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# Micro, Small & Medium Enterprises: Constraints & Opportunities

KNOWLEDGE REPORT





**Ms. A. Manimekhalai**  
MD & CEO  
Union Bank of India

## **From the Desk of MD & CEO, Union Bank of India**

We at Union Bank of India aspire to be the Bank of 1st Choice for MSMEs. We are moving ahead continuously as a digital forward bank, and not just a bank -- integrating digitization across the entire spectrum of banking processes and services. Union Bank of India provides a variety of products, schemes, and services to support MSMEs, which are not only feature-rich but also competitive in terms of pricing and speed.

MSMEs play a significant role in the economic development of a country. MSMEs employ more than 110 million people in the country, which is a significant portion of the workforce. Additionally, they contribute a little over 30% to the country's Gross Domestic Product (GDP). This demonstrates the significant impact MSMEs have on the economy and their importance in driving economic growth and development.

MSMEs, however, frequently struggle with poor financial management and a lack of financial awareness. To support MSMEs and enhance their access to finance, Union Bank of India has put in place various programs and schemes including Union MSME Suvidha, Union Nari Shakti, Union Equipment Finance, Union Ayushman Plus, Union Solar, Union MSME Credit Card etc. As a forward-looking bank, we have launched various Straight Through Processing (STP) journeys with end to end processing and disbursement of MSME Loans.

Bank is front runner in financing to the much needy Micro Entrepreneurs through all Govt Sponsored scheme like, PMSVANidhi, PMMY, PMEGP for MSME and committed to serve the nation by developing entrepreneurship. To outreach to these entrepreneurs bank is observing every Friday as 'Govt Sponsorship Scheme Day'.

Further, with a focussed approach to serve the MSMEs, Union MSME First Branches (UMFBs) are designed to provide personalized service to MSME customers. They offer various services including loans, forex services, LC/BG, credit cards, insurance products, etc. with dedicated relationship managers to fulfil customer needs.

This conclave is an initiative by the Union Bank of India and Resurgent India Ltd. to address assorted financial challenges that MSMEs face on a day-to-day basis. The conclave will act as a forum for customers to seek expert advice from the bank on their funding needs and other pertinent concerns.

**Mr. Jyoti Prakash Gadia**

Managing Director  
Resurgent India Ltd



### **Message from Resurgent India Ltd.**

MSMEs are key to India's long-term economic prosperity as a developing economy. They make a substantive contribution to the economic and social advancement of the country by fostering innovation and promoting entrepreneurship.

However, MSMEs in India must overcome a number of financial constraints in order to survive and grow. The sector's long-term profitability, competitiveness, and sustainability are all impacted by a shortage of working capital and poor financial management. Addressing constraints like a lack of low-cost finance is crucial to solving the complex funding challenges facing India's MSME sector. Small business owners often face challenges in navigating the financial landscape due to a lack of knowledge and understanding of the various products and services available, as well as the process of obtaining them.

Financial institutions often rely on credit scores and credit history to assess the creditworthiness of a borrower, which can be a challenge for small businesses that are just starting out or have not had a long credit history. Additionally, the documentation and compliance requirements for obtaining bank financing can also be overwhelming for some small businesses.

This report outlines various new and diverse funding options for small and medium-sized enterprises (MSMEs) and assists in identifying approaches and strategies to help small businesses finance their growth and overcome germane financial challenges.



**Mr. K K Gupta**

CAIIB, PGDBM (NIIBM), DFM,  
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### **Message from Resurgent India Ltd.**

MSMEs are the key to India's long-term economic prosperity. They are also seen as engines of economic progress as they are more responsive to market changes, can swiftly adapt to new technologies and have the capacity to be more innovative.

However, MSMEs face significant challenges in obtaining financing, with a lack of timely access to credit being one of the biggest obstacles to their growth. Constraints, such as a shortage of working capital, have a significant impact on the sector's long-term profitability, competitiveness, and sustainability. Additionally, a lack of knowledge and understanding of the financial products and services available and how to access them can also be a challenge for some small business owners, making it difficult for them to navigate the banking system and secure financing.

Aside from funding challenges, MSMEs confront a number of difficulties in managing their finances, which affect their creditworthiness and borrowing ability. The inability to manage and strengthen their balance sheets, lack of a detailed business plan and several other related factors act as significant barriers.

