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Finance for Micro, Small, and Medium-Sized Enterprises in India: Sources and Challenge

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Abstract

Finance for micro, small, and medium-sized enterprises (MSMEs) has been a concern for all stakeholders including entrepreneurs, financial institutions, and government organizations. The key objective of the study was to identify various challenges faced by MSMEs in sourcing of finance during different stages of their life cycle. This study is a first-of-its-kind attempt to focus on these aspects. The study further explores whether the financial awareness of MSME entrepreneurs is a major limitation in the identification and utilization of sources of finance. Data was collected through personal interviews using a structured questionnaire from a sample of 85 MSMEs. The survey was conducted mainly in the city of Bangalore covering a wide spectrum of sectors like precision tools, weavers, jewelers, food retailers, metal works, textiles, and book shops. The results reinforce the findings of other studies that utilization of formal sources like banks is significantly small compared with informal sources like personal and family wealth. The study found that the main challenges faced in underutilization of formal sources were inadequacy of collateral assets and lack of financial awareness of entrepreneurs. Based on the conclusion that requirement of finance differs with the life-cycle stage of the MSME, recommendations have been proposed for entrepreneurs, financial institutions, and policy makers.

JEL Classification: O23; G20; L26

Contents

1. INTRODUCTION

Micro, small, and medium-sized enterprises (MSMEs) have gained increased attention in India in recent times, considering their strategic importance to the economy and the country. MSMEs play an important role in generating employment—48.8 million MSMEs in the country provide employment to 111.4 million people. MSMEs in the manufacturing sector alone produce more than 6,000 products and contribute 7.7% of the GDP of the country. Similarly, MSMEs in the services sector contribute 27.4% of the country's GDP.

In spite of their contribution, MSMEs in India face several challenges. They often need to keep pace with rapidly changing technologies and face the risk of becoming technologically obsolete. They also have to face high costs of credit and are usually unable to identify their key competitive strengths to maintain product standards and quality. MSMEs also need to deal with the issue of protection of their intellectual property and with the scarcity of skilled workers. Finally, studies on MSMEs have identified the importance of the availability of sources of finance and the accessibility to these sources as the most crucial factors to promote growth of MSMEs in developing economies. In the Indian context, both of these issues pose inherent challenges to financing of MSMEs due to lack of awareness of funding schemes among MSME entrepreneurs and the limited role of venture capitalists, nonbanking financial companies (NBFCs), foreign banks, angel investors, and initial public offerings in financing MSMEs.

In view of the fact that banks are the predominant source of finance in India, the Reserve Bank of India includes micro and small enterprises in the list of priority lending sectors. Banks have also been advised to achieve a year-on-year growth of 20% in credit to micro and small enterprises and an annual growth of 10% in the number of microenterprise accounts. In view of such policies, this study attempts to understand whether such incentives and schemes have percolated down to the MSMEs and if entrepreneurs are aware of them.

While carrying out preliminary interviews with entrepreneurs for this study, it became apparent that MSMEs have different types of requirements at different stages of their life cycle. This led the authors to establish a better understanding of different sources of finance used by MSMEs during different stages of their life cycle and to explore the challenges in accessing these sources. As there were no studies that captured the financial needs of MSMEs at different stages of their existence, this study is a first-of-its-kind attempt to investigate these aspects. Thus, the paper focuses on the sources of finance used by MSMEs during different stages of the enterprise life cycle, and on the awareness and usage of different financial schemes made available by government.

The research objectives are threefold: (i) to identify the different sources of finance used and the purposes they are used for at different stages of the MSME life cycle, (ii) to identify challenges faced by MSMEs while accessing finance from different sources at different stages of their life cycle, and (iii) to identify factors that lead to higher financial awareness.

2. REVIEW OF LITERATURE

The predominant sources of finance used by MSMEs are bank loans; loans from nonbanking institutions (e.g., NBFCs); venture capital; microfinance institutions; loans from family, relatives, and friends; equity finance; and own funds (Mallick et al. 2010; International Finance Corporation 2012; Asian Development Bank 2014).

According to International Finance Corporation (2012), the supply of finance to the MSME sector is estimated to be 32.5 trillion Indian rupees (Rs). This total comprises contributions from informal finance, formal finance, and self-finance. Informal sources and self-finance contribute Rs25.5 trillion to the sector, of which informal finance accounts for Rs24.4 trillion. In other words, 78% of the finance used by MSMEs is met by informal sources and self-finance. The remaining 22% (Rs6.9 trillion) is provided by banks and NBFCs, of which banks provide the bulk (91.8%).

It is unlikely that the financial services offered by banks sufficiently address the requirements of early-stage small and medium-sized enterprises (SMEs) (Banerjee 2006). There are several conditions that hinder the provision of bank credit to early-stage SMEs in India. Early-stage SMEs do not have an established credit history and have unstable equity patterns. Biswas (2014) noted that access to external finance apart from banks is costly and limited, and poses a challenge to SMEs, although it is essential for the maintenance of long-term opportunities and targets. These external loan products also require collateral and are highly priced. SMEs use finance from NBFCs and informal sources at higher rates of interest, particularly in the early stages.

The dominance of the informal sector in addressing the financial requirements of MSMEs is due to the inherent limitations of formal sources of finance. The Asian Development Bank (2014) has pointed out that barriers to accessing finance by SMEs in India from formal institutions include the requirement for collateral or a guarantee, inflexible policies, high rates of lending, complicated procedures, and entrepreneurs' lack of financial knowledge of applicable schemes. Ambrose (2012) also identified barriers to effective financial assistance to SMEs, which included absence of collateralized security, and the regulatory framework. In addition, the unavailability of skilled workers, the lack of infrastructure, and an inability to raise capital through the stock market (especially for MSMEs with a net worth of less than Rs100 million (about $1.5 million) are other challenges (Lahiri 2012). Barriers have also been examined in the context of gender (Irwin and Scott 2010), firm size, the length of a lending relationship, and the use of overdraft credit (Bebczuk 2004). The Reserve Bank of India (2005) identified the following issues in financing SMEs: (i) inadequate access to finance by tiny firms due to lack of financial information and nonformal business practices, with a lack of access to private equity, venture capital and secondary market instruments; (ii) fragmentation of markets with respect to their inputs as well as vulnerability of products due to market fluctuations; (iii) lack of easy access to interstate and international markets; (iv) limited access to technology and product innovations, and lack of awareness of global best practices; and (v) considerable delays in settlement of dues and payment of bills by large-scale buyers.

