MSME Knowledge Series 2012

Credit Gap Mapping of Select Clusters

Leather Clusters: Chennai and Kolkata

giz Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH

COOPERATION REPUBLIC OF INDIA FEDERAL REPUBLIC OF GERMANY

SIDBI
भारतीय लघु उद्योग विकास बैंक
SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA

Published by:

MSME Financing and Development Component of MSME Umbrella Programme
Implemented jointly by GIZ and Project Management Division – SIDBI

Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

MSME Umbrella Programme
B-5/1, Safdarjung Enclave, New Delhi 110 029, India
Tel: +91 11 4949 5353
Fax: +91 11 4949 5391
Email: amit.kumar@giz.de, singhrk@sidbi.in

Knowledge Partner: Dun & Bradstreet Information Services India Pvt. Ltd.

Responsible:
Amit Kumar

New Delhi, March 2012

Credit Gap Mapping of Select Clusters

Leather Clusters: Chennai and Kolkata

Foreword

The Micro Small and Medium Enterprise (MSME) segment plays a significant role in the Indian and global economy. The domain comprising around 30 million units contributes significantly to national GDP (8%), creates employment of about 70 million, 40% of exports and provides bouquet of more than 6000 products. Nevertheless, MSMEs continue to face various gaps in their ecosystem like access to credit, market access, skill development, technology up-gradation, etc. To address the critical issue of adequate, affordable and timely credit for MSMEs, it is very important to arrive at credit requirement and credit gaps in the MSME sector, more so in the MSME clusters.

Small Industries Development Bank of India (SIDBI), being the principal institution for the promotion, finance and development of the MSME sector and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, an international institution with thrust on Sustainable Economic Development, Energy and MSMEs, have successfully completed the project on estimating the credit gap in select clusters (where SIDBI has been, for past few years undertaking cluster development programme). More importantly, it suggests ways and means in facilitating greater access of credit to MSMEs in these 10 clusters. The objectives of this study are to measure gap in credit supply and demand with respect to selected 10 MSME clusters and develop alternate innovative models or credit delivery channels.

Apart from providing innovative credit delivery channels for these clusters, a number of innovative products based on cluster requirement and sources of credit demand are recommended by the study to ensure strengthening the supply side. These included Financing of Raw Material Procurement, Factoring (or reverse factoring), Pre-approved Collateral-free Equipment Finance Scheme, Up-scaling of Microfinance to cater to Micro Enterprises, Purchase Order Financing, Receivables-linked Bridge Financing for Working Capital Needs, Quality Testing and Registration-linked Financing scheme, Lease Financing, Joint Liability Group (JLG) for MSE lending, etc. Some of these credit delivery models are tried and tested and display scalable potential with regard to their replication.

The outcome of the study has been brought out as an enriched book on "Credit Gap Mapping of Select Clusters". We hope that the banking fraternity, policy makers and other MSME stakeholders would find it useful to attend to the national priorities of increase in income, employment and global competitiveness.

[S. Muhnot]

Chairman and Managing Director,
Small Industries Development Bank of India

Preface

The micro, small and medium enterprises (MSME) sector employs nearly 60 million workers in India, which is next only to the agriculture sector. MSMEs also account for nearly half of India's manufacturing output, especially the export oriented output. Undoubtedly, MSMEs play a critical role in furthering the country's agenda on inclusive growth. However, evidences show that MSMEs in India face various challenges, the most crucial of them being the access to key financial and non-financial services. Moreover, neither the current business climate nor the environment for services encourages the growth of MSMEs.

The MSME Umbrella Programme, being jointly implemented by SIDBI and GIZ, aims at improving the MSME access to demand oriented financial and non-financial services and thereby enhancing their growth and competitiveness. The programme has taken several initiatives to address the issues of access to finance for the 'missing middle'. One such initiative is the study on the measurement of Gap in Credit Supply & Demand in select MSME clusters in India. The results of the study are being published in this book. The study has taken a very comprehensive approach. It not only measures the credit gap based on the demand and supply, it also presents a systematic analysis of the probable reasons causing the gap. And it elucidates the alternative credit delivery channels and innovative loan products suitable to individual cluster requirements.

We hope that this study would be useful for policy makers, financial institutions and other stakeholders for facilitating enhanced and improved financial services to the MSME sector.

[Manfred Haebig]

Private Sector Development, GIZ India

Programme and Partners

MSME Umbrella Programme

The objective of the Umbrella Programme for Promoting Micro, Small and Medium Enterprises (MSMEs) is to improve the business climate and scope of services that benefit MSMEs. This objective is to be reached through measures in areas of financial and non-financial services. It consists of two components – Component 1 focuses on **MSME Financing & Development** and component 2 aims at MSME Support Policies and Programmes.

The **MSME Financing and Development component** is being jointly implemented by Deutsche Gesellschaft für Internatioanle Zusammenarbeit (GIZ) GmbH in co-operation with the Small Industries Development Bank of India (SIDBI). This component aims to further strengthen the success achieved under multi donor MSME Financing and Development Project (MSME-FDP) wherein the World Bank, Department for International Development (DFID), UK and KfW, Germany were other international partners besides GIZ (then GTZ). MSME FDP has been creating an enabling and sustainable environment for the growth and development of competitive MSME sector in India. The progress of the Project had been quite noticeable as it has so far reached out to 1 lakh beneficiaries comprising MSMEs, Bankers, and other stakeholders. The interventions (with thrust on market competitiveness, skill, technology, energy efficiency, environment etc.) were designed to foster competitiveness and sustainability among MSMEs. Current MSME Financing and Development component of MSME Umbrella Programme aims at facilitating improved access to demand-oriented and innovative financial and non financial services and fostering an enabling policy environment for MSMEs. With respect to non-financial services, the Financing and Development component focuses on promoting strategies and implementation of market based generic, embedded and public business development services (BDS) to value chain/ MSME clusters in identified sectors. In regard to financial services, the Financing and Development component offers training and advisory services to participating banks/ institutions/MFIs aimed at increasing credit and other financial services to regional clusters/value chains of MSMEs.

Small Industries Development Bank of India (SIDBI): SIDBI is the principal Financial Institution for the promotion, financing and development of Micro, Small & Medium Enterprises (MSMEs) in India. SIDBI reaches out to the entire value chain (Micro Finance to Missing Middle to MSMEs) by extending Promotional (SETUP) and Development (STEP UP) support. It addresses the gaps in MSME eco system by offering bouquet of financial support to MSMEs covering (a) Refinance to entire gamut of financial support institutions including banks, State entities, Micro Finance Institutions (MFIs) etc., for onward lending to MSMEs (b) Direct assistance in niche areas.

SIDBI is committed to contribute to the expectations on national goals as also Millennium Development Goals (MDGs). It continues to customise its product offerings as also processes so as

to sustainably contribute to emergence of globally compliant competitive Indian MSMEs. SIDBI has devised a number of schemes catering to the financial and non-financial needs of MSMEs. It has been a pioneer in institutional solutions by setting up associates/ subsidiaries in Venture Capital, Credit Guarantee for collateral free loans, credit rating, and technology bank and asset reconstruction. Its international partnership has enabled it to assimilate best practices and adopt it for Indian MSMEs.

Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH: The services delivered by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH draw on a wealth of regional and technical expertise and tried and tested management know-how. As a federal enterprise, we support the German Government in achieving its objectives in the field of international cooperation for sustainable development. We are also engaged in international education work around the globe. GIZ currently operates in more than 130 countries worldwide.