The report offers an in-depth examination of initiatives implemented by the government and regulatory authorities to assist MSMEs in obtaining funding and increasing efficiency, as well as a comprehensive analysis of strategies that can support MSMEs in obtaining financing and closing the funding gap.

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## CHAPTER 1

# A BRIEF OVERVIEW

The Micro Small and Medium Enterprises (MSMEs) sector is a major contributor to the socioeconomic development of the country. In India, the sector has gained importance due to its contribution to the Gross Domestic Product (GDP) of the country and exports. There is a countrywide network of approximately 63 million MSME units. MSMEs provide employment to over 110 million people and contribute a little over 30 % of the GDP. Additionally, MSME exports account for nearly 45% (FY 22) of total national exports.

Approximately 98.5% of the industries fall under the category of MSMEs in India. While some of these businesses export directly, the large majority of MSMEs participate in the export ecosystem indirectly by producing intermediate items for larger businesses that export to foreign markets.

After 14 years since the MSME Development Act came into existence in 2006, a revision in the MSME definition was announced in the Atmnirbhar Bharat package on 13th May 2020. The details are as follows

Type of enterprise	Investment	Turnover
Micro	Rs 1 crore	Rs 5 crore
Small	Rs 10 crore	Rs 50 crore
Medium	Rs 50 crore	Rs 250 crore

The Indian government has revised the criteria for determining which businesses qualify as MSMEs by adding factors like turnover and investment in equipment, enabling more businesses to access benefits such as government schemes, subsidies, and tax exemptions.

MSMEs are being encouraged to market their products on the e-commerce site, especially through Government e-Marketplace (GeM), owned and run by the government, wherefrom Ministries and PSUs (public sector undertakings) source their procurement. MSMEs also require a significant boost in the form of low-interest working capital loans to safeguard their financial health; this stimulus requires the backing of both the government and financial institutions.

## Statutory Bodies for MSMEs

**MSME Ministry has created the following statutory bodies.**

**Khadi and Village Industries Commission (KVIC):** It is responsible for promoting and developing khadi and village industries for providing employment opportunities in rural areas, thereby strengthening the rural economy. **Coir Board:** It is in charge of promoting the overall development of the coir industry and improving the living conditions of workers in this industry. **National Small Industries Corporation Limited (NSIC):** The body is responsible for promoting, aiding and fostering the growth of micro and small enterprises in the country, generally on a commercial basis. **National Institute for Micro, Small and Medium Enterprises (NI-MSME):** It is in charge of

enterprise promotion and entrepreneurship development, enabling enterprise creation, performing diagnostic development studies for policy formulation, etc. Mahatma Gandhi Institute for Rural Industrialisation (MGIRI): It is responsible for accelerating rural industrialization for a sustainable village economy, attracting professionals and experts to Gram Swaraj, empowering traditional artisans, encouraging innovation through pilot study/field trials and R&D for alternative technology using local resources. New online system of MSME/Udyam Registration launched by the Union MSME Ministry, w.e.f. July 01, 2020, successfully registered more than 1.1 million MSMEs until November 2020. In June 2021, the Ministry of Micro, Small and Medium Enterprises extended the validity of the Udyog Aadhaar Memorandum from March 31, 2021, to December 31, 2021.

## The Road Ahead

A majority of Indian Micro, Small and Medium Enterprises (MSMEs) are now using digital payments, with 72% of transactions being conducted digitally and only 28% being done in cash.

When we look at the process of integration into the global value chain, MSMEs face many challenges and it calls for accelerated efforts to strengthen the MSME sector to enable their penetration and reach globally. Access to (a) timely finance (b) at the right cost by MSME is constrained for numerous reasons.

Considering the Role and potential of Indian MSMEs, productivity and quality need to be viewed in the context of both a supportive domestic landscape and a globally competitive market.

In order to realise these goals, the government should invest in providing more back-end services to improve the performance of the MSME sector supplying goods and services to big industrial enterprises. Lack of technology-based production activities and low investment in R&D activities are bottlenecks thwarting the competitiveness of MSMEs. Globally available technology could be subsidised by the government so that the product quality of MSME players can be improved using the existing resources. This also requires greater collaboration with academic institutions for providing research and development (R&D) services for product innovation.





