OICV-IOSCO

32nd Annual Conference
9-12 April 2007, Mumbai, India

Plenary 4

Capital Markets and Economic Development - New Avenues for the Financing of Small and Medium Enterprises (SMEs)

Mr. Patrip Kar

Dean of Finance and Corporate Governance
Tata Management Training Centre, India

12 April 2007

32nd Annual Conference of the International Organisation of Securities Commissions (IOSCO) in Mumbai, India in April 9-12, 2007

Panel 4: Capital Markets and Economic Development-
New Avenues for the Financing of Small and Medium Size Enterprises (SMEs)

Pratip Kar
Dean of Finance and Corporate Governance
Tata Management Training Centre, Pune India

Mr Andrew Sheng Mr Katto, Mr Stuttard, Mr Trindade, Mrs Jane Diplock, Chairman, Executive Committee of IOSCO, Mr Michele Prada, Chairman,Technical Committee of IOSCO, Mr Damodaran, Chairman, Emerging Market Committee of IOSCO, members of the IOSCO family, distinguished guests,

It is indeed a great honour to be invited by IOSCO to speak at the 32nd Annual Conference held in Mumbai. I am grateful to IOSCO for this kind gesture. I am grateful to Mr Damodaran, Chairman SEBI and Chairman of the Emerging Markets Committee of IOSCO for giving me this opportunity. SEBI is an organisation which I had the proud privilege of serving for 18 years. These were the eventful years of economic reforms which saw the emergence of a new India, these were also the years which saw the transformation of the Indian securities market into a world class market with SEBI guiding the process of this transformation. My association with IOSCO also goes back 16 years from the annual conference I attended in 1990 in Santiago, Chile, when IOSCO was a much smaller family than today and the Emerging Markets Committee used to be named as the Developing Markets Committee. Today it is somewhat a trip down the memory lane.

Surveying the SME landscape

Let me first survey the SME landscape and why we should be concerned about the SME sector. This will serve a backdrop of my submissions today.

Small businesses have a key role in modern economics. Schumacher (1973, p. 53)] summed up the argument when he wrote that – "*While many theoreticians – who may not be too closely in touch with real life – are still engaging in the idolatry of large size, with practical people in the actual world there is a tremendous longing and striving to profit, if at all possible, from the convenience, humanity, and manageability of smallness*". The economic significance of the SMEs lies not only in their ability to nurture both - replicative as well as innovative entrepreneurships, but also as bulk provider of employment and contributor to the majority of output and taxes in most countries. According to the International Finance Corporation "*in much of the developing world the private economy is almost entirely comprised of SMEs" and that "they are the only realistic employment opportunity for millions of poor people throughout the world*".

SMEs as a business sector is a potpourri. Firms in this sector array across businesses such as service, trade, agri-business, and manufacturing and are engaged in a variety of activities ranging from village handicraft makers, small machine shops to computer software firms and manufacturing enterprises requiring different levels of sophistication and skills. The behaviour of firms in such a medley of businesses is bound to be idiosyncratic. Some of the SMEs are dynamic, innovative, and growth-oriented, some have the drive to quickly graduate to large business enterprise, while others are family owned and satisfied to remain small and retain control. Examples of the variety which makes up the

SME sector can be found in Microsoft which began with a couple of guys in a small garage in North-America; in Vodafone as we know it today which began as a little spin-off from Racal; in Hewlett-Packard which started in a little wood shack; in Google which was started by a couple of young kids who thought they had a good idea. Even Volkswagen at one point was just a little car maker in Germany (as opposed to being a giant small car maker globally). Infosys in India also began in a small way with a small band of entrepreneurs with vision and dedication, before it went public and went global.

One of the difficulties which arise while dealing with the subject of SMEs is the definition of an SME. There is no uniformity in the definition across countries. The EU for example defines SMEs in terms of head count, annual turnover, and balance sheet total and distinctions are made in accordance with these criteria between medium sized, small and micro industries, within an overall cap of fewer than 250 persons, an have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro. Definition of SME is important, because on it depends the funding approaches and funding programmes and government policies, and it may not be possible to have a uniform definition of SMEs across countries.