GIZ in India

Germany has been cooperating with India by providing expertise through GIZ for more than 50 years. To address India's priority of sustainable and inclusive growth, GIZ's joint efforts with the partners in India currently focus on the following areas:

- Energy- renewable energy and energy efficiency
- Sustainable Urban and Industrial Development
- Natural Resource Management
- Private Sector Development
- Social Protection
- Financial Systems Development

Table of Contents

Study Background and Objectives

GIZ (*or "the client"*), under Micro, Small & Medium Enterprises Financing and Development Project (*"MSME-FDP" or "the project"*), desired to undertake a study on Gap in Credit Supply & Demand, and Development of Alternate Modes of Credit Delivery in select MSMEs Clusters' (*"the study"*). Dun and Bradstreet Information Services India Pvt. Ltd. (*"D&B India"*) undertook the aforementioned study.

The World Bank's parent project, the 'Multi-Donor & Multi-Activity' Micro Small and Medium Enterprises Financing and Development Project (*MSME-FDP*) for MSME financing and development became effective on April 4, 2005. SIDBI is the implementing agency for the project supported by international partners - The World Bank, DFID, KfW, and GIZ. The Department of Financial Services, Ministry of Finance, Government of India is the nodal agency for the project. The objective of the project has been to improve MSME access to finance and business development services, thereby fostering MSME growth, competitiveness and employment.

As a part of MSME umbrella programme, GIZ and SIDBI aim to provide improved access to financial and non-financial services that are innovative and tailored to suit market needs under the component MSME Financing and Development. In order to improve financial and non-financial services to MSMEs, it is important to understand the current schemes implemented by Banks, and FIs for MSME financing, the finance support structure in the cluster and evaluate the finance need gap. Basis this need gap, the study developed directional inputs to eliminate such gap by proposing alternate financing products and delivery mechanisms for the same. The study aims to facilitate enhanced and improved services to the MSME sector.

Objectives of the Study

- To develop a suitable methodology framework for estimating Credit Gap in any industry cluster across India
- To map the credit demand and supply status, measure the credit gap and reasons for the current status in the select identified clusters (*10 clusters in 6 subsectors*)
- To suggest tailor made specific financial products, alternate delivery models and institutional mechanism for implementation in the clusters

D&B India identified 10 MSME clusters, in consultation with GIZ, where SIDBI is active under MSME-FDP, basis discussion with GIZ and selection parameters such as size (*turnover, employment, etc.*) and geographical spread.

The current report provides a summary of project findings, a detailed account of the methodology employed for measuring credit gap and the assessment in Chennai and Kolkata Leather MSME clusters.

Executive Summary

Indian MSMEs are a diverse and heterogeneous group but broadly face a common set of problems. Longer asset conversion cycles, limited market access, and the relative absence of modern technology and quality control, to name a few, are problems plaguing the sector. Access to finance is often limited due to issues such as the inability to furnish adequate collateral for institutional credit and high interest required to be paid on credit from non-institutional sources. Besides, a majority of MSMEs also self-exclude themselves from the formal financial system as they are unaware of their eligibility for credit from banks. According to the Fourth All India Census of MSMEs (2006-07), mere 11.2% registered enterprises in India have access to loans from formal financial institutions.

Micro and Small Enterprises Face Greater Financial Exclusion

The size of enterprises and the scale of their operations is often also a gauge of the extent of financial exclusion faced by them. Small and, more specifically, micro enterprises (MSEs) typically suffer from greater barriers to institutional credit access, relative to medium enterprises. The credit appraisal processes adopted by lending institutions typically lead to the exclusion of MSEs.

Lending institutions have internal rating models for assessment of project proposals. The risk involved in a project is assessed based on various parameters such as project details (project concept, location, sector type, project strength through DSCR, project IRR, payback period etc.), borrower background, fixed asset information, cash conversion cycle, previous relationship of the bank with borrower, and details of existing and proposed credit facilities.

Due to less favorable conditions existing at MSEs, loan approval either takes longer or gets altogether rejected. Security in the form of collateral, guarantees and fixed assets, are not always available. The cash conversion cycle is generally unfavorable leading to unstable cash flows. This is also compounded by absence of credit ratings, basic financial information and a coherent business plan. Awareness of banking processes and modern technical knowledge is also often found to be lacking.

The current report, therefore, concentrates on the credit gap faced by the Micro and Small enterprises, which has often been described as the 'missing middle' on evaluating the status of their access to finance. The financial requirements of MSEs are often considered too large for microfinance institutions to fulfill. At the same time, they cannot be effectively served by applying lending models that pertain to large corporations.

Definition of Credit Gap

Credit gap can be defined as unmet credit requirement of MSEs, over and above the available access to credit from formal institutional sources of finance. The same measures are used by international institutions like IMF and the World Bank.

Non-users of formal financial services amongst MSEs are either involuntarily excluded or voluntarily exclude themselves from the institutional loan market. Involuntary exclusion, as explained above, is due to ineligibility based on loan approval criteria. Amongst MSEs who self-exclude themselves, are those who:

- Currently use informal sources of credit
- Lack awareness of their eligibility for loan from formal sources
- Have no need

The first two categories of MSEs do have a need for credit, which is not being catered to by institutional sources. Hence, the credit requirement of such MSEs would form part of the credit gap.

MSME Clusters under Study and Nature of Data Collection

The credit gap was estimated for 10 MSME clusters, identified by D&B India in consultation with GIZ and SIDBI. The 10 clusters represent all four regions and six sub-industries.

A quantitative questionnaire survey was conducted across the 10 identified clusters. At least 50 MSME respondents (*enterprises*) were identified for each cluster and well distributed across micro, small, and medium enterprises. The questions in the questionnaire included queries on financial information (*such as assets, turnover, profit etc.*), nature of credit requirement, and perception/experience with the banking system.

Industry	Clusters
Engineering	Faridabad, Coimbatore, Rajkot and Rourkela
Leather	Kolkata and Chennai
Fruits & Vegetables Processing	Pune
Textile and Garments (Knitwear)	Ludhiana
Dyes and Chemicals	Ahmedabad
Pharmaceuticals	Hyderabad

The quantitative survey was coupled with qualitative interactions with stakeholders in each of the clusters. This included discussions with District Lead Banks, Industry Associations, District Industries Centers (DICs), SIDBI officials, large enterprises, as well as MSMEs. The objective of the

qualitative interactions was to obtain an understanding of status of institutional credit supply to MSMEs, sources of credit demand, specific credit-related challenges faced by enterprises and to collate ideas on innovative loan products and credit delivery mechanisms.

Credit Demand Estimation

The demand for credit arising from both working capital requirements as well as long-term investment requirements has been estimated. The estimation method for working capital credit requirement broadly follows the method outlined in the Nayak Committee Report (1991). Of the broad contours set for the committee, one of the key requirements was to examine the adequacy of institutional credit for the MSE sector (now MSE sector).

In the process of examining the adequacy of institutional credit, the committee, outlined methods for developing credible demand estimates for credit. While the committee stressed on strong quantitative methods for working capital credit estimation, term credit estimation was fairly qualitative in nature. For estimating working capital requirements, the committee suggested the use of the 'Forecasted Sales Approach'. 25% of the forecasted sales for the enterprises could be considered as requirement for working capital. It was recommended that working capital bank credit could be as much as 80% of the estimated working capital requirements.

