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The Role of SIDBI in the Development of SMEs in India- A Case Study with Special Reference to Mezzanine Finance

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ABSTRACT

The SMEs have always been recognised as a significant contributor to the Indian Economy. But at the same time face the problem of access of finance. In the world of globalisation and the growing need of major investments and the need for unconventional forms of financing has elevated. The methodology used in this paper is case study approach. The objectives of the paper are to understand the concept of mezzanine finance and to understand the efforts undertaken by SIDBI which directly open up avenues for unconventional financial sourcing. By resultant discussion we are able to summarise that the efforts taken up by the Government of India and SIDBI have by and large opened all probabilities for the SMEs to see a bright future and adopt to unconventional sources of financing their business than relying only on traditional sources of financing.

Introduction

The Small and Medium Enterprises (SMEs) sector has been a significant contributor to the country in terms of generating the highest employment growth and also accounting for the major share of industrial production and exports.

Among all the key factors in setting up and developing SMEs, the access to finance being the most acknowledged factor; and it is also recognized that these enterprises in the economy may be underserved, especially in terms of finance

(Beck, 2007). The ability of SMEs to grow actually depends vastly on their potential to invest in restructuring, innovation and qualification. But all of these investments need capital and therefore access to finance (Giurcă, 2010).

In the world of globalization, the SMEs are facing tough economic conditions and having a growing need to make major investments. Due to this the need of unconventional forms of financing has elevated. Private Equity plays a progressively more significant role in the financing of a wide range of businesses. Over the past 20 years, private equity has been one of the fastest rising markets for corporate finance. By its very nature this market is private, not subject to the same disclosure requirements and regulation as the public markets and is characterized by poor levels of publicly available information.

Private equity firms began to specialize in a variety of segments and niches in the mid-1980s. Private equity firms have common labels for categorizations of private equity funds

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such as buyout, venture capital, mezzanine and distressed investment funds.

Mezzanine funds initially arose in the mid-1980s when investors began to use subordinated debt with some equity participation (in the form of warrants) to provide another layer of debt financing for highly leveraged buyout (LBO) transactions. Most private equity firms are involved in this type of investing.

Alternative forms of financing such as mezzanine capital are becoming more and more a supplement to the traditional forms of corporate financing for SMEs and its gaining its relevance as a source of growth capital for SMEs.

Mezzanine financing refers to hybrid financial instruments that possess characteristics of both debt and equity. It lies in the midst of debt and equity on the risk-return spectrum. In the hierarchy of creditors, mezzanine debt is subordinate to senior debt but ranks higher than equity (Sreejith & Anil, 2017). Even though the combination may seem to introduce an unnecessary degree of complexity into the funding equation, mezzanine finance can be an effective and relatively cost-effective way to finance growth strategies that entail an element of risk (Kashyap A. & Acharya, 2014).

The Government of India has long realised the need to develop the SMEs since they have been a significant contributor to the GDP of the Indian Economy and the SMEs have always enjoyed a distinct position in the planning process of the Government since then. Small Industries Development Bank of India (SIDBI) which was set up in the year 1990 under an Act passed by the Indian Parliament as the Principal Independent Financial Institution for the foremost purpose of Financing, Promoting and Developing of Small Scale Industries and also for the supporting purpose of coordinating the functions of other institutions engaged in similar activities.

The remainder of the paper is divided as follows Review of Literature, Methodology, Discussion and conclusion.

Review of Literature

Giurcă, 2010: This paper highlights mezzanine capital as hybrid instrument which combines the benefits of debt and equity and represents it as an alternative source in financing the start-up and expansion of SMEs. This paper also analyses the mezzanine financing instruments which includes private placement and capital market instruments termed as public mezzanine and the stage of development which is persisting in the market for mezzanine financing that diverge across Europe. Some countries have a wide range of different products for the SMEs to choose from, while other countries still have ground to make up in this area. The mezzanine capital has represented itself as an important option to cover the financing gap of the SMEs in EU. This paper also states that this instrument should be considered in the context of the international financial crisis which affects immensely the possibilities of financing for the SMEs. The paper also presents the main features and

advantages offered by this financing instrument from perspective of firms and investors' but also the main challenges.

Svedik & Tetreova, 2012 defines the term mezzanine capital in the alternative concept and also characterizes the properties of mezzanine financing. The paper also discusses possible instruments of mezzanine financing which are also briefly characterized. Further there is focus on the instruments in the form of securities that can be taken into consideration in the conditions of the Czech Republic, to name they are convertible bonds, warrant bonds and preferred stocks. It concludes by identifying the key risk factors causing their limited application and also specifies potential change proposals leading to improvements in the given situation.

