MSME: The opportunity knocks
PREFACE

Small and Medium scale Enterprises (SMEs) are the backbone of India’s socio-economical system. Post the liberalization, India’s tremendous economic surge was led by a sharp growth in the services sector even though manufacturing had remained muted. Although the growth of Micro, Small and Medium Enterprises (MSMEs) always surpassed the overall economic growth rate, it remained a long way from achieving its true potential. In short, options and decisions that India would make today to manage its vast and fast growing SMEs will have a profound impact on the country’s future growth.

`India’s public procurement- The opportunity knocks` details prospects of the Indian public procurement policy for SMEs in general and the SC/ST entrepreneurs in particular. The findings are part of the research by Varhad Capital in collaboration with Dalit Indian Chamber of Commerce and Industries (DICCI). The purpose of this research is to understand and estimate the public procurement policy and its economic impact on SMEs, explore problems and bottlenecks as well as to suggest the way forward.

Varhad Capital has developed its own proprietary model to study public procurement in India and estimate the future opportunity for SMEs. We have studied in detail the past trends of procurement by analysing the annual reports of 116 companies and 74 departments/ministries. Our integrated models forecast substantial growth demand for Indian MSMEs, employment opportunities and vast funding requirements after the mandatory implementation of the Public Procurement Policy (PPP) from FY16 onwards.

We would like to thank DICCI, Small Industries Development Bank of India, BSE Ltd, Ministry of Micro Small and Medium Enterprises and Ministry of Social Justice and Empowerment for their support and sharing the ground-level knowledge.

We would like to emphasize that this research is independent and has not been commissioned or sponsored in any way by any business house, government or institution.

Sau. Usha Dahapute  
Chairperson, Varhad Capital

Prasad Dahapute  
Managing Director, Varhad Capital

Sachin Gupta  
Director, Varhad Capital

June 2013
ABOUT VARHAD INVESTMENT MANAGERS

MSMEs are the backbone of the economy of any country across the globe. They are needed to fuel the growth of the economy along with the social reforms. They are vital cog in the contribution of GDP and employment generation.

Despite their immense contribution to the economy, they face several hardships in raising finances to augment their growth. They have to often resort to the traditional ways of funding via public sector banks, co-operative banks etc. and that too with collateral backing. The difficulty of raising finances restricts them to enhance their production, explore new markets, and improve their visibility & profits and thereby crippling their growth.

Varhad Investment Managers (VIM) is an asset management company, providing SMEs the access to alternatives investment market. Varhad group envisions making at least 1,000 SMEs rupee billionaires over the next 10 years. VIM would play a crucial role in helping the group achieve its goal by investing in SMEs via equity and debt capital. To support our vision, VIM has launched its maiden fund - INR5bn DICCI SME Fund, India’s first SEBI registered social impact investment fund that will invest in SC/ST owned SMEs.

We hope that this report will help to open the door of alternatives investment market to SMEs and create opportunity for the alternative investors to tap this unexplored high growth market of SMEs.

Prasad Dahapute
Director, Varhad Investment Managers
ABOUT VARHAD CAPITAL

Developing a dynamic Micro, Small and Medium Enterprise (MSME) sector has always been a priority amongst economic development goals for both developed and emerging economies since MSMEs are the primary drivers of job creation and GDP growth besides immensely contributing to the economic diversification and social stability.

However, MSMEs by and large face severe constraints to growth than large companies; their lack of critical size resulting in reduced access to markets, skills and capital. Lack of access to financing has been consistently cited by MSMEs as one of the main barriers to growth. Often considered by commercial banks and financial institutions as risky and costly to serve, MSMEs are largely underserved when it comes to basic financial services. Given this limited access to financing, MSMEs find it hard to make critical investments that they need to augment productivity and competitiveness in their businesses.

Varhad Capital is a client focused independent investment bank, serving growing companies. Having a vision to help MSMEs of India, Varhad Capital’s dedicated team has expanded access to finance for sustainable private enterprises. Leveraging this track record and learning from the experience of banks that are successful in serving MSMEs, Varhad has been working with commercial banks to recognize and seize the untapped and profitable potential that the MSME segment offers.