What do SMEs need for success?

The globalisation of business has increasingly drawn SMEs into global value chains through different types of cross-border activities. Many entrepreneurs are recognizing the opportunities that this process offers and gaining access to global markets has become a strategic instrument for their further development. Access to global markets for small businesses is important for them as it can offer a host of business opportunities, such as larger and new niche markets; possibilities to exploit scale and technological advantages; upgrading of technological capability; ways of spreading risk; lowering and sharing costs, including R&D costs; and in many cases, improving access to finance. Gaining access to global markets can help prospective high-growth firms realize their potential and is a strategic move for SMEs with large investments in intellectual property.

Some of the problems and challenges facing the SMEs were identified during the first OECD Ministerial Conference on SMEs and Globalisation, held in Bologna in December 2000Conference. These were as follows:

- inability of SMEs to capture market opportunities which require large production facilities and the consequent inability to achieve economies of scale, homogenous standards and regular supply;
- difficulties in the purchase of inputs such as raw materials, machinery and equipments, finance, consulting services, new technology, highly skilled labour etc.;
- inability to compete with big players in terms of product quality, range of products, marketing abilities and cost and the inability to expand business;
- inability to access internalization of functions such as market research, market intelligence, supply chain, technology innovation, training, and division of labour that impedes productivity;
- inability to make innovative improvements to their product and processes and to capture new markets because of size;
- poor IT and Knowledge infrastructure.

Absence of a wide range of financing and other services that are available to raise money were determined as the root cause of the challenges faced by the SMEs in most countries. These challenges in the area of financing are:

- Non-availability of adequate capital for investment.
- Difficulties in accessing the capital market.
- Inadequate institutional framework for assistance.
- Lack of technological advancement/ updation.
- Reluctance to change the way of functioning especially in family run concerns.
- Lack of opportunities to attract foreign capital.
- Impact of / threat posed by WTO.

- Terms dictated by the large corporate on whom the SMEs depend.

Finance as the key constraint to the growth of SMEs

I now come to the aspect of finance, which has been identified as the key constraint in the growth of SMEs is finance. Economic research suggests that young companies rely mostly on short-term debt and trade credits to finance their operations. Only more mature SMEs use some long-term debt, even then in a limited way. Internally generated funds are another important source of SME finance. In this context, effective and efficient risk capital markets especially in the innovative sectors could be an alternative source of finance and crucial for the development of small and medium-sized enterprises in most countries and hence for both job creation and competitiveness.

Internationally, one of the difficulties in equity financing of SMEs is that the managers often reject the investment by new equity to be issued to undertake a project, because the expected positive net present value could be outweighed by under pricing of the new equity. The problem seems to arise because of considerable information asymmetry between managers and potential subscribers to any new equity issue. Without full appreciation of the likely benefits of an investment project, and not completely understanding the reason of equity issue, the potential subscribers could interpret the issue as “bad news” concerning the business and price equity poorly.

It would not be far from truth if one was to conclude that at the core of the financing decisions of the SMEs is a desire on the part of the SMEs to maintain their independence and high risk aversion amongst many owner-managers. Protection of independence often lies behind the observed equity aversion and a strong preference for the use of debt financing for capital investment. Thus the access to capital market gets restricted. Any effort therefore to enable SMEs to access the capital market must therefore take note of these factors some of which are idiosyncratic to the nature of the SMEs and others pertaining to the environment in which the SMEs in a country operate.

Private equity as we know has seen an expansionary growth in recent years and it has also become an attractive route for financing the SMEs. To the extent that companies have been bought at a premium to the market price by private equity investors and then de-listed, is a challenge to the business and to the fundamental pricing mechanisms of stock exchanges. But if successful, and their track record has been good, private equity investors will at some point need to exit, so these companies may return to the stock market with higher trading volumes. This logic in turn emphasise the need for a liquid capital market for SMEs. Venture capital is also another promising source of finance for SMEs. Venture capitalists need appropriate cost-effective markets for their investments. In other words, they also need organised exchanges to sell their SME equity. Specialised and liquid capital market for SMEs thus becomes an important avenue not only for raising risk capital through direct listing, but also determines the ease with which the private equity investors and venture capitalists can exit from their investment and this in turn makes it attractive for these investors to invest in SMEs.

