which ultimately leads to enormous tax savings for the SME entrepreneur or investor.
- Under the Finance Act, fresh equity shares issued by unlisted companies to investors other than registered venture fund incur a tax liability. However, if a company is listed then no such tax liability is attracted to the shares of the company even while making fresh equity infusions.
- A listed company is also exempted from the imposition of any tax on the acquisition of its distressed assets by a buyer. This motivates buyers to invest in the distressed assets of a listed company.
- Strategic investors are more interested in investing in the market-driven transparent trading platform which provides an easy entry and exit policy.

Public Awareness of the Company

By being listed on the SME exchange, a company gets more visibility through increased public awareness, research coverage by sector investment analysts, media coverage etc., which help small and medium enterprises to build their own brand.7

Attracting New Talents and Motivating Current Employees

Through a “stock option plan” for employee loyalty the company can take the employees as long-term partners. By offering employees a package of shares, the company offers not only additional motivation but also ensures that they stay in the company.

Better Management of Indebtedness

Better management of the debt ratio (debt vs. equity) is a crucial aspect. A listed company is more likely to access the required capital without increasing the indebtedness because it can raise capital by issuing new shares or bonds or convert part of the debt into shares (the creditors become shareholders of the company).

Improved Reputation and Prestige

Companies listed must go through a rigorous process before listing, which leads to increased confidence. Listed companies are considered more transparent and trustworthy than non-listed companies due to reporting requirements and the corporate governance rules they have to comply with.

Migration Provisions

One of the major attractions for SME IPO remains the provision of migration to the main exchanges. Any company listed at the SME platform, after crossing the threshold of Rs 10 Cr Capital may migrate to the main exchange and upon crossing the threshold of Rs 25 Cr has to mandatorily migrate to the main exchange.8

Disadvantages of Listing of MSMES

Compliance with the rules and regulations specific to the capital market.

The process of maintaining good quality relationships with investors requires a great deal of dedication from specially appointed individuals to handle this role.

Cost Of Listing

Although the process of listing is not expensive, there must be some human capital involved in the listing process. The company also has to invest in hiring authorized consultants as well as a broker that can assist it in preparing the necessary documentation as well as in finding investors.9

Length Of The Print Preparation Process

Every company needs training before listing. This involves preparing a company equity story and ensuring that the finances are sound and that the company complies with all the regulatory requirements. But this takes time.

Periodic Reporting

Periodic reporting creates special opportunities, but also requires human capital and time dedicated to preparing these reports. Companies listed on the Bucharest Stock Exchange's main stock market must issue quarterly financial reports.

Great Media Attention To The Company

When the company records great results, media attention is very welcome. However it is important for it to report less positive news, such as, for example, lower financial results than in the previous period. In this case, the attention of the press and shareholders may not necessarily be welcomed, but it is indispensable for a listed company.

Conclusion

It is evident that quality and improvement come at a cost. Spotting the right trade off between the both is a matter of judgement which is a function of application of logical reasoning and education factored with risk taking abilities and appetite. Though globalization has made inroads in to the Indian economy long before, the key essence is not yet adopted by the most vibrant and vast spread MSME sector. Corporate and listed form of business in the more traditional Indian system still needs to seep in to the value creation chain.

Listing of SMEs aims to inculcate the true corporate culture to the conventional risk averse Indian mind-set. It is an accepted fact that this involves significant compliance as well as quality costs. But if successful, the same has got all the probability of creating greater value to all the stake holders besides generation of global business houses which is the need of the hour in the volatile international trade market scenario. It can be concluded that the presence of huge and sizeable gains easily outweigh the minor drawbacks associated with listed SMEs as a solution to the scaling traditional businesses.

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