The perception of an SME as a high-risk and commercially unviable proposition to lend to has resulted in only a few SMEs receiving formal financial assistance (Ambrose 2012). Prasad (2006) highlighted that Indian banks in particular are not inclined to finance small enterprises, due to reasons such as the inability to provide collateral, high levels of nonperforming assets, high transaction costs, and the inability to verify the creditworthiness of applicants.

Grant Thornton and FICCI (2011) concluded that the cost of capital is high for MSMEs, and that there is a need to reduce the time and documentation required for procuring finance. Lahiri (2012) pointed out that with MSMEs' rising need for short-term and long-term capital, banks should move toward more innovative methods of lending to provide for those firms' financial needs.

In light of the abovementioned barriers, the Government of India (2015b) initiated several policy measures: (i) achievement of universal financial inclusion of MSMEs in a time-bound manner, ensuring that every registered MSME has a bank account linked to the Udyog Aadhar; (ii) operationalization of an Rs100 billion equity fund for the MSME sector; and (iii) expanded coverage and enhanced utilization of credit guarantee schemes with inclusion of a wider set of credit providers such as NBFCs and microfinance institutions, which could involve a sevenfold increase in the corpus from Rs40 billion to Rs280 billion.

3. METHODOLOGY

3.1 Description of the Sample

The study was based on primary data collected through a survey. A structured questionnaire was completed by 85 entrepreneurs (business owners) of MSMEs through interviews, mainly during in-person visits but also conducted online and via telephone, largely from selected industrial areas and surrounding suburbs of Bangalore. Most of the enterprises were based in Bangalore (the Silicon Valley of India) and a few were based in Mumbai. In Bangalore, in-person visits to collect data were made to N.S. Palya Industrial Layout, Peenya Industrial Layout, and Weaver's Colony (power-loom cluster), and the commercial areas of the suburbs of Malleswaram, Rajajinagar, and Avenue Road. Telephone and online interviews were used to collect data from enterprises located in Mumbai.

This study used non-probabilistic judgmental sampling. The data was collected from entrepreneurs who had a bank account (either savings or current) to ensure a minimum financial awareness. The survey was carried out in September and October 2015. Percentage analysis was used to draw inferences from the data collected.

This study uses a novel approach in assessing the sources of finance in different stages of the MSME life cycle. The stages of the enterprise that have been defined for this study are (i) start-up, (ii) survival, (iii) growth, and (iv) sustenance. Those in the start-up stage are less than 3 years of age, and those in the survival stage are 3–6 years of age. The entrepreneur's focus in the start-up and survival stages is on establishing the enterprise in the marketplace and breaking even with regard to initial investments made. Entrepreneurs who have crossed the start-up and survival stages then focus on expanding the reach of their enterprises into newer markets in the growth stage. The business later enters the sustenance stage, when it has an established presence in certain markets and growth has plateaued. Those entrepreneurs whose enterprises are more than 6 years old were encouraged to report sources of finance used and challenges faced in accessing finance in respective stages—growth or sustenance—depending on their own assessment of the stage of their enterprise.

A majority of enterprises in the sample were at the sustenance stage, followed by those in the growth stage. The fewest were in the survival stage. Of the 85 enterprises, there were 49 microenterprises, of which 10 were in the start-up stage, 7 in the survival stage, 10 in the growth stage, and 22 in the sustenance stage. The 33 small enterprises included 4 each in the start-up and survival stages, 15 in the growth stage, and 10 in the sustenance stage. Only 3 medium-sized enterprises participated in the survey, with 2 in the growth stage and 1 in the sustenance stage (Table 1).

Table 1: Life Cycle Stages of the Enterprises in the Sample
(%)

Stage of the Enterprise	Micro (N = 49)	Small (N = 33)	Medium (N = 3)	Total (N = 85)
Start-up (<3 years)	20.4	12.1	0.0	16.5
Survival (3–6 years)	14.3	12.1	0.0	12.9
Growth (>6 years)	20.4	45.5	66.7	31.8
Sustenance (>6 years)	44.9	30.3	33.3	38.8

3.2 Sector-Wise Distribution of Enterprises in the Sample

The bulk of enterprises in the start-up and survival stages were from the services sector, while enterprises in the growth and sustenance stages were almost equally distributed between manufacturing and services (Table 2).

Table 2: Sector-Wise Distribution of Enterprises in the Sample
(%)

Stage of Enterprise → / Enterprise Sector ↓	Start-Up (<3 years) (N = 14)	Survival (3–6 years) (N = 11)	Growth (>6 years) (N = 27)	Sustenance (>6 years) (N = 33)	Total (N = 85)
Manufacturing	35.7	36.4	55.6	54.5	49.4
Services	64.3	63.6	44.4	45.5	50.6

3.3 Compliance and Listing Characteristics for Enterprises in the Sample

The enterprises had different legal and financial compliance and listing characteristics. At least half of the enterprises were registered, and this proportion was higher for enterprises in the survival and growth stages. These enterprises were registered possibly under one or more laws such as sales tax, value-added tax, and the Shops and Establishments Act, or were registered as an MSME with the concerned department in the respective state. Enterprises that were not registered as MSMEs with the concerned department were classified by the authors as using investment limits specified under the Micro, Small and Medium Enterprises Development Act of 2006.

A similar proportion of enterprises in the start-up (14.3%) and growth (14.8%) stages were credit rated. For those in the survival stage, only 9.1% were credit rated, which implies that credit rating of enterprises at this stage was not a priority for the owners.