The Indian SME scenario

Let me turn for while and see the developments in India in the area of SME sector. In an environment of sustained high economic growth, economic reforms and opening of the Indian economy, there is now widespread recognition within India that vibrant SME sector plays a significant role in terms of balanced and sustainable growth, employment generation, development of entrepreneurial skills and contribution to export earnings.

The Micro, Small and Medium Enterprises are defined in India on the basis of investments in plant and machinery. Small enterprises are those with an investment of not more than Rs 50 mn in plant and machinery, and medium enterprises with an investment of over Rs 50 mn but less than Rs 100 mn in plant and machinery.

SMEs in India like in other emerging markets face serious growth constraints. There are several nonfinancial issues bedevilling the SMEs in India including lack of adequate infrastructure, international competition for exports and national regulations as well as social constraints such as education. Lack of access to finance has seriously affected the success of SMEs, impacting the sales of those enterprises. High cost of funds and lack of working capital finance for example reduces the expansion opportunities of these units. In addition, lack of training among bankers dealing with SMEs has impacted on the services provided to SMEs. The Hon'ble Finance Minister, Government of India had announced certain measures in the Parliament on August 10, 2005 for stepping up credit to small and medium enterprises which are required to be implemented by all public sector banks. A range of programmes in diverse areas, viz. financing, technology, innovation, market information, technical training and developmental assistance have been initiated to facilitate the growth of the SMEs.

The Reserve Bank of India had sometime back set up a committee to suggest ways to improve the credit flow to the Small Scale Industries Sector, particularly tiny sector and examine the issues of linkages with large corporates/producers and to enhance the credit delivery to the sector on a timely basis. The Report had suggested adoption of a 4C approach – Customer focus, Cost control, Cross sell and Contain risk – for extending full service banking to SME clusters and several other innovative ways and new vehicles and instruments of finance such as bank promoted (non-deposit taking) Non Banking Finance Companies, micro credit intermediaries dedicated to SME financing and developing a set of standard products for SMEs. Some of the large public sector and cooperative sector banks are taking initiatives to increase credit flows to the SME sector. But what is more interesting is that the private sector banks and foreign banks have now discovered the fortune at the bottom of the pyramid and are actively engaged in working out innovative instruments to finance the SME sector. These banks have now seen an opportunity in the SME sector and are now pursuing aggressive lending programme, which does not only include plain vanilla loans but also a full service concept ranging from e banking, advisory and procedural simplification.

Specialised stock exchanges for SMEs – global overview

Having traversed the landscape of SMEs and examined the various avenues for financing let me turn to the possibility of stock market as a source of risk capital for the SMEs. Over the past several years there has been a growing evidence of a worldwide trend towards the expansion of capital markets and the emergence of new SME-level listing programs, specifically designed to meet the needs of the SMEs not only in North America and Western Europe but also in many of the emerging markets. This by itself is a welcome development for several reasons. For one, greater opportunities are now available for the SMEs in these countries or regions to gain access to capital for growth and expansion; second there is a wider range of investment options for private and corporate investors, and the potential boost to the small business sector can have far-reaching economic and social benefits, particularly in emerging markets whose economies are often characterized by a high proportion of SMEs.