Svedik & Tetreova, 2014: This paper states that mezzanine financing instruments as a possible source of financing large industrial enterprises. These instruments can be considered as suitable tools for financing large enterprises with capital-intensive manufacturing, such as metallurgical, chemical or machinery industrial enterprises. The paper has aimed to compare the advantages and disadvantages of individual mezzanine financing instruments, in particular of participating loans, participating bonds, subordinated loans, subordinated bonds, convertible bonds, bonds with warrants, silent participations and preferred stocks. These individual instruments were evaluated on the basis of the identified key factors and the evaluation was performed using the binary scale, where individual instruments were subsequently compared with each other.

Czajkowska, 2015: This paper assesses mezzanine financing as an innovative form in Poland, which might play a significant role in the dynamically growing companies which actually cannot obtain required capital from the conventional sources in the form of bank credits. The paper presents the idea of mezzanine financing, its mechanism, structures and comparison to alternative funding. An important part is indication of types of mezzanine capital and applications in the USA, the EU including Poland as well as comparative analysis of mezzanine advantages and disadvantages.

Methodology

The methodology adopted in this paper is case study approach. The data collected from the SIDBI Annual Reports, Optimism E-Magazine, Publication and Reports of SIDBI and other research articles. An attempt has been made to analyse the SIDBI's efforts to elevate the SMEs development process altogether with special reference with SMEs access to finance and especially with mezzanine finance.

Objectives

1. To study the theoretical framework of mezzanine finance.
2. To study the efforts undertaken by SIDBI towards the development progress of SMEs in India.

Scope of the Study

SIDBI has been established for the purpose of development and promotion of SMEs in India therefore, the scope of the study includes all the SMEs in India.

Limitations of the Study

This study is basically taken from the published annual reports of SIDBI and therefore its findings also depends entirely on the accurateness of this data. The present study is largely based on the financial and non-financial support provided by the SIDBI to the SMEs only and Micro Units have been excluded from the study.

Discussions of the Study

Meaning of Mezzanine Finance

Mezzanine financing instruments are those hybrid instruments which combine the characteristics of equity and debt. These instruments are called mezzanine instruments because they lie comfortably between the equity and senior debt in the capital structure of a company. These instruments have been considered as suitable tools for financing large enterprises but off late mezzanine financing has gained its momentum in SMEs, Real Estate and Infrastructure. Mezzanine Finance breaks the traditional sources of financing a business and is known as an unconventional way of financing a business.

Business Cycle Model

Each business enterprise has its own life cycle and during its various periods of life cycle there will be requirement of different financing needs and resultant change in its capital structure.