We hope our report on the Public Procurement Policy will help MSMEs and financial institutions alike capitalize the tremendous possibilities. We present this report with the firm belief that this potentially high growth sector would accomplish key success facets that would ensure a profitable MSME financing.

Sachin Gupta
Director, Varhad Capital
ABOUT VARHAD FCS

MSMEs play a crucial role in India’s holistic development alike the countries across the world. They are the driving force of economic growth along with equitable development. They have outplayed the economic growth by a phenomenal contribution of around 12%-13% of India’s GDP along with employing nearly 73m people in 31m units.

Even with their commendable share to the economy, they operate out of poor infrastructure, financial crisis, lack of proper planning and execution, limited market access for input and output, etc., which obstructs them to achieve their optimum growth potentials. Besides, due to lack of entrepreneurship in the society the first generation entrepreneurs have to go through the social stigma in case of failure.

Varhad Financial Consultancy Services (VFCS) is the financial cum business consultancy division, supporting MSMEs through their research and outsourced CXOs programmes. The research focus on impact investment should help MSMEs in accessing alternative means of finance and expand their business operations. VFCS also covers 60 BSE listed SME companies.

We hope that this report will help SMEs understand their true potential and prepare them to tap the opportunity of INR17tn thrown open by the Public Procurement Policy.

Sau. Usha Dahapute
Director, Varhad FCS
FOREWORD BY DICCI

It is an honor and my pleasure to write a foreword for the report “MSME: The Opportunity Knocks” which brings out the vast opportunities that shall be created for MSMEs through the Public Procurement Policy (PPP). At the very outset, Dalit Indian Chambers of Commerce and Industry (DICCI) would like to thank Varhad Capital, our knowledge partner, for their on-going commitment to the conceptualisation and development of the report at our behest.

The Scheduled Caste (SC) and Scheduled Tribe (ST) communities have been deprived from various opportunities such as education, health care, jobs, mainstream businesses, etc. over the past 2,000 years. They were kept apart from the main strata of the society.

SC/STs got the first boost in 1950, when Republic of India was formed and they got a preferred chance to get education at par with others. Most of the entrepreneurs from these communities started their businesses post liberalisation of Indian economy in 1991. In the recent years, the affirmative action programmes has broadly benefited the SC/ST entrepreneurs.

The advent of PPP will give a boost to the SC/ST MSMEs through the earmarked mandatory procurement of 4% reserved for them. It shall create huge business opportunities for this entrepreneurial class which will encourage more number of SC/ST youths to become entrepreneurs and ultimately bring them out of the social stigma and discrimination. It will also help improve their livelihoods, generate employment, and alleviate poverty.

DICCI, in contributing for its share to uplift the bottom of the pyramid, has collaborated with Varhad Investment Managers (VIM) to setup up the DICCI SME Fund (DSF) of INR5bn, fully dedicated to these enterprises which will help them access the non-conventional means of finance.

In my opinion, this report will start a new trend of MSME focused research in India which will help MSMEs grow by leaps and bounds.

Padamashri Milind Kamble
Chairman, Dalit Indian Chambers of Commerce and Industry (DICCI)
FOREWORD BY CEO, BSE LIMITED

Micro, small and medium enterprises (MSMEs), particularly in developing countries, are the backbone of the nation’s economy. They constitute the bulk of the industrial base and also contribute significantly to their exports as well as to their Gross Domestic Product (GDP) or Gross National Product (GNP). Special roles for MSMEs were earmarked in the Indian economy with the advent of planned economy from 1951 and the subsequent industrial policy followed by government. By and large, MSMEs developed in a manner, which made it possible for them to achieve the desired objectives.

The Prime Minister’s Task Force (Jan. 2010) recommended setting-up a dedicated Stock Exchange/Platform for SME. SEBI has also laid down the regulation for the governance of SME Platform. Bombay Stock Exchange Ltd, an Exchange which has founded the equity cult in the country has witnessed many companies becoming big from small by raising funds from Capital Market. We therefore understand the importance of setting-up an Exchange for Small and Medium Enterprises. We launched SME Exchange in March 2012. In brief span of one year it already has more than 90% market share with 22 listings.