# Supporting MSMEs for better business growth - Strategies and Initiatives

MSMEs' growth depends on their better access to efficient factors of production through industry-friendly labour reforms, proper land acquisition policy, free access to capital, a vibrant entrepreneurship culture, modern technology, enabling infrastructure, and simplified tax policy. Various ministries extend support in the areas of skill development programs, market development assistance, technology support, credit flow, public procurement policies, participation in exhibitions both within the country and overseas, etc. The transition from micro to small and medium enterprises is a continuous process in the entrepreneurial domain. This can be achieved by harnessing the resources and support that are prevalent and those fashioned by the government of India through various ministries. It is necessary to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to enable them to continue to play their role in investment, growth, innovation, and employment.

## Alternative Financing Models for MSME

Capital gaps also exist for companies undertaking important transitions in their activities as well as for MSMEs seeking to de-leverage and improve their capital structures. Accessing Traditional bank finance poses challenges to MSMEs, in particular to newer, innovative and fast-growing companies, with a higher risk-return profile – hence, the importance of Alternative Financing Instruments for MSMEs.

## Types of Alternative Financing Models for MSME

### Factoring

Factoring is a financial arrangement whereby a business entity sells its account receivables (invoices) to a third party called a “factor” at a discount to meet its present cash needs.

Factoring has become a more widely used and accepted alternative mode of financing for liquidity-strapped MSMEs in many countries, with volumes expanding significantly over the last decade. Recent amendments allowing more NBFCs to operate in this space will be a shot in the arm for small businesses in India.

**TReDS Platform:** TReDS is a platform for facilitating the financing/discounting of trade receivables of Micro, Small and Medium Enterprises (MSMEs) through multiple financiers. These receivables can be due from corporates and other buyers, including Government Departments and Public Sector Undertakings (PSUs). With TReDS, discounting can be done online and in a clear and transparent manner.

## Private Equity and Private Placement

**Private equity** has emerged as a widely accepted form of financing for MSMEs in developed countries. It led to a decongestion in the mainstream capital market and serves as an avenue for MSMEs who cannot access finance from the capital market.



## Peer to Peer Lending

Peer to Peer lending is a novel concept and an attractive option for many MSME units. It connects investors to borrowers through the P2P online platform. It is a form of debt financing wherein borrowers can request a loan from another individual/entity without the need for any financial institutions to act as the intermediary. Parties involved in P2 P lending are Lender, the borrower and the P2P platform.

## Business Angel Investments

Business Angel investment plays a very crucial role in terms of bridging the financing gap of MSMEs by serving as an alternative financing option. Business angels provide not only finance but also managerial experience since many of the investors have made their fortunes in the same industries that they subsequently invest in.

The Ministry of Micro, Small, and Medium Enterprises (MSME) implements various programs/ MSME schemes for making funds easily accessible to the MSMEs for their continual growth and development. Moreover, the government of India has been proactive in ensuring that all benefits of these MSME schemes reach them on time.

### Existing supports

Self-Reliant India Fund, a fund of funds that intends to provide growth capital to Micro, Small, and Medium Enterprises, was established by the Indian government. The SRI fund will help MSMEs grow more quickly, boosting the economy and creating more jobs.

The SRI Fund, which will take the shape of a Category II Alternative Investment Fund (AIF), will be focused on supporting the Daughter Funds with cash so that they can provide growth capital to MSMEs in the form of equity or quasi-equity for the following purposes:

1. Help in listing small businesses on stock exchanges
2. Supporting Businesses to become National or International 'Champions'
3. Help in promoting faster growth for MSMEs
4. Improving equity-like financing for small businesses



The key objective here is to provide opportunities and benefits to MSMEs to avail the support of Venture Capital from the private sector. Businesses that were unable to come to fruition now have the doors open to outside capital for their growth and development. The entry of private sector VCs will accelerate the growth and expansion plans of the MSMEs. MSMEs are spread across the country and have structures that differ from large startups. It is, therefore, crucial to create new institutions that can aid in building the ecosystem for investing in MSMEs.

The partnership between rural fintechs and traditional banking institutions can pave the way for the development of the MSME sector and ensure that credit access is available to the intended beneficiaries. This collaboration can help the country realise its goal of financial inclusion and create a self-reliant India by bridging the credit gap and bringing MSMEs within the ambit of formal credit.

Another major potential driver for the growth of MSMEs in India could be the introduction of global technology and best practices to the MSME ecosystem. To scale up the growth of the MSME sector, it is imperative to map the technology practices followed by the MSMEs in international markets and introduce ideas that can work for Indian MSMEs. We must focus on incorporating new-age automation and data exchange in manufacturing technologies, including cyber-physical systems, the internet of things (IoT) and cloud computing. The strategic partnerships between the government, regulatory bodies and fintech players can help in addressing the complex and unique challenges faced by the MSME sector.