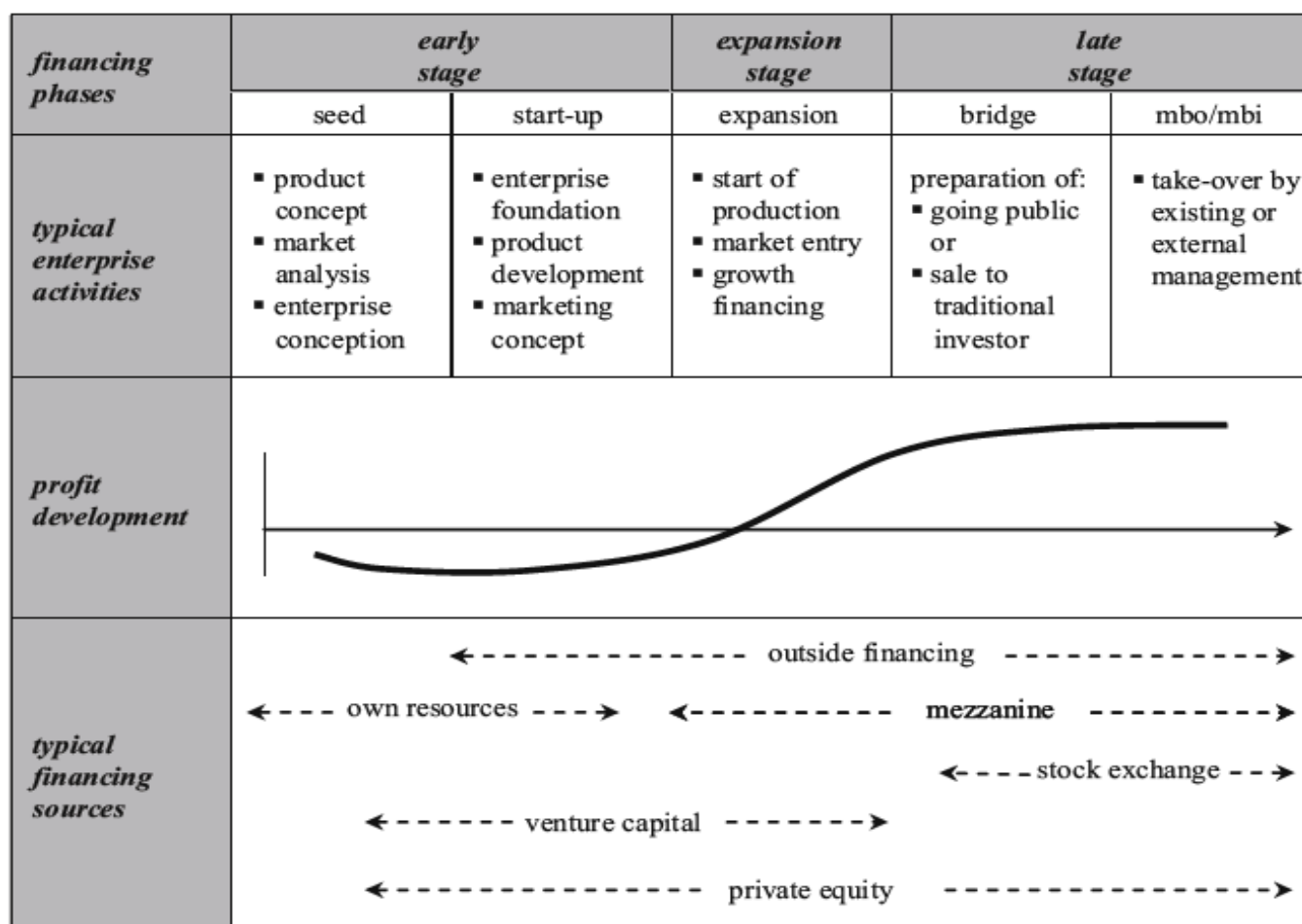


Fig.-1.1: The Forms of Financing in the Enterprise Development

(Source: Entrepreneurship in a European Perspective-Concepts for the Creation and Growth of New Ventures. pp. 293)

In Figure 1.1 we can analyse that there are five stages viz., *Seed Stage* which is characterised with the introduction of the company along with product concept and market analysis, at this stage the financing used is usually own resources and to some extent even venture capital and private equity or business angels. The second stage is *start-up stage*, where in due to

successful development the company cross the threshold into the stage of early growth. The investment is essential for the product development and marketing of services and also funding of the production activity of the company. Here the funding is usually by the Venture Capitalists who agree to take up high risk and obtain significant control over company

decisions, in addition to a portion of equity. The third stage is *expansion stage*, here the companies are in the early stage of expansion typically have a regular cash flow and have the necessity of finance for expansion of their activities. The banks are still diffident to finance the company's expansion activities. Here its activity could be financed by Mezzanine finance. Since, such type of financing is usually in the form of flexible structure, The Mezzanine finance is attractive in the cases where the senior debt capacity has been exhausted or when the company experiences complications in meeting the profile for repayment which mandatory by a bank. The fourth stage is *Maturity Stage* in which the company's life cycle at which their advancement is completed and the investors are able to exit their investment and generate returns on the funds already invested. Here at this stage they also prepare for being listed on the stock exchange. Here the company requires Bridge financing which is an interim financing option used by companies and other entities to solidify their short-term position until a long-term financing can be arranged. This financing normally comes from either Banks or Private Equity Firm or even Mezzanine Funds. The last stage is the *Decline Stage* where in the company might undergo successful reorganisation and restructuring of the business or it is being taken over by another company or the worst consequence is liquidation.

Steps Undertaken by SIDBI for SMEs

The total SMEs in India account for 42.50 million, registered and unregistered both together, which account for a total of 95% of the total industrial units. The more SMEs being in the unregistered sector, the Udyog Aadhar has been a blessing which gives a single window registration facility making the registration as easiest as it can be. This registration form is just of one-page and it constitutes a self-declaration format wherein the MSMEs have a self-certification of its own existence, give their bank account details, their owners or promoters Aadhar details and other basic required information. Based on the same, the MSMEs can be issued online, a unique identifier i.e. Udyog Aadhaar Number.

Corporatisation of SMEs

Corporatisation is a process of converting from proprietorship or partnership into a corporate entity which will enable an SME to enjoy the benefits what a corporate entity does. After reaching to a level of advancement, when they need to upscale their operations, its when a corporate entity benefits from being professional, transparency and accountable systems along with having financial discipline. The SMEs also will be able to employ various other sources of financing than the traditional sources of financing like Private Equity or Venture Capital or Mezzanine Finance. If the SMEs expect themselves to be recognised by financial institutions as financial sound and having stable cash flows then the corporatisation of SMEs becomes instrumental to their growth.