To cite some examples, SME-specific securities exchanges have been set up in some countries such as the US, Germany, France, Italy, Austria, Australia and New Zealand, Hong Kong, Thailand China (Shenzhen Stock Exchange) and Malaysia. AIM or the Alternative Investment Market was created in 1995 by the London Stock Exchange; EASDAQ is a pan-European Stock Market established in 1996 and operating from Brussels. It aims to provide a European alternative to the NASDAQ market in the USA, which is home to the world’s most important high tech companies. EuroNM is a network of markets created in 1996-1997 by the Amsterdam stock Exchange, the Brussels Stock Exchange, Die Deutsche Börse and La Société du Nouveau Marché to increase the European dimension of their own domestic initiatives. Currently the network is formed by: the Nouveau Marché (Paris), the Neuer Markt (Frankfurt), the Nieuwe Markt (Amsterdam) and the Nouveau Marché (Brussels). In Australia, the Bendigo Stock Exchange (BSX) or Newcastle Stock Exchange (NSX) enables SMEs to raise equity via a public company listing.

Although some of the existing SME listing programs in developed markets are targeted specifically at companies in domestic markets, a particularly interesting aspect of the new developments is that many listings are open to foreign issuers, creating enormous potential for transnational investment and global inter-connectivity in SME capital markets.

A recent survey of stock exchange of the emerging global situation regarding SME listing initiatives stock exchanges and Over the Counter Boards with websites, spanning 133 countries shows that

- Of the 133 countries surveyed 38 countries (29% of the total) have some form of SME or other lower tier listing, an SME exchange or an OTC Board, though this does not necessarily mean that they do not exist in the remaining countries. In most cases, the main distinction between SME programs and main exchange boards is that the SME or other lower-tier listing has significantly less lower listing and compliance requirements and costs, offering an easier and cheaper route to capital-raising.

- There were a total of 51 separate SME exchanges/listings, other lower tier listings or OTC Boards identified across the 38 countries. The breakdown of exchanges by type of listing is as follows: 10% are SME- specific exchanges, 26% are SME listings, 12% are growth company listings, 22% are OTC Boards, 18% are lower tier boards, and the balance are some combination of these categories.

Assessing the success of SME Exchanges

But the jury is still out on the accomplishments attained by stock exchanges dedicated to serving SMEs and the extent to which they have been successful in bringing SMEs to the capital market. While some exchanges such as the AIM (long after it was set up) and Nasdaq and to some extent BOVESPA's Novo Mercado and Novo Mercado and BOVESPA MAIS in Brazil have been success stories but this cannot be said as yet for the other initiatives. On one side, there is thus a support for the notion that, stock exchanges are particularly relevant to help medium size indigenous firms gain access to finance and promote local market development. On the other hand, given the nature of SMEs, there is a debate on the regulatory structure that needs to be adopted for the SME specific exchanges to encourage listings of the SMEs. In his study, M. A. Schulman claims that the "responses to the FIBV's SMB Questionnaire strongly indicate that SMEs are benefiting from coming to market". Another study, carried out by Grant Thornton on European New Markets, ranks the perceived benefits of flotation only for medium sized companies. According to this study, 41% of them named "availability of capital" as the most important benefit of being listed.

The emerging developments in global SME capital markets are thus at once encouraging and disconcerting. Encouraging because development of a market for risk capital is necessary for the growth of the SMEs. Disconcerting because there are signs of countries being under pressure to design markets with the sole objective of attracting domestic and cross border SMEs and for that if necessary to lower the regulatory standards. Developed markets could find this to be a particularly desirable option to attract SMEs from emerging markets. This trend could place some of the emerging markets under increasing pressure to develop their own SME listing programs in order to avoid outflows of capital and a weakened investment market as domestic SMEs choose to list overseas.

Regulatory design – issues and challenges

The emerging developments in global SME capital markets are at once encouraging and disconcerting. Encouraging, because development of a market for risk capital is necessary for the growth of the SMEs. Disconcerting, because there are signs of countries being under pressure to design markets with the sole objective of attracting domestic and cross border SMEs and for that if necessary to lower the regulatory standards. Developed markets could find this to be a particularly desirable option to attract SMEs from emerging markets. This trend could place some of the emerging markets under increasing pressure to develop their own SME listing programs in order to avoid outflows of capital and a weakened investment market as domestic SMEs choose to list overseas.