Working capital credit demand for the MSME clusters under the current study has been estimated by applying the Nayak Committee method to the cluster turnover estimated on the basis of the cluster survey.

Term Credit requirements have been estimated by applying fixed asset growth forecasts to current 'Investments in Plant and Machinery', which in turn has been estimated on the basis of the cluster survey.

D&B India also studied the report prepared by the National Commission for Enterprises in the Unorganized Sector (NCEUS) under the chairmanship of Dr. Arjun K Sengupta. Under this method, the average credit needs of the unorganized units were obtained from a survey. Average credit need was then multiplied by the total number of estimated unorganized units to obtain the Total Credit Demand.

While the commission's method was most effective for estimating credit requirements of unorganized enterprises (mostly micro proprietary units), extrapolated estimates of credit requirements are prone to outliers in the sample surveyed. Existence of detailed diagnostic studies on the clusters and a detailed survey among a limited but representative sample enabled D&B India to rely on the 'Forecasted Turnover Approach' for estimating WC requirements and its own method (explained above) for estimating Term Loan requirements, separately.

Credit Supply Estimation

Scheduled Commercial Banks (SCBs) account for the bulk of the institutional lending to MSMEs, with Non-Banking Financial Corporation's (NBFCs), Cooperative Banks, State Financial Corporation's (SFCs) and other Financial Institutions playing a minor role as well. The estimation of credit supply to the MSME clusters under the current study considers lending by the SCBs. Lending by large and dominant Cooperative Banks, SFCs and SIDBI has been added to the total credit supply to clusters where available and where their contribution to the cluster is significant.

The proportion of cluster turnover to state turnover in the same industry is first computed. Thereafter, the ratio is applied to the outstanding lending by SCBs in the state to that particular industry, to arrive at the credit supply estimate to a specific MSME Cluster.

D&B India also contacted various Lead Banks for the identified district clusters under the current study and obtained aggregated (*of financial institutions*) credit supply data at district level. The estimates for Credit Supply Outstanding for each cluster computed by D&B India were matched with Lead Bank data on Outstanding Total Advances, Priority Sector Advances and MSE Advances, in order to ensure consistency.

Sources of Credit Demand in the 10 MSME Clusters under Study

Nature of Raw Material Procurement and the Asset Conversion Cycle

Procurement of raw materials takes place in bulk and typically during certain times of the year. Raw-material suppliers, in most cases, need to be paid on the spot. Considering the fact that many primary commodities are prone to market fluctuations, maintaining competitiveness in terms of end-product prices demands that MSEs buy their raw material supplies at reasonable prices, whenever available.

While the raw-material suppliers hardly provide any credit and sell in bulk, realization from sale of end-products in most MSME industries takes place over a longer period. In some cases, the seasonal nature of end-product demand requires that raw-materials are procured and stored for a significant period before they are further processed.

The need for raw-material procurement in large quantities at discrete intervals and the longer asset conversion cycles gives rise to a significant need for working capital among MSEs.

Examples include the:

- Fruit and vegetable procurement at mandis / market yards in the Pune Food Processing cluster
- Knitting and garmenting units in Ludhiana, which are dependent on suppliers of yarn, chemical, accessories and packing materials, fabricating units and distribution networks

- Tanneries in Kolkata and Chennai Leather clusters that have to procure the raw hides and skins from traders / local suppliers who source the skins from across the country
- Procurement of commodities such as pig iron, coke, copper, aluminum, etc. by MSMEs at uncertain prices in engineering clusters from retailers, unlike larger firms who buy in bulk directly from raw material manufacturers at pre-determined prices

Subcontracting Arrangements

Contract manufacturing is common in many industrial clusters, especially in the Engineering clusters.

- Micro and small units (many of which are foundries) in the Rajkot Engineering cluster produce sub-assemblies for more organized manufacturers of automobile parts, diesel engine, pump-sets and machine tools in the cluster. Usually, the manufacturers or middlemen purchase their goods directly from their doorsteps
- Large scale industries like Hero Motor Company, New Holland, JCB, Escorts etc. in the Faridabad Light Engineering cluster rely on MSMEs for contract manufacturing. Further, many medium and small auto-ancillary units in the cluster rely on micro-units for activities such as electro-plating
- Micro enterprises in the Coimbatore Engineering Cluster (mainly foundries), act as sub-contractors to small and medium enterprises in the business of manufacturing pumps, motor and automobile components

Credit cycles of greater than 30 days and the absence of discipline among large buyers in meeting payment deadlines typically lead to working capital shortages among MSMEs.

Manpower-related Expenses

Most MSME clusters across the country employ technologies that are manpower intensive and are plagued by productivity issues and labor issues. Therefore, the requirements of the working capital to make continuous labor payments increase.

Specialized skills required in many MSME clusters are procured at high prices and lead to working capital requirements. This includes payment for services rendered by external GMP consultants in the Hyderabad Pharmaceutical cluster, CNC programmers in engineering clusters and quality consultants in the Pune Food Processing cluster.

Technology Up gradation and Compliance with Quality and Environmental Norms

The need for technology up gradation has led to an increase in Term Credit requirements in many MSME clusters. The trend is being driven by the following factors:

- The need for improving productivity and reducing reliance on labor-intensive technologies

- Aspiration to access global markets requires greater competitiveness. Besides, adherence to global quality, safety and environmental standards, has become a pre-requisite for exporting to many developed countries of the world
- The need to reduce costs of maintaining aging machinery that are faced with frequent breakdowns

Medium enterprises in the Pune Fruits and Vegetables cluster are exploring newer business models for technology up-gradation and newer products. Like the pharmaceutical industry in other parts of the world, Indian pharmaceutical units also intend to increase investments in ensuring Good Manufacturing Practices (GMP) is followed. This would require investments in setting up Effluent Treatment Plants (ETP) that typically require large upfront investments. ETPs also need to be installed in the Dyes and Chemicals cluster in Ahmedabad, if enterprises intend to tap funds from institutional sources in the future.

Other Sources of Demand for Credit

The need for credit can also arise from factors such as unregistered units looking to get registered and rated, MSME units trying to meet tax payment deadlines, availing services of a Common Facility Center (such as a Tool Room), availing skill training from a Business Development Services (BDS) provider, export marketing and associated documentation, etc.

Exhibit 1: Credit Gap Estimates for 10 MSEs Clusters

Cluster	MSE Credit Gap: Nayak Committee Method - In ₹ Crore	MSE Turnover (Year 2010-11) - In ₹ Crore
Pune	98	846
Coimbatore	1,231	4,739
Rajkot	1,248	9,157
Faridabad	1,989	10,240
Rourkela	42	316
Ahmedabad	441	2,730
Kolkata	121	2,876
Ludhiana	1,235	11,905
Chennai	275	3,060
Hyderabad	105	1,378

Source : D&B India Estimates

Recommended Products and Delivery Mechanisms

Financing of Raw Material Procurement

A scheme for financing raw material procurement by banks and financial institutions is recommended for almost all clusters, where raw materials need to be purchased in bulk during certain months of the year and where bulk purchase enables MSEs to benefits from discounted prices. The scheme and its variants would be applicable to the following clusters:

Cluster	Potential Implementation Agency
Pune Fruits and Vegetables	Agriculture Produce Market Committee
Ludhiana Knitwear	Knitwear Club / KAMAL / LAKMA
Rourkela Engineering	Orissa State Industrial Corporation (OSIC)
Kolkata Leather	Indian Leather Products Association (ILPA) / Central Leather Research Institute
Chennai Leather	