The new public procurement policy is likely to catapult MSMEs into higher growth orbit. The report “MSME: The opportunity knocks” is an effort which highlights the huge opportunity coming for MSMEs and the eco-system which would be required to facilitate the growth. Traditional banking may not be sufficient to cater to this demand. Capital market has to think and act differently to aid MSMEs to tap this opportunity. I want to congratulate The Varhad Group and DICCI for being the first one to bring out the landmark report on this subject.

Ashishkumar Chauhan
MD & CEO, BSE Limited
THE GREAT OPPORTUNITY:
PUBLIC PROCUREMENT IN INDIA

20% GDP contribution by MSME by FY20

INR\text{28} \text{tn} PPP opportunity in FY20

INR\text{17} \text{tn} incremental SME opportunity over FY14-20

INR\text{3.4} \text{tn} incremental SC/ST SME opportunity over FY14-20

INR\text{10} \text{tn} incremental investment in fixed asset required over FY14-20

INR\text{3} \text{tn} incremental working capital required over FY14-20

140m incremental employment creation over FY14-20

2x spurt in employee productivity
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EXECUTIVE SUMMARY

Worldwide, the Micro, Small and Medium Enterprises (MSMEs) are considered to be the backbone of socio-economic growth. In India, the MSME sector plays a very important role in its social and economic development by providing employment to almost 40% of the population, contributing ~12% to the GDP and accounting for 45% of the value addition in the manufacturing sector.

Implementation of the Public Procurement Policy (PPP) by the Government of India by year FY16 onwards is likely to accelerate growth of the MSME sector, creating a multi-trillion business opportunity. Provision for a mandatory sourcing of 20% from the SC/ST segment in this opportunity is a positive step towards the social inclusion.

Varhad Capital’s research team has worked for more than six months to understand the PPP policy, its current status and implementation and global experiences. We have met policy makers and secured information from government agencies and public corporations. Small Industries Development Bank of India (SIDBI), a pioneer in MSME financing and Dalit Indian Chamber of Commerce and Industry (DICCI), a body working to promote entrepreneurship amongst SC/ST were instrumental in providing insights into the policy.

We have developed proprietary models to assess the opportunity and expect the public procurement in India through MSMEs to reach INR33tn in FY20. Incremental cumulative opportunity for MSMEs should be INR17tn during FY14-20, of which, a cumulative opportunity worth INR3.4tn would be earmarked for SC/ST owned SMEs. The implementation of the PPP policy would also trigger an incremental fixed asset requirement of INR10tn and working capital needs of INR3tn for MSMEs.
MSME Definition in India

According to the MSME Act, 2006, an SME is an entity engaged in the production of goods and services involving an investment of above INR1m but below INR100m.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Investment Ceiling for Plant, Machinery or Equipment</th>
</tr>
</thead>
</table>
| Micro          | Manufacturing Enterprises: Upto INR2.5m (USD50 thousand)  
                    Service Enterprises: Upto INR1m (USD20 thousand) |
| Small          | Manufacturing Enterprises: Above INR2.5m (USD50 thousand) to INR50m (USD1m)  
                    Service Enterprises: Above INR1m (USD20 thousand) to INR20m (USD40 thousand) |
| Medium         | Manufacturing Enterprises: Above INR50m (USD1m) up to INR100m (USD2m)  
                    Service Enterprises: Above INR20m (USD40 thousand) to INR50m (USD1m) |

Source: Dept of MSME, Govt. of India

MSMEs— The vital cog in India’s development

MSMEs play a crucial role in the socio-economic development of India. The sector accounts for about 12-13% of the country’s GDP, 45% of its manufacturing output and 40% of exports. The sector employs nearly 73m people in 31m units, producing over 6,000-8,000 products.

Despite the muted growth in the Indian manufacturing sector over past two decades, MSMEs have grown faster than the Indian economy. With the government’s effort to accelerate growth of manufacturing through the National Manufacturing Policy by 2022 and the implementation of PPP, the growth of MSME sector is likely to far outstrip India’s growth in the next decade.