Only a few enterprises (7.1%) in the start-up stage were listed. None of the enterprises in the other stages were listed (Table 3).

Table 3: Enterprise Compliance and Listing Characteristics
(%)

Enterprise Characteristic	Start-Up (<3 years) (N = 14)	Survival (3–6 years) (N = 11)	Growth (>6 years) (N = 27)	Sustenance (>6 years) (N = 33)	Total (N = 85)
Enterprise registered	50.0	81.8	88.9	63.6	71.8
Enterprise credit rated	14.3	9.1	14.8	12.1	12.9
Enterprise listed	7.1	0.0	0.0	0.0	1.2

Note: Data reflects individual responses from entrepreneurs; figures may not add up to 100%.

4. SOURCES OF FINANCE AND CHALLENGES IN ACCESSIBILITY

4.1 Finance Used by MSMEs in Different Stages of the Life Cycle

The survey results revealed the major financial needs of MSMEs at different stages of their life cycle and the predominant sources of finance used to meet those requirements. Enterprises were not restricted to reporting this data for the current stage of their life cycle but could also report perceptions and experiences for other stages. The values have been computed as the percentage of enterprises reporting the sources of finance used in different stages. Therefore, the total of all reporting enterprises will be different from the total number of enterprises in the sample (Table 4).

Start-up stage: Enterprises in this stage reported the use of funds from personal and family sources, from friends, and from public (i.e., government-owned) banks largely for the purpose of working capital. The other highly reported use of an institutional source was public banks for collateral financing. This implied a high degree of preparedness or risk aversion, or both, while starting an enterprise.

Survival stage: Working capital, short-term loans, and overdrafts were the primary purposes for which enterprises in the survival stage sought financial assistance. Finance for working capital was sourced largely from public banks and moneylenders, followed by personal funds and private banks. Private banks were also used to secure short-term loans and overdraft facilities. Enterprises also reported use of moneylenders, though to a lesser extent. The trend of using formal sources or trusted informal sources seemed to continue from that reported by enterprises in the start-up stage. Enterprises in this stage would be looking to pay off debts, for which they would require smooth day-to-day functioning with adequate availability of working capital for the same.

Growth stage: Enterprises at this stage required working capital, collateral financing, and short-term loans. Working capital was sourced from public banks, personal and family sources, and to a lesser extent from private and cooperative banks. Collateral financing was obtained from public banks, and to a lesser extent from cooperative banks. Private and cooperative banks were used for obtaining short-term loans, although the use of moneylenders did find a mention. This observation possibly means that enterprises were more focused on their specific financial needs and the sources required to fulfill them. The dominant use of public banks for collateral financing and the use of the banking system and family wealth to meet working capital needs are indicative of the role played by trust in securing this type of finance. As cooperative banks were also mentioned as a source to fulfill multiple financial needs of enterprises at this stage, it needs to be seen if these banks' policies and procedures are conducive to providing the quick access to short-term finance needed by enterprises in the growth stage.

Sustenance stage*:* Enterprises in this stage reported the use of finance from personal funds, cooperative banks, public banks, and private banks for the purpose of working capital. Cooperative banks were also used for collateral financing and to secure short-term loans. Working capital, collateral financing, and short-term loans seem to dominate the landscape of requirements of enterprises at this stage. This continues the trend, noted above, of using finance from sources that are perceived to be trusted by enterprises. An enterprise in this stage would choose to borrow from sources with which it has well-established relationships and those which could be trusted. Enterprises at this stage reported the dominant use of cooperative banks for working capital, collateral financing, and short-term loans, and it would be interesting to examine the reasons for this prevalence.

Table 4: Major Sources of Finance Used by Enterprises in Different Stages
(%)

Purpose	Sources of Finance	Start-up Stage (N = 45)[a]	Survival Stage (N = 11)	Growth Stage (N = 25)	Sustenance Stage (N = 31)
Working capital loan	Personal funds/savings	64.4	18.2	12.0	19.4
	Money borrowed from friends	15.6	0.0	0.0	12.9
	Public banks	13.3	27.3	28.0	16.1
	Family wealth	11.1	0.0	12.0	3.2
	Moneylenders	4.4	27.3	4.0	6.5
	Private banks	2.2	18.2	8.0	9.7
	Cooperative bank	0.0	0.0	8.0	19.4
Collateral financing	Public banks	17.8	0.0	20.0	3.2
	Cooperative banks	2.2	0.0	8.0	12.9
Short-term loan	Moneylenders	0.0	9.1	8.0	3.2
	Private banks	0.0	9.1	16.0	6.5
	Cooperative banks	4.4	0.0	12.0	9.7
Overdraft	Public banks	6.7	0.0	4.0	6.5
	Private banks	2.2	9.1	4.0	3.2
	Cooperative banks	0.0	0.0	4.0	3.2
	Personal funds/savings	0.0	0.0	0.0	3.2
Long-term loan	Moneylenders	2.2	0.0	0.0	0.0
	Public banks	2.2	0.0	0.0	6.5
	Private banks	2.2	0.0	0.0	0.0
	Cooperative banks	2.2	0.0	4.0	6.5
	SIDBI	0.0	0.0	4.0	0.0
	Personal funds/savings	0.0	0.0	0.0	3.2

SIDBI = Small Industries Development Bank of India.

[a] As enterprises could report the sources of finance used in multiple life-cycle stages, the sum total of enterprises reporting the data may vary from the total number of enterprises in the sample.

Sources of Finance Not Used by Enterprises in Different Stages

A number of sources of finance were not used by enterprises in different stages of the life cycle (Table 5). Enterprises from all four stages did not avail themselves of financing from angel investors, other entrepreneurs, foreign banks, initial public offerings, pawnbrokers, and venture capitalists. In the survival stage, the number of unused sources of finance was more pronounced than in other stages, suggesting that enterprises at this stage were quite risk averse and intent on breaking even with their existing level of investment, which had been financed previously by other sources.