The salient features of the proposed raw-material purchase financing scheme are as follows:

- A group of banks catering to the cluster can form a consortium and enter into a common Memorandum of Understanding (MoU) with an implementation agency for the scheme in the cluster
- The implementation agency has to be an existing integral stakeholder in the raw material procurement process or an agency implementing a cluster-specific government scheme
- A forecast of annual production of the MSE units and their corresponding annual raw material requirements needs to be prepared. This can be prepared on the basis of inputs from individual MSEs, industry associations (say, Mahratta Chambers of Commerce and Industry – MCCIA in Pune), large sub-contracting industrial buyers (say, Khadims / Sreeleathers in Kolkata), as well as cluster sector-specific research institutions (say, Central Leather Research Institute – CLRI in Chennai)
- The implementation agency would procure the raw material with the MoU banks / FIs financing the purchase. The raw material procured would serve as collateral with the implementation agency serving as the facilitator / guarantor. The industry association could charge a nominal fee for providing this service
- The implementation agency, effectively, becomes the primary raw material supplier. The discount obtained by acquiring the raw material in bulk may be passed on to the MSEs after deducting a fee towards costs of provision of the service by the implementation agency. The

interest charged by the bank for financing the purchase will be the predominant cost of service. For the raw material financing scheme to be economically viable, the costs of service must be less than or equal to the difference in procurement price and sale price to MSEs

Factoring

Factoring (or reverse factoring) has been recommended in all clusters, where strong inter-linkages and sub-contracting of manufacturing activities exist. Open account sales are the preferred arrangement between larger buyers and smaller sellers in the Rajkot and Coimbatore Engineering Clusters, the Hyderabad Pharmaceutical Cluster and the Kolkata Leather Cluster. Banks should embrace products that enable them to extend working capital finance on an ongoing basis against invoices raised by their clients on their buyers.

Factoring is a method, in which the 'factor' (bank / FI offering the service) obtains control over the sales ledger of the client. In effect, the entire receivables management is taken over by the factor and disclosed to the client's customer (buyer). The offerings of a 'Factor' are far more than just the discounting of individual bills by a bank.

As opposed to Cash Credit, under 'Factoring', there is scope for flexibility as to quantum of potential funding. The credit line is based on the financial strength of the borrowing client's debtors, as well as on the borrower's own financial strength. In many industries, it is observed that the sales do not occur on a uniform basis, but fluctuate from month to month. Hence the predominant system of receivable financing through 'Cash Credit' is found to be inappropriate, leading to intermittent over-financing or under-financing. Factoring is more appropriate for MSMEs with potential for rapidly expanding sales and units with unpredictable cash flows and a high proportion of receivables in their working capital cycle.

In cases, where banks are hesitant towards extending Factoring products to cluster units (as the case may be for Kolkata Leather and Hyderabad Pharmaceutical clusters), 'Reverse Factoring' can be looked at as an alternative mechanism, where banks purchase accounts receivables only from high-quality buyers. The bank only needs to collect credit information and calculate the credit risk for buyer (in this case a large transparent, internationally accredited firm). In Reverse Factoring, the credit risk is equal to the default risk of the high-quality customer, and not the risky MSME.

Factoring ensures the following benefits for MSEs:

- Improved cash flows
- Fixed assets freed up for collateralization for other credit requirements
- Benefit of sales ledger management
- Increased ability to extend open account terms to clients
- Improved receivable days and current ratio

The use of 'Factoring' can be further encouraged if Non-Recourse Factoring is introduced. This would enable the complete elimination of default risk.

Pre-approved Collateral-free Equipment Finance Scheme

MSMEs are often faced with situations when certain equipments need to be acquired urgently, either because the supplier is offering a discount or because the acquisition is required to comply with a norm. Moreover, these enterprises need to acquire a number of small-value equipment that aggregate to significant value through the year. Applying for loans to make these purchases is considered tedious and time-consuming with no certainty of sanction and disbursement. Hence, either unsecured loans are sourced at high interest or working capital credit is employed for the purpose of acquisition of such equipment.

In order to overcome this challenge, under the MSME-FDP, SIDBI along with FSIA (a dominant industry association in the Faridabad Auto Components and Engineering cluster) designed a special scheme. Under the scheme, a collateral-free line of credit upto ₹ 50 lakh is sanctioned to enterprises, which can avail this facility any time during the year, either in full or in parts, for purchasing equipment. Disbursals are typically made within three days on a pre-approved loan. The association is responsible for processing of application, doing appraisals, recommending limits as per prescribed norms and providing it to SIDBI, as well as verifying the pro-forma invoice, ensuring margin payment, asset value, etc.

Similarly, SIDBI currently has a credit delivery arrangement with the Gujarat State Plastic Manufacturers Association (GSPMA) for meeting the capital expenditure requirements of the member MSME plastic manufacturing units.

Enterprises in the Rajkot and Coimbatore Engineering clusters have significant credit needs arising from a need to upgrade technology. Similarly, enterprises in the Hyderabad Pharmaceutical cluster are under pressure to implement technology-intensive Good Manufacturing Practices (GMP), while units in the Ahmedabad Dyes and Chemicals cluster are expected to invest heavily to comply with state pollution control norms, both of which will involve acquisition of Effluent Treatment equipment.

It is recommended that banks and financial institutions, which are currently catering to the four clusters, can approach the major industry associations to proceed with a MoU that will enable a FSIA-SIDBI type of arrangement.

Up-scaling of Microfinance to Meet Credit Requirements of Micro Enterprises

A number of unorganized micro enterprises in the Coimbatore, Rourkela and Kolkata clusters that carry out sub-contracted work for larger enterprises face a high degree of financial exclusion. Most of these units do not even approach the banks for their requirements with the apprehension of

excessive documentation, site-audits and inspections etc. Many do not have any tangible assets, which could act as collaterals nor any formal work order. Hence banks refuse credit to the cluster.

Given this scenario, up-scaling of micro finance programs in these clusters would prove to a potent method to handle this issue. Microfinance has made significant inroads into Tamil Nadu, Orissa and West Bengal. The total number of microfinance clients in these states (Credit Self Help Group (SHG) members and MFI Client put together) stood at roughly 1.12 crore, 62 lakh and 1.09 crore, respectively in 2011. The various microfinance models have been tried, tested and have met with success, creating an overall conducive environment for microfinance in these states. Microfinance loans in Tamil Nadu, Orissa and West Bengal aggregated to over ₹ 13,000 crore, in 2011, with average loans outstanding per poor household standing at ₹ 22,109, ₹ 7,582 (2010 figure) and ₹ 9,365 respectively.

MFIs that upscale typically target the lower end of the MSME spectrum that have more features in common with their existing microfinance clients, as reflected by the average loan size of micro firms. For micro firms operating on the verge of informality, up-scaling of micro-finance seems to have great potential. MFI active in and around the three clusters can modify their microfinance business models to incorporate MSME operations by taking advantage of their market knowledge and network, and by adapting their microfinance methodologies. The benefits of up-scaling may encourage a transition from an informal to a formal enterprise.

Refinancing (or on-lending) and other support from development finance institutions, such as SIDBI, would be critical for helping MFIs adapt their current lending practices to serve the new clientele, as well as in building the MFIs' capacity in staff training and information management.