## CHAPTER 3

# Capital Market Access for SMEs - Advantages and Hurdles

SME platforms in India are known as BSE SME and NSE EMERGE. It should be noted that after listing on an SME exchange, both the NSE and the BSE offer the option of transferring the listing to the main exchange at the opportune time.

Listing on stock markets can lead to increased professionalism among small and medium-sized enterprises (SMEs) as it attracts institutional investors who have an interest in investing in the SME sector. This market has evolved as a genuine alternative for early-stage enterprises seeking to raise expansion capital without incurring interest costs.

A vibrant business environment, empowering government initiatives and incentives, globalization and exposure to vast geographical markets, availability of funds from banks and financial institutions, and, most importantly, the hunger and drive of Indian entrepreneurs have all contributed to the growth of MSMEs in India over the last few decades.

Smart India, Startup India, Digital India, and Make in India campaigns aim to promote fairness and equity for micro, small, and medium-sized enterprise (MSME) operators and help them improve efficiency. Additionally, the increased use of the internet and comfort with cashless transactions facilitated by B2C e-commerce companies are also contributing to the growth of the MSME sector.

## Pertinent Challenges

Capital markets have not traditionally been a preferred method of funding for MSMEs. A great majority of MSMEs are unaware of what it will take to list on the stock exchanges. Many cannot afford the expenses of listing even on dedicated and low-cost platforms for SMEs on the Bombay Stock Exchange and the National Stock Exchange. Yet, several enterprising entrepreneurs are finding ways to overcome barriers to taking their businesses public.

**Timeframe for funding** - Micro, small and medium-sized enterprises (MSMEs) frequently have urgent financial needs, particularly for loans, as many of these needs are related to meeting working capital requirements.

**Procedural ease** - MSMEs typically lack the customary compliance team and other associated support systems to handle challenging procedural requirements for accessing capital markets -- procedural tasks related to this need to be simplified and made low-cost.

An IPO is unquestionably an efficient way for a new firm to raise equity money. However, it was difficult for MSMEs to attract public financing through IPO due to stringent rules, fears of public issue failure, and a lack of support, among other factors.

There should be a special window for SMEs to launch their initial public offerings (IPOs). The minimum lot size of Rs 1 lakh is a significant barrier to the success of an SME IPO. This is significantly greater than the minimum lot size for a mainboard IPO. Investors would rather invest small tranches across several IPOs on the mainboard than Rs 1 lakh in an SME IPO. Regulators should reconsider the minimum lot size for SME IPOs in order to encourage greater participation by retail investors.

Making a specific platform available for small and medium-sized firms and reducing regulatory requirements may not be enough to induce SMEs to enter the capital market.

There should be a special window for SMEs to launch their initial public offerings (IPOs).



If a mainboard IPO is launched concurrently with an SME IPO, retail investors would prefer to invest in the mainboard IPO. This influences the subscription numbers of the IPO of a small company. Therefore, a separate platform is needed to prevent conflicts between the mainboard and MSME initial public offerings (IPOs).

The lack of readily available information for MSMEs who intend to raise funds on the capital markets is a key concern for a large number of potential investors. However, this might not be a challenge that an MSME can overcome on their own since they typically do not have the resources to be capital-markets ready. And so, it is important that the government create an independent body that can advise and provide consultancy to MSMEs for this at a nominal cost, which can be subsidised by the government. This will also help improve trust in micro, small and medium-sized enterprises (MSMEs) as the data would typically be vetted by a quasi-governmental body. There must be some form of incentive on the investment side as well. It could take the form of a tax exemption for investing in these issuances. MSME investments are often high-risk-high-return investments and are hence avoided by most investors. However, a mix of investor education programs and incentives for investors should help grow interest in this category, making it more mainstream than it is today.

A larger investor pool will also help increase volumes and help in efficient price discovery. Less than 50% of the companies listed since the inception of the exchanges are being actively traded on the two premier exchanges in India. As a result, secondary trades are few and far between, reducing the overall desirability of these stocks.

Finally, India's debt markets are also beginning to take shape. High-yield bonds are popular among major investors and high-net-worth individuals. The promotion of SME bond issuances helps boost MSMEs' participation in debt capital markets. Such issuances can provide micro, small and medium-sized enterprises (MSMEs) with lower interest rates compared to other financial intermediaries. Increased reliance on capital market funding will ensure that MSME growth and expansion plans are not hampered in the long run by short-term setbacks and that the growth momentum is sustained for an extended length of time.