Table 5: Sources of Finance Not Used by Enterprises in Different Stages

Source of Finance	Start-Up	Survival	Growth	Sustenance
Angel investors	X	X	X	X
Another entrepreneur	X	X	X	X
Cooperative banks	✓	X	✓	✓
Family wealth	✓	X	✓	✓
Foreign banks	X	X	X	X
Initial public offering	X	X	X	X
Microfinance institutions	✓	X	X	✓
Money borrowed from friends	✓	X	X	✓
Money borrowed from relatives	✓	X	X	✓
Pawnbrokers	X	X	X	X
SIDBI	X	X	✓	X
Venture capitalists	X	X	X	X

✓– used, X – not used.

SIDBI – Small Industries Development Bank of India.

4.2 Challenges in Accessing MSME Finance

Enterprises were asked to report the challenges they faced in accessing finance, including in stages other than their current stage. A scale of 1–3 was used, in which 1 means *not at all challenging*, 2 is *manageable*, and 3 is *challenging*. Percentage values were calculated from the number of enterprises rating an issue *challenging* and the total number of enterprises that rated at least one issue *challenging* at each stage (Table 6).

***Start-up stage**:* Major challenges in accessing finance reported by enterprises in this stage included the difficulty in providing collateral or a guarantee, processing time for loan applications, lack of knowledge about available schemes, and procedural complications, in that order. Enterprises also felt that high service fees for loan requests and difficulty in completing required documentation were challenges. Enterprises in the start-up stage may not be able to provide collateral for a loan and they lack knowledge about available schemes, which may hinder them from choosing the most effective option for financial assistance.

Survival stage: The major challenges encountered by enterprises at this stage were similar to those reported by enterprises in the start-up stage, though the order was different. The difficulty in providing collateral or a guarantee and procedural complications were jointly rated the highest. The four issues of lengthy processing time, lack of knowledge about available schemes, high service fees for processing loan requests, and difficulty in completing the required documentation were rated to be equally challenging. Enterprises in this stage would usually be looking to break even with regard to investments made at start-up, and would also like to grow in their markets. They would therefore need working capital to meet their day-to-day needs. These enterprises cannot be expected to provide collateral, and would be hindered by complicated procedures and delays in loan disbursals. They also continue to lack knowledge of available financial assistance schemes.

Growth stage: Major challenges reported by enterprises in this stage included a lack of knowledge about available schemes, high service fees for processing loan requests, difficulty in provision of collateral or guarantee, high rates of interest, and difficulty in completing the required documentation.

As there would be both working capital and short-term loan requirements for enterprises in this stage, a lack of knowledge regarding specific schemes could hinder owners from making the most appropriate choice of financing for their enterprise. Though enterprise owners may be more inclined to seek formal financial assistance, high service fees and high rates of interest could be a deterrent. Enterprises in the growth stage also would be in a state of rapid transition and therefore the need to provide documentation for securing financial assistance would be a deterrent to accessing funds.

Table 6: Challenges in Accessing Finance at Different Life Cycle Stages
(%)

Challenges	Start-Up Stage (N = 24)[a]	Survival Stage (N = 11)	Growth Stage (N = 24)	Sustenance Stage (N = 30)
Difficulty in collateral/guarantee	87.5	63.6	54.2	83.3
High rates of lending	54.2	45.5	54.2	50.0
Procedural complications	70.8	63.6	45.8	63.3
Lack of knowledge about available schemes	75.0	54.5	62.5	60.0
Lengthy processing time for the loan application	87.5	54.5	45.8	60.0
High service fees for processing loan requests	62.5	54.5	58.3	56.7
Difficulty in procuring/completing the required documentation	62.5	54.5	50.0	56.7
Lack of available infrastructure	41.7	0.0	4.2	10.0
Lack of availability of skilled workers	29.2	0.0	8.3	13.3
Absence of current account (active for 6 months)	16.7	18.2	8.3	0.0
No formal accounting system	20.8	18.2	12.5	3.3
Tax compliance issues	16.7	18.2	16.7	16.7
Labor law compliance issues	12.5	0.0	12.5	16.7
Registration of enterprise	12.5	0.0	20.8	16.7

[a] As enterprises could report the sources of finance used in multiple life-cycle stages, the sum total of enterprises reporting the data may vary from the total number of enterprises in the sample.

Sustenance stage: Common challenges to accessing finance reported by enterprises in this stage included difficulty in provision of collateral or a guarantee, procedural complications, lack of knowledge about available schemes, lengthy processing time for loan applications, high service fees for processing loan requests, and difficulty in completing required documentation. A reasonable number of enterprises also reported high rates of interest to be a challenge. Although entrepreneurs in this stage reported procedural difficulties, processing time, and high rates of interest to be challenges in accessing finance, the role of a lack of knowledge about available schemes and its influence on other challenges needs to be examined. The entrepreneurs were concerned about the requirement to have collateral or security. This would suggest that banks or lending institutions need to be more realistic about lending to MSMEs that have already established themselves in the market.

To summarize, MSMEs face numerous challenges at each stage of the life cycle. Each issue regarding financing was rated *challenging* by at least one enterprise in both the start-up and growth stages. In the survival stage, enterprises did not feel that infrastructure, labor, labor law compliance, or enterprise registration were challenges in accessing finance. Enterprises in this stage have access to adequate labor and infrastructure. Enterprises in the sustenance stage would most likely have active current accounts, and therefore did not feel that to be a challenge (Table 7).

Table 7: Challenges Faced by MSMEs in Accessing Finance

Challenges	Start-Up	Survival	Growth	Sustenance
Difficulty in collateral/guarantee	✓	✓	✓	✓
High rates of lending	✓	✓	✓	✓
Procedural complications	✓	✓	✓	✓
Lack of knowledge about available schemes	✓	✓	✓	✓
Lengthy processing time for the loan application	✓	✓	✓	✓
High service fees for processing loan requests	✓	✓	✓	✓
Difficulty in procuring/completing the required documentation	✓	✓	✓	✓
Lack of available infrastructure	✓	X	✓	✓
Lack of availability of skilled labor	✓	X	✓	✓
Absence of current account (active for 6 months)	✓	✓	✓	X
No formal accounting system	✓	✓	✓	✓
Tax compliance issues	✓	✓	✓	✓
Labor law compliance issues	✓	X	✓	✓
Registration of enterprise	✓	X	✓	✓

✓ – challenging, X – not challenging.