SME Exchanges

SME exchange have been defined in the Chapter XA of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations as a trading platform of a recognised stock exchange which has been permitted by the Securities Exchange Board of India (SEBI) to list the securities issued in accordance with Chapter XA of SEBI (ICDR) Regulations and it excludes the Main Board. Having a separate exchange for SMEs have become unfeasible because of previous experiences which were not successful, SEBI had given its approval consequently BSE SME and NSE Emerge went live on 13 March, 2012 with a separate trading platform for SME.

Table-1.1: Number of SME IPOs and Amounts Raised in the Last Five Years

Year	No. of Companies	Amount (Rs. Crores)
2017	133	1,679
2016	67	537
2015	43	260
2014	40	267
2013	35	335
2012	14	103

Source: Optimism Dec 2017 Magazine

The table 1.1 depicts the number of SME IPOs and the amounts raised in the past five years from the year 2012, the year that SME Exchange have been commenced till the year 2017. We are able to see a tremendous improvement from 14 Companies to 133 Companies with 103 Crores to 1,679 Crores. This shows a lot of improvement from the SMEs that they are realising the importance of raising finance from the SME Exchanges.

Credit Assessment of SMEs

The rating agencies approved for the purpose of credit assessment are Credit Rating Information Services of India (CRISIL), Fitch Ratings India Private Ltd., Investment information and Credit Rating Agency of India (ICRA), Credit Analysis & Research Ltd (CARE), Onida Credit Rating Agency of India Ltd (ONICRA) and Brickwork Ratings India Private Limited which follow standardised approach for credit risk calculation. Even SME Rating Agency of India Ltd. (SMERA) has been accredited by the Reserve Bank of India (RBI) in September 2012 as an external credit assessment institution (CAI) for lending and investing community in the MSMEs. SMERA is the rating agency which has been exclusively established for rating of SMEs. SMERA has successfully completed 7000 ratings till date. Ratings is done after considering various financial, non-financial parameters, past credit history and future outlook with respect to economy and the sector in which the MSME is operating or would like to operate. Ratings reduces delays and enhance cash flow assistance to MSMEs.

Udyami Mitra

SIDBI has also launched the Udyami Mitra Portal to improve the accessibility of credit for MSMEs. This portal is a virtual market place which endeavours to provide all end to end solutions for not only for credit delivery but also for additional services which is required for speedy credit delivery. A series of portals have been launched by the SIDBI viz., sidbi.in and standup mitra for the SMEs. This interactive portal is an additional portal which aims for instilling ease of access to MSMEs financial and non-financial service needs. Currently, there are 1.25 lakh branches of public sector banks, private sector banks of foreign banks of total of 38 banks and 56 regional rural banks which have been mapped on the portal for the SMEs to benefit. The portal helps in replacing the manual operations with electronic platform where the pre-sanction process shall be standardised in all banks in much simpler way.

Risk Capital

The SMEs have always known to face financial constraints from time immemorial. The Government of India has stepped up for priority sector lending to this sector but it still does not solve the problem of its access to finance. The SMEs require risk capital at its different stages of business cycle, whether it's at seed finance or start up stage or growth stage or maturity stage. Risk Capital is very instrumental for not only for start-ups but also for growth companies who want to expand but may be unable to do so because of its inability to have timely access to finance. Private equity firms always look in to for large companies for larger returns. Therefore, SIDBI has been mandated by the Government of India for an amount of Rs. 2,000 Crore Risk Capital Fund for the MSMEs. SIDBI provides Equity/Quasi Equity for growth oriented SMEs as risk capital which is also known as mezzanine finance.

Conclusion

The financial need of SMEs is something which not unknown. The more unconventional sources of financing available is all the more advantageous for them since more options will be available for them to utilise. The Government of India also has made constant recognition of the finance requirements of SMEs and always given them importance and position in getting benefit of various allocations by the Government. One such notable act is the establishment of SIDBI. SIDBI has made tremendous efforts for the development of SMEs in India. Even though they are many to mention the ones worth mentioning are the Udyog Aadhar for one single window application for registration for MSMEs. The Corporatisation of SMEs where in easy process of enabling the SMEs to be converted to a corporate entity which makes it easy for availing many benefits which otherwise it cannot. The establishment of SME exchanges viz., BSE SME and NSE Emerge which gives platform for the SMEs to raise their capital from primary and secondary securities markets. The credit rating which have been started exclusively for SMEs for credit assessment increases the prospects for them to reduce time delays and enhance their cash flows. The virtual market place

of Udyami mitra which has aimed for instilling ease of access for MSMEs for their financial and non-financial needs. Lastly, the risk capital of Rs. 2,000 Crores which has been mandated to the SIDBI for the purpose of providing risk finance to the SMEs in the form of venture capital, private equity, etc. These have by and large opened all probabilities for the SMEs to see a bright future.

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