Further, a few issues need to be addressed before up-scaling of MFI can become a sustainable model:

- New Product Development
- Collection Cycle
- Recovery Mechanism
- Capacity Building for MFIs and Borrowers

Typically, MFIs have daily/weekly collection cycle, which calls for modification while serving micro and small manufacturing units. MFIs need to understand the borrower's business and particularly "Asset Conversion Cycle" and revise its credit collection cycle to suit the needs of borrowers and simultaneously ensure profitability of the lending business model. Suitable loan products and associated attributes (interest rate, tenure, and credit amount) need to be developed keeping in mind the nature of borrowers business. This shall be particularly important because the product and its attributes shall govern the efficacy of collections affecting top-line growth. Further, training would be

needed both for MFIs and borrowing micro units on the business cycle, lending model, and practices adopted to ensure smooth implementation.

Historically, the MFI lending model had been successful despite the high borrowing rate of MFI from Banks. Companies in this space had built a sound base of foot-workers, creating an effective credit delivery and recovery mechanism and with the help of SHG/JLG model, they could cut down on transaction costs. This was a unique differentiator for MFIs compared to banks that did not have such effective mechanisms for credit delivery and reducing transaction costs. However, MFIs charged very high interest rate and allegedly followed coercive credit collection practices to make the lending model economically sustainable and these cast serious doubts on socially driven objective of MFIs. This has led to widespread criticism from different corners and threatened the very existence of MFIs. What followed was Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010 to regulate MFIs in the state and RBI Committee (Malegam Committee) Report on MFI sector detailing issues, concerns, and recommendations on the prevailing ill-effects of the MFI lending and recovery practices. The committee also reviewed the proposed Micro Finance (Development and Regulation) Bill 2010 and recommended few changes to it along with its own set of recommendations on MFI regulation.

Though, the recent MFI regulation in AP, and the more recent draft bill on MFIDR have put the MFI lending model under a scanner, the potential for such model to work effectively does exist.

Up-scaling MFI Lending – A Success Story under MSME-FDP

Under the GIZ portion of MSME-FDP, an innovative financial product and delivery model for the upstream apparel supply chain had been worked out in association with a Delhi-based MFI named Satin Creditcare Network Ltd (SCNL). SIDBI had sanctioned a line of credit to SCNL for onward lending to the MSEs in the apparel supply chain. Capacity building support involved:

A. Assistance to design and develop a special credit scheme with the following features:

1. Loan ticket size in the range of ₹ 50000/- to ₹ 2,00,000/-;
2. Loan to be available for investment in machinery or for work capital needs;
3. Repayment period up-to 2 years;
4. Repayment in fortnightly/monthly installments instead of daily installments depending on cash flow of the borrower;
5. No collateral security;

B. Assistance in HR development for appraising and risk assessment of credit to MEs

C. Interactive sessions were held with apparel supply chain MEs to understand their needs followed by sensitization workshops to motivate them to borrow from SCNL. They were given an orientation course in accounting, finance, quality improvement and marketing after working hours.

The results of pilot intervention (started in late 2008) are as under:

1. SCNL granted loans to 60 MEs. Each ME, on an average, employed 40 workers and therefore this intervention impacted the lives of around 2400 families and around 12000 people at pilot stage
2. The enterprises financed under the scheme have shown much better financial discipline and have been repaying installments in time with no default

Purchase Order Financing

Enterprises in almost all the MSME clusters under study indicated the absence of appropriate collateral as a reason for their loan applications to be rejected. In some cases, the units were already over leveraged and did not have any collateral based on which they can take fresh loans.

In such a scenario, enterprises can still borrow against the purchase orders placed by their credit worthy buyers. One of the primary requirements for this system to work from the bank's perspective is for the buyer to furnish a comfort letter to the bank detailing the seller information and credibility. This allows the seller to receive funds far sooner than if it had to wait for the buyer to pay on the invoice and even sooner than if the invoice is discounted. Purchase Order Financing (POF) allows the seller to receive funds even before the goods are shipped and the invoice is issued. The seller procures the raw materials, manufactures the goods and ships the products to the buyer. PoF allows the unit to take on multiple orders and deliver them successfully.

Typically, the seller prepares and submits an invoice directly to the bank and the buyer pays the invoice according to the payment terms, usually directly to the bank. When the bank receives payment on the invoice from the buyer, the bank withholds the amount it advanced to the seller as repayment on the POF loan, and also deducts the agreed amount of interest and fees. The balance is then remitted to the seller.

POF is indeed an effective product for easing working capital shortages where strong linkages exist between large and established buyers and a host of small and medium enterprises that carry out sub-contracted work for them.

Working Capital Term Loan

Working capital term loans (WCTL) are intended to cover the core (permanent) part of the working capital. Cash credits and overdraft facilities are generally understood to assist enterprises through transitory (fluctuating) part of working capital requirements. While larger enterprises are offered WCTLs, sometimes even carved out of their WC limits, MSMEs do not enjoy the same luxury. It is generally believed that MSMEs possess lower control over their working capital and therefore lack the expertise in managing loan funds intended for meeting working capital requirements.

Most units in the Ludhiana Knitwear cluster do business through buyer seller meets organized during certain months of the year, where traders from across India come and place orders at a pre-determined price. Based on the orders placed, the units forecast the demand of raw materials and buy the raw material from the yarn suppliers in bulk. Also, most of the units tend to buy raw material in bulk so as to get competitive prices for the same.

While the orders are booked at the buyer-seller meets, payments are only realized after the goods are finally sold in the end-market. The buyers of these products deposit only 10-20% of the total value of goods as advance payments, which leaves the unit owners to arrange for working capital for the intermediate period. Often, enterprises have to extend credit of more than 120 days to their clients, which ties up the working capital finance. The credit limit set by the banks in the cluster is often not sufficient for the units to cover their working capital expenses.

Such shortages of credit in the Ludhiana cluster could be provided through WCTL accounts. Although this arrangement is presently applicable to borrowers having working capital requirement of ₹ 10 crore or above, this service can be extended to small enterprises with needs less than ₹ 10 crore as well.

Receivables-linked Bridge Financing for Working Capital Needs

One of the major factors inhibiting Bills Discounting in the cluster is the lack of payment discipline amongst buyers. This creates a serious and endemic problem in the cluster for MSEs of inability to procure future orders. The issue of post-dated cheques (PDCs) by buyers can bring about payment discipline, especially because dishonor of cheques is a criminal offence under the Negotiable Instruments Act. However, buyers from MSMEs typically do not agree to issue of PDCs.

A possible way through which receivables bills can be made to work in favor with MSEs will be to club it with the 'bridge financing' concept, where funding can be extended with bills as collateral to enable the units to take further order and not suffer from the delayed payment from debtors (customers).

Bridge financing is used to maintain liquidity in the scenario of anticipated cash inflows. This can be seen as temporary loan that shall map the sales receivables cycle to future order procurement to facilitate continuous operation of MSEs. Under this method, banks can finance MSEs on procurement of new orders, based on the bills issued by them for executed orders. At around the same time, the bank may be repaid out a payment received by the MSE from an earlier transaction.

Small units, such as those in the Rourkela Engineering Cluster, would find this as an effective method for overcoming difficulties with the current bill-discounting schemes.

Apart from the above credit products and delivery mechanisms, a number of innovative products based on specific purposes (such as the Quality Testing and Registration-linked Financing scheme in the Pune F&V cluster) and renewed application of standard products (such as Lease Financing) to clusters where such products are generally unavailable, have been recommended in the current report. Where appropriate, new credit delivery mechanisms, such as the formation of Joint Liability Group (JLG) for MSE lending in the Coimbatore Engineering cluster has been recommended.