MSMEs – micro, small, and medium-sized enterprises.

Other Challenges: Processing Times and Fees

Enterprises were asked to report loan processing times and processing fees, and to rate the experiences they had with banks, nonbanking financial companies (NBFCs), and microfinance institutions. This was done to assess the ease of access with which enterprises were able to secure financial assistance from formal financial institutions.

Enterprises in the start-up stage reported a very high average processing time for bank loans. The average value was, however, influenced by the highest reported time, which was 1 year. The average time taken for loan processing was low for NBFCs and microfinance institutions at 4 and 10 days, respectively. The lone reporting enterprise in the survival stage reported a processing time of 1 day for loans taken from a microfinance institution. For enterprises in the growth stage it took 35 days to secure a loan from a bank, which was nearly six times the period for NBFCs (6 days).

In the sustenance stage, banks took on average one-and-a-half times longer than NBFCs to process loan requests for MSMEs. Microfinance institutions were reported to take 1 week on average. The average processing time for loan requests by banks for enterprises in the survival and growth stages were similar. Although quicker to process loan requests than banks on average, NBFCs took almost four times longer at this stage than at the growth stage. It may be premature to conclude anything with regard to microfinance institutions considering the small number of enterprises reporting on this aspect. It is possible, however, that a higher degree of due diligence on the part of banks and NBFCs could be the cause for the longer processing times for enterprises at the growth and sustenance stages.

Table 8: Average Loan Processing Times for Loans Sought from Banks, NBFCs and MFIs
(days)

Stage of Enterprise	Source of Finance Used	Mean	Minimum	Maximum	Median	No. of Responses
Start-up	Bank	114	2	365	44	4
	NBFC	4	1	7	4	2
	MFI	10	10	10	10	1
Survival	MFI	1	1	1	1	1
Growth	Bank	35	15	73	29	18
	NBFC	6	3	9	6	5
Sustenance	Bank	38	22	82	33	30
	NBFC	24	14	33	24	3
	MFI	7	7	7	7	1

MFI - microfinance institution, NBFC - nonbanking financial company.

Very few enterprises in the start-up and survival stages reported loan processing fees. In the survival stage, only one enterprise reported a fee for loans taken from microfinance institutions. The number of reporting enterprises in the growth and sustenance stages was significantly higher compared with the start-up and survival stages. In the start-up stage, the processing cost for loans by banks was reasonably low. The average processing costs for bank loans to enterprises in the growth stage was nearly double that for enterprises in the sustenance stage, though the median values were comparable. The average processing fee for loans from NBFCs was negligible for start-up enterprises, but increased significantly for enterprises in the growth stages, with the cost being almost three times the average processing cost for enterprises in the sustenance stage. The average processing cost of loans from microfinance institutions was significantly higher for enterprises in the survival stage when compared with the sustenance stage. Though average cost of processing reported in the case of banks was higher, a larger number of reporting enterprises suggested a preference for seeking financial assistance from banks. It is possible that NBFCs were considered the second-best option for enterprises in the growth and sustenance stages (Table 9).

Table 9: Average Processing Cost of Loans by MSMEs from banks, NBFCs and MFIs
(Indian rupees, thousands)

Stage of the Enterprise	Source of Finance Used	Mean	Minimum	Maximum	Median	No. of Responses
Start-up	Bank	3.50	2.00	5.00	3.50	2
	NBFC	0.00	0.00	0.00	0.00	1
Survival	MFI	10.00	10.00	10.00	10.00	1
Growth	Bank	80.03	7.17	290.00	25.83	16
	NBFC	18.83	15.08	22.58	18.83	5
Sustenance	Bank	42.05	3.67	150.00	22.52	20
	NBFC	6.88	1.25	12.50	6.88	3
	MFI	1.00	1.00	1.00	1.00	1

MFI – microfinance institution, NBFC – nonbanking financial company, MSMEs – micro, small, and medium-sized enterprises.

Note: Exchange rate $1.0 = Rs65.63 (3 November 2015).

5. ANALYSIS OF FINANCIAL ACCESSIBILITY

5.1 Factors Influencing Financial Access

Enterprises were also asked to report ease of financial accessibility with regard to three anchored choices: the proximity of a bank or financial institution to the enterprise's location, approachability of the bank or financial institution, and the simplicity of the process to access finance.

The proximity of a financial institution was found to positively influence the opinion of financial accessibility of a large number of enterprises in the growth and sustenance stages. Enterprises in these stages would most likely have immediate financial requirements and so perceive the proximity of a financial institution to be a significant positive factor.

Enterprises in the start-up, growth, and sustenance stages rated highly the approachability of formal financial institutions in influencing financial access. The rating of this factor in influencing financial access was lowest for enterprises in the survival stage. It is probable that the enterprises in the survival stage were keen to break even and pay off their debts, and felt that having a good relationship with a financial institution with whom they had started out, irrespective of location or approachability, was more important.

A high proportion of enterprises from all four stages reported simplicity in processes to be advantageous in helping them secure access to finance (Table 10).

Enterprises were also asked to report qualitative details on the following four issues: factors that encourage financial access, factors that impede financial access, whether they expected government to do anything for financing their enterprise, and government support required for financing their enterprise. A cross-section of responses provided by enterprises is provided.

Table 10: Key Factors Influencing Financial Access
(%)

Key Factor	Start up Stage (N = 14)	Survival Stage (N = 11)	Growth Stage (N = 27)	Sustenance Stage (N = 33)
Proximity of a bank or financial institution to the location of the enterprise	50.0	45.5	74.1	57.6
Ease of approachability of the bank or financial institution	71.4	54.5	92.6	72.7
Simplicity of the process to access finance	78.6	63.6	92.6	81.8

Note: Data reflects individual responses from entrepreneurs; figures may not add up to 100%.