## Schemes And Incentives For Manufacturers And Exporters

Global trade has bounced back from the Covid-19 pandemic-era slump, but it still faces challenges from causes including anticipated recessionary pressure, rising protectionism, and regionalism. Government efforts to reduce trade barriers, boost manufacturing, and improve infrastructure have helped position India for sustained growth, even in light of the new global dynamics.

A number of initiatives have been launched to assist micro, small, and medium-sized enterprise (MSME) exporters in expanding their market reach and increasing their visibility and access to capital.

Revisiting the entire approach to credit evaluation and monitoring is crucial for addressing these issues. Initiatives such as sponsorship, promotions, seminars, conferences, and research and development, aimed at improving export quality, performance, and market reach will go a long way in extending the much-needed support to MSMEs. Export incentives are benefits provided by the government to exporters in exchange for generating foreign currency and compensating them for the expenses of exporting products and services outside the country.

- **Remission of Duties and Taxes on Export Products**, often known as RoDTEP, is an export incentive that came into effect on January 1st, 2021. Under the RoDTEP Scheme, exporters get a refund of taxes and duties paid in India while manufacturing or processing goods for export.
- **Service Exports from India Scheme (SEIS)** aims to promote and optimize the export of regulated services from India. Under the SEIS Scheme, service exporters in India are eligible for a 3%/5%/7% incentive on their net foreign exchange revenues for designated services.
- **The Advance Authorisation Scheme (AAS)** allows the duty-free import of raw materials used in the manufacture of export goods. In other words, if the commodities are used for the production of export products, they would be exempt from the import levies.
- **The Duty Drawback Incentive** : It is an incentive scheme that offers reimbursement of government-imposed duties. The Department of Revenue (Customs Department) administers and monitors this initiative. Customs and excise charges imposed on imported and domestic materials used in the production of exported goods are repaid under this scheme. The duty drawback rate varies depending on the product.
- **Rebate on State and Central Tax and Levy (RoSCTL)** : Made-up products and garment exporters can make use of RoSCTL duty credit scrips. To encourage exports, the government offers tariff credit scrips that may be transferred or sold based on the FOB (free on board) value of the exported goods.
- **The Market Promotion and Development Assistance Scheme (MPDA)** is a unified scheme merging different schemes implemented by the Khadi sector. Grants/subsidies are also available for the construction of Khadi plazas. The overall objective of the scheme is to ensure increased earnings for artisans.



- **Export Market Revamped Scheme of Fund for Regeneration of Traditional Industries (SFURTI)**

It seeks to organize traditional industries and artisans into clusters to make them competitive and provide support for their long-term sustainability. It also aims to improve the marketability of products from such clusters by providing support for new products, improved packaging, and the enhancement of marketing infrastructure.

- **Quality Management Standards (QMS)/Quality Technology Tools (QTT)**

It aims to enable the manufacturing sector to be competitive through Quality Management Standards (QMS) and Quality Technology Tools (QTT).

The scheme for enabling the manufacturing sector to be competitive through Quality Management Standards (QMS)/Quality Technology Tools (QTT) is an initiative of the Ministry of Micro, Small and Medium Scale Enterprises.



# Resolving the Issues and Grievances of MSMEs

MSMEs' grievances up until May 31, 2020, or before the launch of the Champions portal, were addressed through the Internet Grievance Monitoring System (IGMS). However, it was decided that a more comprehensive and technologically advanced platform was needed to better support and promote the growth of MSMEs in the country. This led to the development and launch of the Champions portal, which aims to be a unified, empowered, robust, and technology-driven platform for supporting MSMEs. The Champions portal offers a wide range of services, such as access to finance, skill development, and market linkages, to help MSMEs overcome the challenges they face and grow their businesses. It also provides MSMEs with a single point of contact for all their needs, making it easier for them to access government services and support. It is designed to be a one-stop shop for MSMEs in India, providing them with the resources and support they need to thrive in a competitive business environment.

The portal seeks to extend support to MSMEs in terms of finance, raw materials, labour, permissions, etc.; help MSMEs capture new opportunities in the manufacturing and services sectors; identify 'sparks' i.e., bright MSMEs who can become national and international 'champions'.