Exhibit 1: MSME growth outclasses GDP growth over the past decade

![Graph showing MSME growth outclasses GDP growth over the past decade](source: World Bank)

MSMEs growth has been robust despite the poor infrastructure and limited access to finance. Study of different states reveals that states with higher economic growth and better infrastructure for MSMEs have seen higher success for them.
Public Procurement Policy: Unleashing the SME prowess

Public Procurement Policy (PPP) introduced by the Government of India in the Finance Bill of 2012 will act as a driving force towards socio-economic reforms by creating a huge opportunity for the SME sector. The policy aims to create INR17tn of demand over FY14-20 for the SME sector by making it mandatory for all public sector organisations to source a minimum 20% of their total respective procurement from MSMEs (including 4% from SC/ST owned MSMEs) from April 2015 (FY16) onwards.

Globally, developed countries in the West and Japan have successfully implemented public procurement whereas procurement in some countries has reached nearly 50%, thus creating a huge scope of growth of SMEs.

Source: Planning commission of India, MSME Ministry data
## PPP comparison with other countries

<table>
<thead>
<tr>
<th>Country</th>
<th>PPP policy for SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>India</strong></td>
<td>In 2009, only 5% of the Central Government and PSUs procurement came from SMEs. However, with the PPP bill 2012, 20% is set aside for MSMEs (4% from SC/ST) to be achieved in 3 years.</td>
</tr>
<tr>
<td><strong>Australia</strong></td>
<td>The government is committed to source at least 20% of its purchases by value from SMEs.</td>
</tr>
<tr>
<td><strong>Brazil</strong></td>
<td>The state buys from SMEs while simultaneously providing technical assistance to businesses involved in procurement.</td>
</tr>
<tr>
<td><strong>EU</strong></td>
<td>The EU has no regulation related to setting aside procurement from SMEs. However, in France and Germany, procurement from SMEs ranges from 15%-25% through the active support policy.</td>
</tr>
<tr>
<td><strong>JAPAN</strong></td>
<td>High degree of support policy for SMEs. In 2002, public procurement through SME was 47%, amounting to JPY5.6tn.</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>In the UK, it is proposed to award 25% of public contracts to SMEs along with the transparency agenda, according to which, all government spending, up to a specified limit, is published online.</td>
</tr>
<tr>
<td><strong>USA</strong></td>
<td>The US has been most active in terms of SME procurement programmes with acts such as Competition in Contracting Act (1984), the Federal Acquisition Streamlining Act (1994), the Federal Acquisition Reform Act (1996) and the Buy America Act (which requires only such articles, materials, and supplies as have been mined or produced or manufactured in the United States to be acquired for public use unless federal agencies shall determine it to be inconsistent with the public interest or the cost to be unreasonable). In the US, 23% of the Federal government’s procurement is reserved for SMEs. In 1995, procurement from SMEs reached 33% of the total procured amount amounting to USD1.5tn.</td>
</tr>
</tbody>
</table>

Source: METI Japan, EU report on SME 2010, USA Government website
PPP: Varhad Capital’s “SME Vision FY20”

The Public Procurement Policy (PPP) will induce an additional demand of INR17tn and a fixed asset requirement of INR10tn for Indian MSMEs over FY14-20, thus creating a huge socio-economic development opportunity. SMEs would require additional working capital to the tune of INR3tn over FY14-20. Our SME Vision 2020 focuses on these opportunities for SMEs, financial institutions and the society as a whole.