Financial Inclusion through BDS Initiatives under the MSME-FDP

Apart from the successes of the BMO-centric model in Faridabad Engineering cluster and the MFI-centric model among micro enterprises in the Delhi Apparel industry, there have been other successes from motivating cluster level financial institutions to lend to MSMEs under the MSME-FDP.

In Coimbatore, four interaction meets were organized with financial institutions, which were attended by nearly 200 cluster firms. As a consequence, many firms have obtained loans from TIIC and Banks and SIDBI. Coimbatore implemented the Faridabad financial model for the benefit of MSMEs. 24 cluster firms got financial support from Bank of Baroda and 3 firms got financial support from SIDBI.

Similarly in Rourkela, BDS initiatives under the MSME-FDP have helped establish linkages among SBI, SIDBI and a local Micro-finance Institution (MFI) named Sambandh Financial Services. 37 microenterprises are in the process of obtaining loans under the initiative. Further, access to finance has also been facilitated through Special Purpose Vehicles (SPVs) such as the Rourkela Techno-Park Self Help Cooperative Limited (RTPSHCL).

Credit Gap Definition under the Current Study

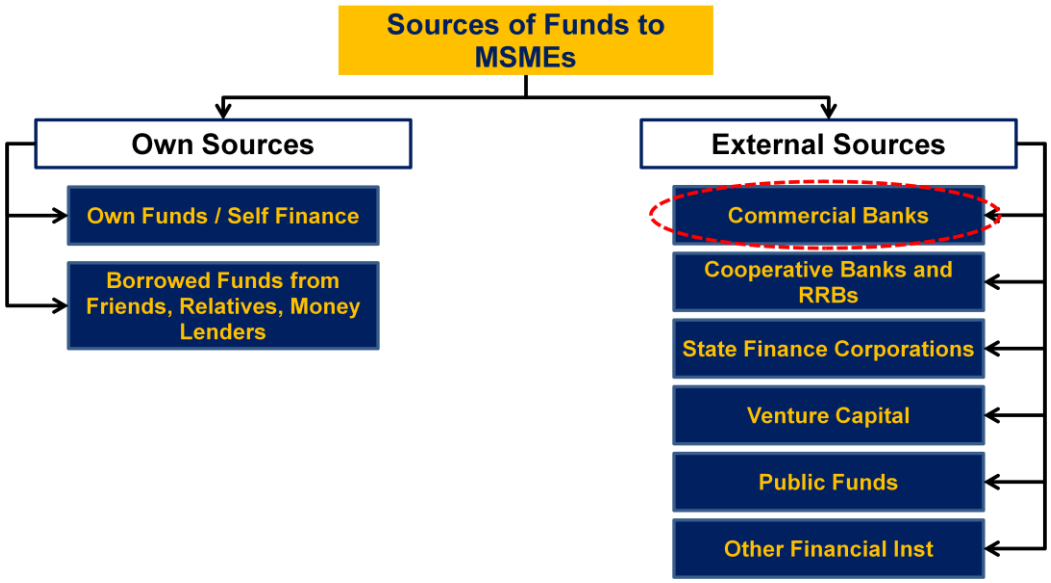
Overview of Credit Flow to the MSME Sector

The micro, small, and medium enterprise (*MSMEs*) sector is an important and integral part of Indian economy, contributing significantly to the industrial output, employment, and exports. The sector acts as an incubator of entrepreneurship and helps spread the wealth at the grass-root level. According to the "PM Task Force Report on MSME", released in early 2010, MSME sector contributes 8% of country GDP, 45% of the industrial output, and 40% of total exports. Additionally, it provides employment to approximately 60 million people through 26 million enterprises. The report also mentioned that 94% of total MSMEs are unregistered, with a large number of them being informal or unorganized. Recognizing the significant contribution of the sector, there has been special emphasis on its growth and promotion by government.

To shore up the MSMEs in the country, financial inclusion has been identified as one of the critical requirements as none/inadequate/delayed supply of credit has been a major impediment to the growth of this sector. There is a growing awareness and agreement towards financial inclusion and it has become a national and a government imperative in the last few years. Several nationalized banks in public and private sector extend loans to MSME sector through their branches/specialized centers across India but the services are restricted and limited. The direct intervention of banking the unbanked is fraught with challenges for financial institutions that include high barriers to entry, long gestation period, and high go-to market and servicing costs. This is further aggravated with a lack of awareness and trust amongst the financially excluded regarding the benefits of banking system.

According to Fourth All India Census of MSMEs (2006-07), only 11.2% of the registered units availed institutional finance, while only 4.8% of the unregistered units had limited access to bank finance. Most of MSMEs, for their credit needs, depend on self-finance, borrowed funds from friends, relatives, and moneylenders charging high interest rates.

Exhibit 2: Source of Funds



Source: Report on Trend and Progress of Banking in India 2008-09 and Ministry of MSMEs, Annual Report 2009-10

Taking note of the significant contribution of the sector towards national GDP, exports, and employment coupled with lack of sufficient credit supply, Government of India and Reserve Bank of India have been taking appropriate policy measures for promotion of these enterprises.

To analyze the impact of policy initiatives taken to improve the flow of funds to MSE sector, including complexities of the system and related procedures, RBI has constituted various committees since the nineties decade. Prominent among these are Nayak Committee, S.L Kapur Committee, and Ganguly Committee. These committees have given a number of recommendations covering various aspects relating to Credit Demand estimation and Credit flow to MSE sector. Subsequently, a number of recommendations of these committees have been translated into policy guidelines by RBI and Government of India for financial and other support service institutions engaged in the development of this sector. Below is the summary of each committee's recommendation and relevance for current project.

Exhibit 3: Summary of Committee Recommendations

Committee Name	Key Recommendations	Relevance to the current assignment
Nayak Committee Report (1991)	• Estimated the working capital need for the enterprise as 25% of the forecasted sales • Endorsed the Tandon committee views that 80% of the working capital need be funded by banks i.e. 20% of the	• Method of estimation of working capital finance • Insights for estimation of term credit

Exhibit 3: Summary of Committee Recommendations		
Committee Name	**Key Recommendations**	**Relevance to the current assignment**
	forecasted sales	
Abid Committee Report on Small Enterprises (1997)	• Setting up of a ₹ 2500 crore fund to help enterprises that are negatively affected by the recommended abolition of reservations for small scale industry • Setting up specialized branches catering to needs of small scale industry	• Insights on channels and medium of credit delivery
Kapur Committee Report on Credit (1998)	• Recommended training for branch managers for appraising small projects • Increasing the limit for composite loan to ₹ 5 lakh (currently limit is ₹ 1 crore) • Opening more specialized branches for MSME sector • Urging banks to pay more attention to backward states	• Credit Delivery Mechanisms
Gupta Committee Interim Report on Development of Small Enterprises(1999)	• Recommended that MSME sector be given the same importance as agriculture sector under priority sector lending • Urged banks to directly lend to the MSE sector instead of adopting soft approaches like subscription to bonds of SFCs, NABARD, etc.	• Priority Sector Lending and Delivery Mechanisms • Emphasis on direct Lending
Chakraborty Committee Report on Rehabilitation of Sick MSMEs (2008)	• Recommended to simplify procedures in preparing techno-economic feasibility • Suggested setting up single point credit processing cells • Stressed the need for simplification of financial reporting requirements • Legislation to encourage factoring, refinance at concessional rates	• Effective credit delivery • Timely disbursements and process simplifications