5.2 Factors That Encourage Financial Access

Start-up stage: Enterprises highlighted the need for loans without collateral, affordable interest rates, and loan guarantees provided by government. They also reported the need for guidance by personnel from the financial institution, and the need for a paradigm shift by which financial institutions view MSMEs as prospective customers rather than as an interference. A few entrepreneurs emphasized that financiers should have faith in lending to businesses that had continued to operate in the same place for generations.

Survival stage: Enterprises asked for provision of quick finance and flexibility in the repayment schedule.

Growth stage: Enterprises emphasized the need for information on MSME finance schemes and the need for banks and other financial institutions to deliver the benefits prescribed through these schemes, especially those that involve minimal or no collateral. The role of a good relationship with a bank in securing access was also highlighted. Respondents also felt that approved or empaneled suppliers with long-term experience of supplying to the government must get preference over others while taking advantage of assistance through MSME finance schemes.

Sustenance stage: The primary concern reported by enterprises was the interest rate. Respondents felt that their relationship with public banks was better (because it was more personalized) compared with private banks. There was also concern regarding the time needed to process loan requests, with some enterprises resorting to taking gold loans for meeting immediate financial requirements.

5.3 Factors That Impede Financial Access

Start-up stage: The major concern was the delay in the processing of loan applications. Business owners also felt that it was not practical to frequently visit banks for clarifications, and that the role of agents in the system needs to be minimized.

Survival stage: The primary concerns were complications in the process and the response of bankers.

Growth stage: Enterprises reported that bank officials had a very bad attitude toward them because nonperforming assets of MSME schemes were increasing and managers were averse to considering their applications for finance. Two major issues were the long time needed to process applications and inadequate information provided about available government schemes. Owners also noted that small businesses are generally volatile in nature, which add to their vulnerability and mean that capital requirements vary throughout the year, and that the nature of their operations was not recognized or factored into the lending decisions made by financial institutions.

Sustenance stage: Enterprises highlighted high interest rates as an impediment to financial access. Two other key issues that caused problems were (i) lack of understanding on the part of financial institutions of the sector in which enterprises operated and the corresponding policies needed; and (ii) red tape involved in hierarchical processing of loans (i.e., moving loan applications from one branch to another), thereby causing a loss of time. Enterprises also suggested that recovery of payments from customers must be enforced through proper implementation of laws.

5.4 Government Support Required for Financing Enterprise

Start-up stage: Support required by start-up enterprises included lowering interest rates for finance provided directly by the government. Respondents from the power-loom cluster felt that weavers must be included on par with agriculturists in terms of securing government loans.

Survival stage: Enterprises felt that the government needed to provide loans at lower interest rates and also consider loan subsidies.

Growth stage: Enterprises were of the opinion that government must keep business owners informed of MSME schemes and eligibility requirements. Many respondents felt that the implementation of the goods and services tax would help in the resolution of payment-related issues, and that red tape hampered value-added tax payments and annual license renewal. They also felt that bank managers and government representatives must meet with MSME owners periodically to communicate features of various schemes, including eligibility, and to streamline the MSME registration process.

Sustenance stage: Enterprises highlighted the need for proper communication of MSME finance schemes and their eligibility, and for the provision of financial subsidies to entrepreneurs whose enterprises cater to the needs of government departments and public sector enterprises. Other key issues included proper implementation of tax schemes, minimizing delayed payments from customers, and catering to industry-specific issues and requirements. Examples included delays in providing credit to travel agents for government-sponsored travel and to weavers for the procurement of computerized equipment for power looms.

5.5 Expectations of Government Support to Finance Enterprise

Start-up stage: Enterprises felt that the government should provide proper information regarding MSME schemes and should provide financial assistance to MSMEs after evaluating their ideas and verifying their financial status.

Survival stage: Respondents felt that the government should support the expansion of business by providing capital for business owners.

Growth stage: Enterprises wanted the government to strictly enforce laws, including proper implementation of tax schemes (income and sales tax), and to provide a single-window system for labor-related issues such as provident fund, employees' state insurance, and tax deduction at source (i.e. the workplace). at source. They also wanted easier internet banking, a reduced role for mediators (agents), and loans with lower interest rates for businesses operating out of rented premises. There was also a suggestion for the government to assist in the transition of enterprises operating in industries offering standard or traditional products to the next higher stage (e.g., from a small enterprise to a medium-sized enterprise). This transition would help other enterprises in receiving benefits under the MSME category.

Sustenance stage: Business owners felt the government should assess the genuineness of any need before providing financial assistance. There were also innovative suggestions including the funding of research and development for new technology, and industry-specific training programs. Enterprises also wanted a guaranteed method of repayment in case of financing through government schemes that would take into account business fluctuations. Other issues included competitive pricing of raw material and machinery parts for MSMEs, checking of property registration of the loan applicant, and the need to increase the upper threshold in defining MSMEs so that the Credit Guarantee Fund Trust for Micro and Small Enterprises scheme could be better utilized.

5.6 Experiences in Seeking Financial Assistance from Financial Institutions

Enterprises were asked to rate their loan-seeking experience with banks, nonbanking financial companies (NBFCs), and microfinance institutions on a scale of 1–3 with 1 meaning *bad*, 2 meaning *neutral*, and 3 meaning *good*. In the case of banks, a high proportion of reporting enterprises in the start-up stage rated their experiences *good*, through this proportion declined for enterprises in the growth and sustenance stages. Close to half of enterprises in the growth stage reported their experience with banks as either *bad* or *neutral*, while this proportion was more than half for enterprises in the sustenance stage. In the case of NBFCs, a similar proportion of enterprises in the start-up, growth, and sustenance stages rated their experience *good*. The only reports of bad experiences with NBFCs were from enterprises in the growth stage. Very few enterprises rated their experiences with microfinance institutions. The lone reporting enterprises in the start-up and survival stages rated their experiences *good* and *neutral*, respectively, while the rating was split between *good* and *bad* for the two reporting enterprises in the sustenance stage. More than half of enterprises rated their experiences with banks, NBFCs, and microfinance institutions *good*, with the exception of the rating for banks by enterprises in the sustenance stage (Table 11).