Exhibit 3: PPP to provide INR17tn business opportunity over FY14-20

Source: MSME Ministry, Varhad Research

Exhibit 4: PPP to create INR3.4tn opportunity for SC/ST SMEs over FY14-20

Source: Company Annual Reports, Varhad Research

Exhibit 5: Incremental fixed investment in Indian SME sector to reach INR10tn over FY14-20, propelled by PPP

Source: MSME Ministry, Varhad Research
**Exhibit 6:** Working capital needs of MSMEs if PPP is implemented (production grows at a CAGR of 14%)

- Source: Varhad Research

**SME policy roadmap for India**

**Exhibit 7:** Varhad Capital’s suggestions on SME Policy in India

- Large pool of skilled & competent SMEs supplying to large industries
- Increase entrepreneurship & raise employment contribution to 80% by 2020
- Provide better financing avenues
- Establish training for upgrading skill & technologies
- Increase rural participation in the SME growth
- Provide linkage with, and to be a source of raw materials to large scale industries

- Technology driven production of goods and services
- Strengthen technological base of the industrial sector and the economy
- Create base for adoption of appropriate technology for SMEs
- Provide funds for adoption of modern technologies
- Provide policies for the growth of SMEs

- Creating strong and globally competitive SME sector
- Increase procurement of goods & services from SMEs (from 20% to 50% by 2030)
- Provide transparency in procurement process through E-procurement
- Provide export credit for SMEs

- Source: Varhad Research
Exhibit 8: SMEs show high agility and low cost advantage when compared to large enterprises

<table>
<thead>
<tr>
<th></th>
<th>Large enterprises (%)</th>
<th>SMEs (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Swiftness of decision-making</td>
<td>32.2</td>
<td>24.9</td>
</tr>
<tr>
<td>Speed and agility</td>
<td>15.0</td>
<td>22.1</td>
</tr>
<tr>
<td>Low costs</td>
<td>3.3</td>
<td>6.2</td>
</tr>
<tr>
<td>Ability to provide attentive support</td>
<td>12.4</td>
<td>16.7</td>
</tr>
<tr>
<td>Ability to provide products and services closely matched to local needs</td>
<td>9.9</td>
<td>5.3</td>
</tr>
<tr>
<td>Ability to flexibly meet consumer needs</td>
<td>6.8</td>
<td>7.0</td>
</tr>
<tr>
<td>Good communication as employees all know one another</td>
<td>4.1</td>
<td>3.8</td>
</tr>
<tr>
<td>Ability to hold multiple posts and exercise greater individual discretion</td>
<td>4.1</td>
<td>4.3</td>
</tr>
<tr>
<td>Ability to give younger employees more responsibility</td>
<td>6.3</td>
<td>2.8</td>
</tr>
<tr>
<td>Ease of obtaining information more directly</td>
<td>2.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Warm family-like atmosphere</td>
<td>3.1</td>
<td>5.0</td>
</tr>
<tr>
<td>Other</td>
<td>0.2</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Source: MRI, Questionnaire Survey of Enterprises Supporting Industries and Communication (November 2010), commissioned by SME Agency

Note: The results were calculated by scoring in order of ranking: 3 points for first, 2 points for second and 1 point for third
The fundamental growth target for the SME sector as the nation aspires to be one of the leading 10 economies in the world by FY20

### 1. Economic Contribution

<table>
<thead>
<tr>
<th>FY11</th>
<th>Varhad Capital Vision-FY20</th>
</tr>
</thead>
<tbody>
<tr>
<td>The overall economic activities of small and medium enterprises (SMEs) in India have been estimated to amount to less than 13% of the country’s Gross Domestic Product (GDP)</td>
<td>Contribution of SMEs to GDP is projected to rise to 25% by FY20</td>
</tr>
</tbody>
</table>

### 2. Enterprise Creation

<table>
<thead>
<tr>
<th>FY11</th>
<th>Varhad Capital Vision-FY20</th>
</tr>
</thead>
<tbody>
<tr>
<td>In most parts of the world, micro, small and medium enterprises currently represent about 87% of enterprises in the country</td>
<td>India’s SMEs should contribute to 90% of the total enterprises in the country contributing nearly 40% to the total industrial production.</td>
</tr>
</tbody>
</table>

### 3. Employment Generation

<table>
<thead>
<tr>
<th>FY11</th>
<th>Varhad Capital Vision-FY20</th>
</tr>
</thead>
<tbody>
<tr>
<td>India’s official unemployment rate was 3.8% for the last year and higher for urban than rural areas. The SME sector has emerged as the second largest employment creator employing 73m workers thus help in reducing unemployment and increase in per capita income.</td>
<td>Employment generated by the Indian SMEs to reach around 140m by 2020 with per employee productivity at INR250,000 (~ USD 4,700).</td>
</tr>
</tbody>
</table>