Exhibit 3: Summary of Committee Recommendations		
Committee Name	**Key Recommendations**	**Relevance to the current assignment**
	• Setting up a rehabilitation fund for revival of sick MSMEs and a National Fund Equity scheme that can be utilised for Greenfield or expansion projects	
Prime Minister Task Force's Sub-Group on Credit to MSMEs	• Urged SEBI to expedite the process of setting up an MSME exchange • Recommended that all scheduled commercial banks should achieve a year-on-year credit growth of 20% to micro and small enterprises and strictly adhere to allocation of 60% to micro enterprises under the priority sector lending • Suggested changes in bank lending norms for innovation start-up firms • Recommended increasing mandatory coverage under CGTMSE from ₹ 5 lakh to ₹ 10 lakh for MSMEs	• Insights on methodology for estimation of credit gap • Effective credit delivery mechanisms

Comparison of MSEs and Medium Enterprises w.r.t Financial Inclusion

Indian MSMEs are a diverse and heterogeneous group but broadly face common set of problems. They are primarily in the areas of:

- Credit
  - Unable to provide collateral required for institutional credit
  - High interest rate incurred on credit borrowed from non-institutional money-lenders
  - Delay in institutional credit disbursal upon loan approval
- Long Asset Conversion cycle
- Lack of suitable quality control facilities and non-awareness of new technology.
- Hard to procure raw materials without credit
- Limited end markets access
- Not equipped to suitably manage financial books on their own

As we set out to identify the Credit Gap in the identified clusters, it is imperative to understand where Micro and Small enterprises stand vis-à-vis Medium enterprises, when it comes to financial inclusion. This understanding will also help us in defining the credit gap.

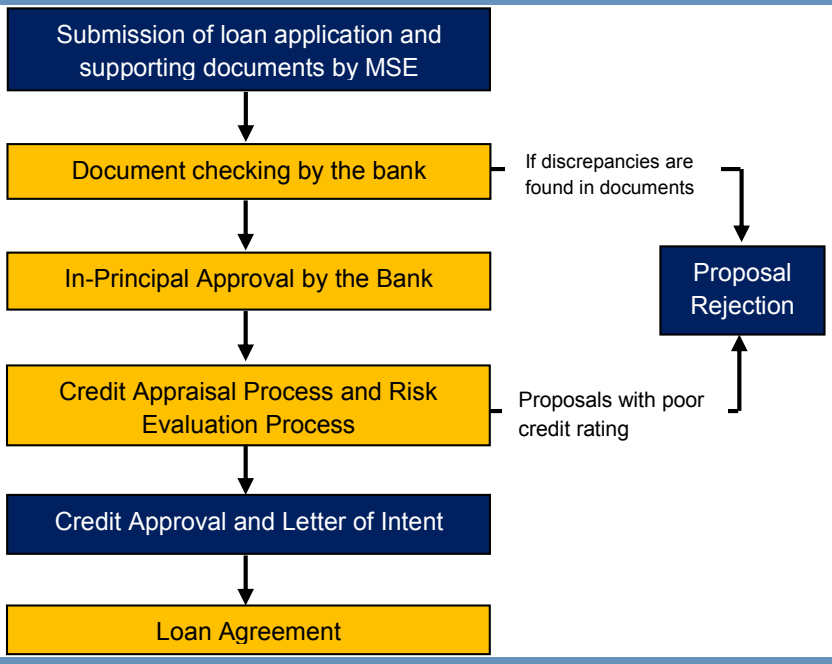
Further, to gain a better understanding of the status on financial inclusion of various forms of enterprises, we need to understand how the credit appraisal process works and the typical characteristics associated with MSEs and Medium-sized enterprises.

Credit Appraisal Process

Once the loan application is received, the bank assesses the risk involved in the project based on various parameters such as project details (*project concept, location, sector type, project strength through DSCR, project IRR, payback period etc.*), borrower background, fixed asset information, cash conversion cycle, previous relationship of the bank with borrower, and details of existing and proposed credit facilities. Lending institutions have internal rating models for assessment of project proposals, and few lending institutions accept ratings of external credit rating agencies.

The proposal acceptance rate is relatively high (*almost 90-95%*) in case of Public Sector Banks compared to Private Sector and Foreign Banks. The lower rate of acceptance in case of Private Sector and Foreign Banks is mainly due to their focus on large corporates and perceived risk in MSE sector.

Exhibit 4: MSE Lending Process



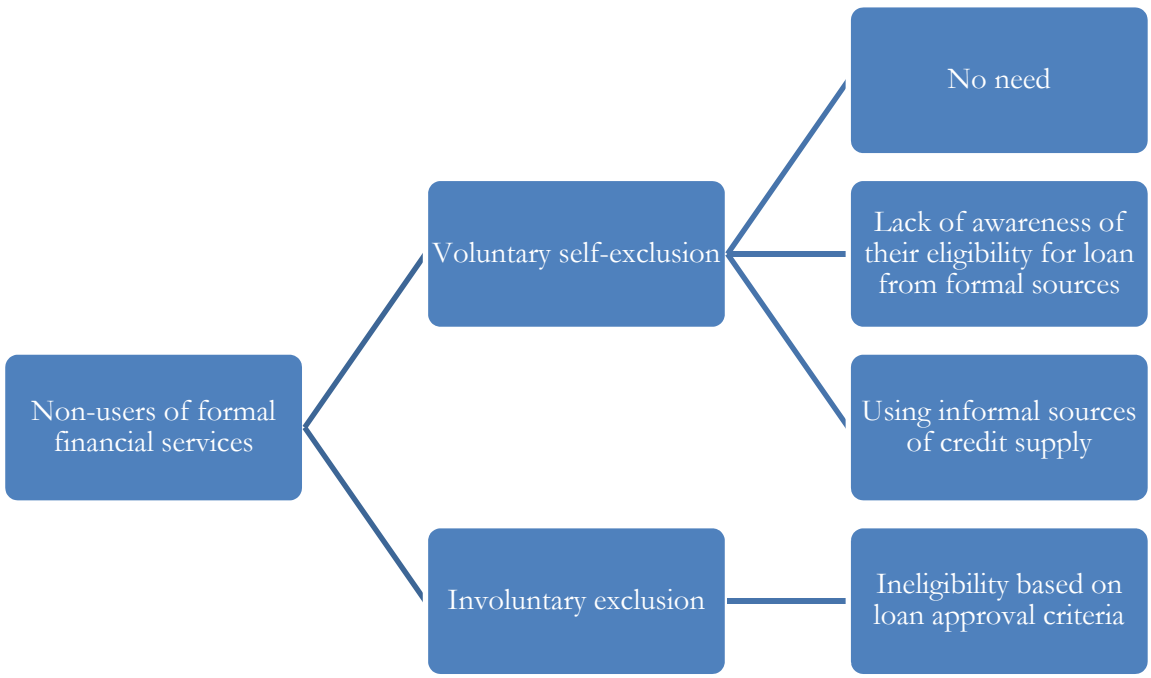
Source: Primary Survey of Lending Institutions, D&B India

The table below provides a comparison of characteristics of MSE vs. Medium enterprises in terms of certain parameters that determine their likelihood of being financially excluded.