Table 11: Experience Rating of MSMEs while Seeking Financial Assistance from Banks, NBFCs and MFIs

(%)

Source of Finance Used	Experience Rating	Start-Up Stage	Survival Stage	Growth Stage	Sustenance Stage	Total
Bank	Bad	20.0	–	19.0	33.3	27.1
	Neutral	20.0	–	23.8	24.2	23.7
	Good	60.0	–	57.1	42.4	49.2
	No. of Responses	5	0	21	33	59
Nonbanking financial company	Bad	0.0	–	20.0	0.0	9.1
	Neutral	33.3	–	20.0	33.3	27.3
	Good	66.7	–	60.0	66.7	63.6
	No. of Responses	3	0	5	3	11
Microfinance institution	Bad	0.0	0.0	–	50.0	25.0
	Neutral	0.0	100.0	–	0.0	25.0
	Good	100.0	0.0	–	50.0	50.0
	No. of Responses	1	1	0	2	4

MSMEs – micro, small, and medium-sized enterprises, MFI – microfinance institution, NBFC – nonbanking financial company.

6. ANALYSIS OF FINANCIAL AWARENESS

The level of financial awareness among entrepreneurs was captured by their awareness of well-known financial schemes for MSMEs. The schemes included the Credit Guarantee Fund Trust for Micro and Small Enterprises Scheme, the Credit Linked Capital Subsidy Scheme for technology upgradation, and the Growth Capital and Equity Assistance Scheme of the Small Industries Development Bank of India (SIDBI). The questions were dichotomous requiring a “yes” or “no” response. A composite score for the level of awareness was then computed. The entrepreneurs were also asked whether they had availed themselves of any of the schemes for their enterprises. Each entrepreneur reported his or her level of educational attainment with the following choices: less than 10 years; 10 years (i.e., secondary school leaving certificate); 12 years (pre-university college); bachelor’s degree; master’s degree; professional qualifications (e.g., chartered accountant or company secretary); or another level of education, such as a technical diploma.

6.1 Awareness of Schemes

The awareness score indicates the number of MSME financing schemes that the enterprise could recognize. The results are presented in Table 12. Most enterprises—49 of the 85 surveyed—were not aware of any schemes, while nearly all of the other enterprises were aware of 1 to 4 schemes. The highest proportion of entrepreneurs in each educational category was not aware of any schemes. Business owners with a bachelor’s degree had greater awareness than those with a lower level of education. These overall results suggest that MSMEs have a very low awareness of schemes that could benefit them by providing access to formal credit.

Table 12: Awareness of Schemes
(%)

Entrepreneur Qualification→ / Awareness Score[a]↓	10th/ SSLC (N = 24)	12th/PUC (N = 4)	Bachelor’s Degree (N = 25)	Master’s Degree (N = 6)	Professional Qualification (CA/CS) (N = 2)	Others (N = 24)
0	70.8	75.0	40.0	66.7	50.0	50.0
1	20.8	0.0	16.0	16.7	0.0	33.3
2	4.2	0.0	24.0	16.7	50.0	0.0
3	4.2	25.0	8.0	0.0	0.0	12.5
4	0.0	0.0	4.0	0.0	0.0	4.2
6	0.0	0.0	4.0	0.0	0.0	0.0
9	0.0	0.0	4.0	0.0	0.0	0.0

CA/CS – chartered accountant/company secretary, PUC – pre-university college, SSLC – secondary school leaving certificate.

[a] Awareness score is the total number of schemes that the respondent reported awareness of.

6.2 Use of Schemes

The proportion of schemes availed by MSMEs is provided in Table 13 and is differentiated by educational attainment. Overall, only 10 of the 85 enterprises have obtained finance through an MSME credit support scheme. Entrepreneurs with less than a bachelor’s degree were less likely to have availed themselves of such a scheme for their enterprises than those entrepreneurs with higher qualifications

Table 13: Use of Schemes
(%)

No. of Schemes Availed	10th/ SSLC (N = 24)	12th/ PUC (N = 4)	Bachelor's Degree (N = 25)	Master's Degree (N = 6)	Professional Qualification (CA/CS) (N = 2)	Others (N = 24)
0	95.8	100.0	80.0	83.3	50.0	91.7
1	4.2	0.0	20.0	16.7	50.0	8.3

CA/CS – chartered accountant/company secretary, PUC – pre-university college, SSLC – secondary school leaving certificate.

7. CONCLUSIONS

The study found that the source of finance utilized by an MSME depends on its current stage in the enterprise life cycle. Four stages were identified: start-up, survival, growth, and sustenance.

Enterprises in the start-up stage use funds from personal savings, friends, and family, primarily for the purpose of working capital. They also use public sector banks for working capital and collateral financing. Finance was sourced from trusted informal sources (personal, family, and friends) and trusted formal sources (public banks). Particularly in the case of trusted informal sources, there would be reduced pressure in case of difficulties in repayment.

Enterprises in the survival stage use moneylenders and public banks, followed by personal funds and private banks, primarily for the purpose of working capital. Private banks and moneylenders are also used to secure short-term loans. Enterprises in this stage would be looking to break even with regard to investments made and would therefore seek to meet their specific requirements through both informal and formal sources. Short-term requirements were probably sourced from private banks and moneylenders due to their ready availability and quick disbursal.

Enterprises in the growth stage use public banks for working capital and collateral financing, and they use private banks for short-term loans. The move toward private banks is possibly due to greater financial need and an increase in the ability of enterprises at this stage to afford the higher cost of finance.