### 4. Export Earnings

<table>
<thead>
<tr>
<th>FY11</th>
<th>Varhad Capital Vision-FY20</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSME exports accounts for nearly 25% of the total production growing at 16% CAGR over the last decade.</td>
<td>SME exports expected to reach nearly 55% of the total exports at CAGR 25% over 2014-20.</td>
</tr>
</tbody>
</table>
Accelerating SME capitalism

Indian MSMEs, armed with an additional Public Procurement Policy demand of INR17tn over FY14-20, will require huge funding for their greenfield and brownfield expansions. This, however, opens up a vast prospect for the investor community in terms of fixed asset investments of INR10tn and working capital investments of INR3tn by FY20.

Currently, the public sector banks are preferred for MSME funding while term and working capital loans are the most popular way of seeking funding. However, given the strong growth envisaged for MSMEs due to PPP implementation, the scope for PE investment as growth capital would also increase. This will likely trigger higher listings on SME exchanges. We also expect the development of a strong corporate debt market for MSMEs.

Steps for a successful SME Procurement Policy

Collusion and corruption are two distinct challenges within the public procurement. The anti-competitive issues arising due to corruption would also pose serious questions on grass root benefits of the PPP.

Transparency in tendering and providing financial and fiscal benefits to MSMEs should help them tap these benefits.

<table>
<thead>
<tr>
<th>Policy</th>
<th>Goal</th>
<th>Potential effects (advantages &amp; disadvantages)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical assistance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ Goal setting and advocacy</td>
<td>Increasing awareness</td>
<td>Advantages ▪ Less interventionist</td>
</tr>
<tr>
<td>▪ Advice and marketing assistance</td>
<td>Promoting SMEs</td>
<td>▪ Rewards SME efficiency</td>
</tr>
<tr>
<td>▪ Cooperatives</td>
<td>▪ Supporting SMEs</td>
<td>▪ Optional feature</td>
</tr>
<tr>
<td>▪ Community participation – donor-financed procurement</td>
<td></td>
<td>▪ Interest group capture</td>
</tr>
<tr>
<td>Training</td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ Human capital development</td>
<td>Advantages ▪ Relatively cheap</td>
<td></td>
</tr>
<tr>
<td>▪ SME managers</td>
<td>▪ Develops skills</td>
<td></td>
</tr>
<tr>
<td>▪ Government administrators</td>
<td>▪ Costly to government</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ Problematic goals</td>
<td>▪ Conflicting public policies</td>
</tr>
<tr>
<td></td>
<td>▪ Information problems</td>
<td>▪ One size fits all</td>
</tr>
<tr>
<td></td>
<td>▪ May not be enough</td>
<td>▪ Administrative costs</td>
</tr>
<tr>
<td></td>
<td>▪ Need for local focus</td>
<td>▪ Potential for abuse</td>
</tr>
<tr>
<td></td>
<td>▪ Potential for abuse</td>
<td>▪ Need for local focus</td>
</tr>
</tbody>
</table>
# MSME: The opportunity knocks

## The Varhad Group

### Policy | Goal | Potential effects (advantages & disadvantages)
--- | --- | ---
**Financial assistance and subsidies**
- Financing
- Bond/guarantee
- Reform/assistance
- Prompt payment reform

- Increase level of SME participation in public and private markets

**Advantages**
- Sustains demand on SMEs
- Similar to set-sides
- De-links some political interplay
- Second-best trade policy

**Disadvantages**
- Costs and inefficiency
- Implicit political market
- Hard to dismantle

**Price preferences**

- Targeted assistance in procurements

**Advantages**
- Direct SME assistance
- Awards to SMEs

**Disadvantages**
- Very likely inefficient
- May reward inefficient SMEs
- Implicit political market
- Poor incentives
- Hard to dismantle

Source: World Trade Organization, Varhad Research