The market and regulatory design underpins the success of a SME listing. These are similar in nature to the use of appropriate technologies in developing the rural economy. The main board listing requirements and regulatory oversight are elaborate and hence the cost of compliance for listed companies is high. The corporate governance standards and onerous disclosure requirement significantly raise the compliance costs to the extent that even the companies listed on the main board and the market intermediaries trading in these companies complain. But high regulatory standards are not irrational; these are necessary for investor protection. Such standards cannot be different for an investor investing her savings in a company listed on the main board or on the SME- specific exchange. In both cases the investor's savings have the same colour and quality and the investor is bound to seek the same level of protection for a dollar invested on the main board or on the SME- specific exchange.

Pursuance of the objective of developing the SME sector giventhis enormous potential of SMEs to generate employment and output could often be a sufficient incentive for the development of a SME market with a friendly regulatory design. Such an approach is fraught with two risks – first, such softer regulation in a financial world which inherently fosters on greed, hope, fear, uncertainty and hubris, could be an open invitation to market misconduct which will seriously impair long term investor confidence. Investors who were wooed to the market will be deeply hurt. This is a situation which regulators and governments could ill afford. Second, softer regulation does not necessarily guarantee a deep and liquid market without which an exchange cannot succeed in the long run.

The development of a SME market thus raises a healthy debate between the much needed growth of a key economic engine versus establishing a market which will thrive on regulatory arbitrage as one of the key drivers for growth. Clearly, there is a need to establish a fine balance to resolve the dichotomy. The first question to resolve is whether to establish a separate exchange for the SME or to allow a separate trading board as a part of the main market in the same exchange. Both models have been tried out with varying degrees of success and it is too early to sit in judgement. The second is about the entry norms for listing. While the entry point norms and listing fees could be suitably adjusted to a commensurate level which will enable the SMEs to list on the Exchange, there need not be any let up on the disclosure, corporate governance and surveillance and the use of the exchange's arbitration mechanism for dispute resolution. But setting up of an exchange is by itself not a guarantee for market liquidity, without which a market is not viable in the long run. A sustained multi pronged effort is needed by the exchange to market itself and to provide non regulatory marketing incentives to companies such as offering a discount in listing fees, launching training programmes, propagating success stories, encouraging analysts to cover the companies and strengthening intermediation.

The existing regulatory designs for the SME markets display varying characteristics. There is a lack of consistency and a variation of standards; these variances are raising a debate about a desirable standard for a SME exchange. IOSCO in its capacity as standard setter for global securities market could perhaps play a critical role in setting the standards and laying down the fundamental principles for a SME exchange and SME listing. The standards should ideally be such that they do not curb the commercials and entrepreneurship of the stock exchanges, while ensuring consistency and uniformity in regard to regulatory standards.

SME exchange in India

Currently there is no SME specific exchange in India. The Securities and Exchange Board of India (SEBI) is actively engaged in working out ways to enable the SMEs access the capital market, which will complement the efforts of the banks and financial institutions to provide financial support to this sector. The task is by no means easy. In designing such an exchange, SEBI faces the same set of challenges and issues outlined in the preceding paragraphs. Choice would have to be made between the cost involved in setting up a separate exchange for the SMEs and piggy backing on the two existing exchanges by establishing a separate trading platform. Once that choice is made, appropriate market design which also takes into account innovative trading mechanism, different from the existing auction market, simplification of issue and listing procedures would have to be worked out. Given that investor protection along with market development are the twin mandates of SEBI, the regulatory architecture would have to be carefully crafted which will encourage the SMEs to list on that exchange and provide liquidity, while not compromising on the governance, disclosure, risk management and market surveillance standards. The task is by no means easy.

Epilogue

This paper has discussed and evaluated the case for using the stock market as an avenue of finance. But as already discussed in this paper, other innovative sources of finance are also available. Private equity funds are entering into innovative funding structures; banks and financial institutions are also setting up new schemes which are extensively using the cluster models. But the success of a model whether through the access to the risk capital, or collateral bank lending would depend on a host of endogenous factors such as the state of economic development and the maturity of the financial architecture of the country. But that is the subject matter of another paper for a different forum.

****