## Recent developments

The government's grievance resolution portal for small businesses has seen a 35% jump in the number of grievances redressed. As of July 12, 2022, 48,308 MSME complaints were resolved in comparison to 35,562 complaints resolved as of July 15, 2021, since the portal's launch on June 1, 2020. This (portal) covers many aspects of e-governance including grievance redressal and handholding of MSMEs.

Months after the launch, the government integrated the portal with artificial intelligence (AI) and machine learning (ML) to get "social media insights relating to MSME," "know the pulse of the entire MSME sector without stakeholders going to the portal", "know emotions of people involved with or dependent on MSMEs in real-time" and more.

## Pertinent Challenges

Long delays in the payment of dues by central government departments/PSUs, state governments, state PSUs, and private sector enterprises have hampered the ability of MSMEs to tide over business cycles. According to the MSME Act, the recipient of any goods or services has 45 days to pay the MSME supplier. The interest rate for any late payment would be three times the bank rate announced by the Reserve Bank of India. MSMEs, on the other hand, rarely seek recourse to the rule for fear of losing business. A financing gap occurs when there is a discrepancy between the credit period offered by their suppliers (of raw materials) and the credit period extended by MSMEs to their consumers. While many businesses are aware of bill discounting to finance their bills, few are aware of TReDS, an electronic bill discounting platform, underscoring the need for cluster-based financial literacy programs.

Delayed payments are a critical problem that not only hinders the growth of micro, small, and medium-sized enterprises (MSMEs) but also disrupts supply chains and harms the economy. This issue is not exclusive to India, as most businesses around the world offer credit to their customers and subsequently face difficulties in receiving timely payments. However, there are variations in the extent of the delay, the length of delay, available



solutions, mitigation strategies, and the overall business environment.

With about 63 million MSMEs contributing to around a third of the country's GDP and employing 11.10 crore people, the performance of the sector is key to India's economic growth. However, out of the total debt demand of MSMEs of INR 69.3 trillion, only 16% (INR 10.9 trillion) is sourced from formal institutions.

The Code of Bank's commitment to Micro and Small Enterprises set out by the Banking Codes and Standards Board of India (BCSBI) details the conduct of regulations for banks to be followed in meeting their commitments to Micro and Small Enterprises. While the commitment towards addressing the grievances of Micro and Small Enterprises mentioned in the Code is identical to the commitment for other customers (mentioned and defined in BCSBI's Code of Bank's Commitment to Customers), there is no mention of commitment towards Medium enterprises.

Micro, Small and Medium Enterprises Development (MSMED) Act, contains the provisions of Delayed Payments to Micro and Small Enterprises (MSEs). Micro and Small Enterprises Facilitation Council (MSEFC) was initiated by the respective state governments. It is commonly known as the 'MSME Court'.

## **DISPUTE RESOLUTION MECHANISM**

### **How to File a Case in MSEFC?**

It is stated that when the buyer does not make payment or delays the payment of the seller after buying goods or services from the seller, then according to the Provisions in the MSMED Act, 2006, the seller unit, can file a suit against the buyer unit before the Micro and Small Enterprise Facilitation Counsel for the recovery of the amount.

The case or suit can be filed online on the site <https://msme.gov.in/> and upon the acceptance of the case filed by any unit, the MSEFC would call upon both the units along with their Advocates/Lawyers to present their points of view and their arguments, according to which the MSEFC makes a decision on the particular case. The application should be suitably drafted to satisfy the Act's requirements.



# External Commercial Borrowings - Challenges & Opportunities

External Commercial Borrowings (ECB) refers to the debt shouldered by an eligible entity in India solely for commercial purposes -- extended by external sources, i.e. from any recognized entity outside India. These borrowings are expected to conform to norms and conditions put forth by the RBI.

ECBs have proven to be instruments that greatly aid Indian firms and organisations in their efforts to raise funds from beyond India's borders, especially with regard to bringing in fresh investments. One might recognize that structures similar to ECBs include those of Foreign Currency Convertible Bonds (FCCBs) and Foreign Currency Exchangeable Bonds (FCEBs). It is important to note that while the main purpose underlying the issuance of FCCBs is the raising of capital, ECBs are more expansively applicable; within the latter's ambit lie commercial loans including securitized instruments, bank loans, suppliers' credit, buyers' credit, and bonds. The minimum maturity period of the aforementioned instruments is, on average, three years.