Enterprises in the sustenance stage use personal funds, cooperative banks, public banks, and money borrowed from friends, again primarily for working capital. Cooperative banks were also used for short-term loans and collateral financing. Business owners are more aware of meeting specific financial needs from specific sources. The degree of conservatism in the sourcing of finance is exemplified by the use of trusted informal sources (personal wealth and friends) and formal sources (public banks and cooperative banks) for working capital in this stage as well.

In a nutshell, sources of finance used across the various stages of the life cycle are limited largely to personal funds; family wealth; friends; moneylenders; and the banking system, comprising public, private, and cooperative banks.

The major common challenges faced in accessing finance by enterprises in the start-up and survival stages were difficulty in provision of collateral or a guarantee, lengthy loan processing, and a lack of knowledge about available schemes. Enterprises in both these stages had not yet fully established their businesses and so were not in a position to either provide collateral or security or endure complex loan procedures.

In the growth stage, the major challenges in accessing finance were a lack of knowledge about available schemes, high service fees for processing loan requests, difficulty in providing collateral or a guarantee, and high interest rates. The financial needs of enterprises seeking to expand and grow into newer markets may be different, and they may be on the lookout for short-term capital that could be borrowed at more competitive rates. This is also a stage in which entrepreneurs would feel the limitations of not having explored available options in terms of MSME finance schemes due to their lack of awareness in the earlier life-cycle stages of their enterprise.

For enterprises in the sustenance stage, the major challenges are the difficulty in providing collateral or a guarantee, procedural complications, lack of knowledge about available schemes, and lengthy processing times for loan applications. A lack of knowledge of available MSME finance schemes, together with collateral requirements for loans, were common challenges in this stage, as in the other stages. It was interesting to find that financial institutions would insist on collateral from enterprises that have established themselves in the market over a period of time, and that goodwill was not considered sufficient.

While considering the owner's educational qualifications, it was found that those business owners with a bachelor's degree had higher awareness of MSME finance schemes than business owners who had other levels of qualifications. More educated business owners were also more likely to avail themselves of such schemes for their enterprises.

8. RECOMMENDATIONS

The government, enterprises, and financial institutions are all stakeholders in the development of the MSME sector. This section provides recommendations for each group of stakeholders based on qualitative feedback obtained from the respondents.

8.1 Recommendations for the Government

Enhance financial awareness. Adequate and timely information about MSME schemes needs to be actively disseminated through advertisements in newspapers and magazines and on television. The government could consider starting a dedicated TV channel to address MSMEs' need for information and to communicate policies.

Reduce documentation. It would be better to do away with complex documentation requirements for seeking financial assistance and replace them with simpler procedures like a "know your customer" form that captures basic information of the owner or enterprise that can be utilized by all financial institutions.

Ease legal requirements. There is an urgent need to ease the burden of legal compliance on MSMEs, at least in the first 3 years of their existence.

Enhance sensitivity in lending institutions. There is a need to build the capacity of lenders so that they are more sensitive to the specific needs of enterprises in different sectors and at the different stages of the enterprise life cycle.

Ensure that tax policies are fully implemented. By doing so, there will be an emphasis on enhancing the visibility of transactions and this would provide a more accurate idea of the transaction history of the enterprise involved, thus helping determine its creditworthiness.

Support credit enhancement. Expand credit guarantee schemes so that they are available to MSMEs.

Enforce rules for delayed payment. Ensure proper action against defaulters and against those who make delayed payments to MSMEs. A delay in payment affects cash flow to the MSME and also negatively impacts its ability to process other orders. There is also a need to determine repayment periods carefully based on the nature of the sector in which the MSME operates, especially in sectors with high seasonality of production.

8.2 Recommendations for Financial Institutions

Realign approach toward MSMEs. Financial institutions need to change their perspective from that of being just a lender to that of being a strategic business partner. They must try to establish long-term relationships with those MSMEs that have the potential to be successful. Banks must not adopt a negative attitude toward MSMEs despite high levels of nonperforming loans from past lending experiences.

Promote financial awareness. An enterprise's transaction history with financial institutions plays a crucial role in determining the enterprise's creditworthiness. Financial institutions can invest in training for loan officers so that they can communicate their institution's policies effectively to MSMEs.

Relax the need for collateral. Explore alternatives to requesting collateral, especially from enterprises in the early stages of the life cycle.

Expand financial schemes for MSMEs. Build up a corpus of funds that can be provided to MSMEs in need of a sudden capital infusion. Also examine different and flexible repayment arrangements for loans disbursed to MSMEs.

Reduce documentation requirements. Consider reducing the burden of documentation required for MSME loan applications. As nonbanking financial companies can provide loans with less documentation, banks need to consider changing their approach toward MSMEs.

8.3 Recommendations for Entrepreneurs

Use proper accounting practices. Maintain a proper and robust accounting system, as this can increase the chance of accessing credit by providing a transparent basis for a lender to assess the viability and profitability of the enterprise.

Register the enterprise. Ensure that the enterprise is registered and that all registrations and licenses are renewed periodically.

Create prototypes and obtain patents. Prepare a prototype and try to patent the product. Approach the enterprise's accelerator or venture capitalists for financial assistance only after a prototyping cycle is complete.

Develop networks and markets. Entrepreneurs should participate actively in trade fairs and industry events for both showcasing their products or services and for enhancing their financial awareness.

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ANNEX: CLASSIFICATION OF MICRO, SMALL, AND MEDIUM-SIZED ENTERPRISES IN INDIA

Classification	Manufacturing Enterprises (Investment Limit in Plant and Machinery)	Service Enterprises (Investment Limit in Equipment)
Microenterprise	Rs2.5 million	Rs1 million
Small enterprise	Rs50 million	Rs20 million
Medium-sized enterprise	Rs100 million	Rs50 million

Rs = Indian rupees. Exchange rate: $1.00 = Rs65.63 (3 November 2015).

Source: Government of India, Ministry of Micro, Small and Medium Enterprises. 2015. *MSME at a Glance*. New Delhi.