The post-crisis deleveraging in the banking sector has revived the debate around the need for an efficient – and transparent – securitisation market, which may allow the banking sector to access funds at a relatively low cost, for SME lending. The ECB has demonstrated the importance of developing primary and secondary markets for the securitisation of SME loans, in order to foster SME lending.

## Pertinent Challenges

Numerous benefits of ECBs have been mentioned, but there are also some drawbacks that merit attention. One could hypothesize that the company could develop a lax/lazy attitude, as they increasingly come across funds available at lower rates (though overseas interest rates are high right now). This could lead to irresponsible borrowing and higher debt on the balance sheet of the company.

Since raising funds through External Commercial Borrowing is done in foreign currencies, the principal and the interest shall have to be paid in foreign currencies. As such, the company opens itself up to the risks associated with exchange rates. Though ECBs can be availed at lower rates, there are several guidelines and restrictions that cannot be sidestepped. These restrictions primarily apply to the amount that can be borrowed, and the maturity of the External Commercial Borrowing. While amounts in excess of USD 20 million will have maturity periods of at least five years, amounts under USD 20 million will have maturity periods of at least three years on average.

During bull markets, there is no stress on the financial performance of companies with ECB debt. However, during bear markets, as profits begin to decline and the rupee depreciates, the Interest Cover, Return on Equity and PAT margin of companies with high ECB exposure reduce greatly. Moreover, FCCBs will not be converted into equity if the stock is trading at a discount to the FCCB conversion price. In depressed equity markets, this is often the case. In such a scenario, the company which has issued the FCCB can face severe liquidity and solvency issues as it is forced to repay its external debt commitment (while it had planned to convert it into equity at the time of redemption).

**In the event of such a default, the company may have the following options at its disposal:**

- i. Refinance the FCCBs by rolling over the bonds with later maturity dates, often at higher coupons.
- ii. Lower the conversion-to-equity price and further dilute promoter holdings.
- iii. Get bondholders to accept a haircut (only a partial repayment of their principal).



## Benefits of ECB

While equity becomes locked in, ECB is a loan that is set up with a pre-planned repayment schedule and early repayment, refinancing or modifications remain possible. An ECB loan can be secured or unsecured. Further, overseas borrowing is usually available at significantly lower rates than rates offered in India.

The following are some of the key benefits of raising funds using the ECB:

- Foreign currency funds: Companies need funds in foreign currencies for sundry purposes such as paying suppliers in other countries.
- Since the markets for raising funds through ECBs are vast, companies can easily meet large requirements from international players. Moreover, External Commercial Borrowing is just a way to take a loan. It does not necessarily have to be of an equity nature, and therefore the company's stakes will not be diluted. Borrowers can essentially raise funds without relinquishing control, as debtors will not have any voting rights in the company.
- The investor base can be diversified by the borrower, leading to greater constancy for the borrower.



# Key Findings

### Government Initiatives

The new definition of MSMEs by the Indian government expands the criteria used to determine which businesses qualify as MSMEs, and includes criteria such as turnover and investment in plant and machinery or equipment. This will help more businesses qualify as MSMEs, making them eligible for government schemes, subsidies and tax exemptions.

### Factoring

MSMEs also need to embrace alternative financing choices, especially factoring, which involves selling account receivables to a third party. Recent government amendment allowing more NBFCs into this space has the muscle to change the game for MSMEs.

### TReDS

TReDS, an online platform for factoring, allows MSMEs to register as bill providers and NBFCs/banks to bid for them. The transactions processed under TReDS are “without recourse” to the MSMEs, and may prove to be a game changer.

### Thrust on digital transformation

MSME digitalization may prove to be transformative for small businesses and needs to be accelerated to achieve improved cash flows, quicker money realisation, higher store cost-effectiveness and a better understanding of spending patterns.

### Rural fintech & bank partnership

Partnerships between rural fintechs and traditional banks should be strengthened to increase credit flow to MSMEs. Strategic partnerships between the government, regulatory bodies and fintech players can help assemble data on informal MSMEs, and handhold and register them as formal enterprises.

### Capital markets

A separate window should be created for SME IPOs to avoid competition with mainboard IPOs. The lack of information and resources for MSMEs to raise funds on the capital markets is a key concern; it is important that the government create an independent body that can advise and provide consultancy to MSMEs for this at a nominal cost, which can be subsidised by the government. This will also help enhance trust in MSMEs as the data would be typically vetted by a quasi-governmental body.

## Our Presence

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