	Criteria	MSEs	Medium-size Enterprise
1	Bank's Requirement for Loan Approval		
1.a	Collateral Presence	Absent-Low	Available/Acceptable
1.b	Guarantee	Not Always Available	Available
1.c	Fixed Asset	Not Always Available	Available
1.d	Credit Rating	Not Always Available	Available
1.e	Cash Conversion Cycle	Not Favorable	Favorable
1.f	Stability of cash flows	Low-Mid-High	High
1.g	Business/Project Plan	Not Always Available	Available
1.h	Accounting Information	Not Always Available	Available
1.i	Previous Relationship with the Bank	None-Low	Yes
2	Other Factors		
2.a	Banking System Awareness	None-Low	High
2.b	Borrowing from-Non Institutional Sources	Low-High	Low
2.c	New/Upcoming Technology know-how	None-Low	High

Due to unfavorable conditions existing at MSEs end, the loan approval either takes longer or gets rejected compared to that of medium size units.

Enterprises that do not use formal financial services fall into two categories viz., Voluntary self-exclusion and involuntary exclusion. The figure below illustrates the difference between the two.



Non-users of formal financial services, who fall under involuntary exclusion is definitely a critical parameter for defining credit gap. Equally important are those who fall under voluntary self-exclusion bracket. Enterprises that do not need credit can be safely assumed to be self-sustainable w.r.t credit requirement and is not a serious concern to policy makers. However, those enterprises "*who do tap funds from informal source of credit supply at higher interest rate*" and "*those who curtail production rather than borrow, because they perceive themselves as being ineligible for loans from formal sources at reasonable interest rates*" needs attention due to lack of credit supply from formal financial institutions.

Considering that MSEs suffer greater financial exclusion, as explained above, Credit Gap estimation under current study is aimed only at MSEs and the study shall not consider medium size enterprises for computation of credit gap.

Credit Gap Definition and Concerned Clusters

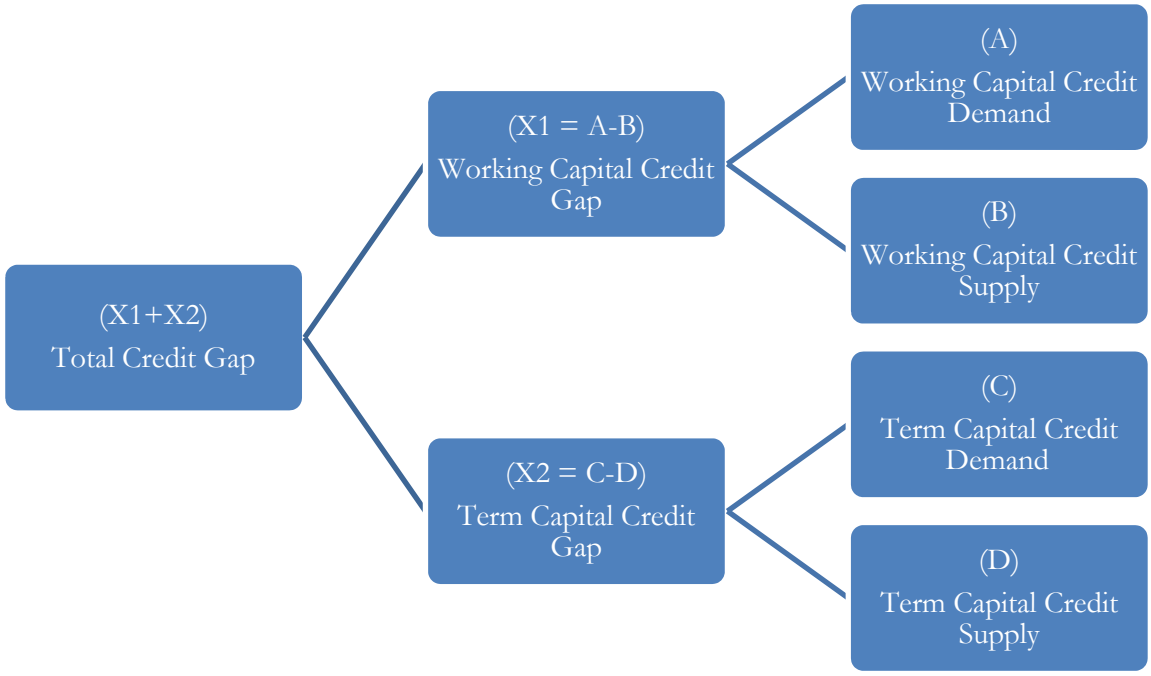
In light of the above, Credit gap can be defined as unmet credit requirement of MSEs, over and above the available access to credit from formal institutional sources of finance. The same measures are used by international institutions like IMF and the World Bank.

Below is the list of selected clusters for the current study.

Selected Clusters			
Cluster	**District**	**Industry**	**Lead Bank**
Faridabad	Faridabad	Engineering	Syndicate Bank
Coimbatore	Coimbatore	Engineering	Canara Bank
Rajkot	Rajkot	Engineering	State Bank of India
Rourkela	Sundargarh	Engineering	State Bank of India
Ahmedabad	Ahmedabad	Dyes & Chemicals	Dena Bank
Hyderabad	Hyderabad	Pharmaceuticals	State Bank of India
Ludhiana	Ludhiana	Knitwear	Punjab & Sind Bank
Chennai	Chennai	Leather	State Bank of India
Kolkata	Kolkata	Leather	United Bank of India
Pune	Pune	F&V Processing	Bank of Maharashtra
Source: RBI Annual Publications, Branch Banking Statistics			

Methodology for Credit Gap Estimation

Estimation of Credit Gap requires identification of Credit Demand and Credit Supply to MSEs. Further, these can be broken down into Working Capital gap (*demand, supply*) and Term Loan gap (*demand, supply*). Below is the schematic of credit gap estimation and discussion of suitable credit gap estimation methodologies.



Credit Demand Estimation

Credit Demand is defined as capital required for running a business – both for daily operation as well as in the longer term. The need for credit in case of MSEs arises from the following activities conducted by them:

- ✓ Raw materials purchase
- ✓ Labor cost
- ✓ Facility rent, and utilities cost
- ✓ Machinery maintenance
- ✓ External facilities/units (*Manufacturing & Quality compliance*) usage
- ✓ Credit rating approval
- ✓ Support & Development Services such as financial audit and monitoring, project development and report preparation etc.
- ✓ Excise tax
- ✓ Technology up-gradation

- ✓ Fixed Asset revision
- ✓ Construction of new facilities for manufacturing & quality compliance

Credit Demand for MSEs is broadly divided into two parts viz. Working Capital and Term Capital Demand.

Working Capital Demand

It is the working capital required for managing day to day business operations and compliance activities.

The Cash Conversion Cycle plays a critical part in determining working capital requirements for enterprises. Cash Conversion Cycle-CCC (*also known as Asset Conversion Cycle*) is an important analysis tool to identify the need of cash at different stage of production cycle. It is the number of days that an enterprise takes to convert resource inputs into cash flows. This metric looks at the amount of time needed to sell inventory, the amount of time needed to collect receivables, and the length of time to pay the bills. Effectively, it is the time gap between cash outlay and cash recovery.

CCC = DIO + DSO -DPO

Where:

DIO = days inventory outstanding

DSO = days sales outstanding

DPO = days payable outstanding

The shorter the cycle, lesser the time capital is tied up in the business processes.

Term Credit Demand

It is the demand that emanates from requirement for new facilities establishment, technology up-gradation, and fixed asset revision.

Methodology for Credit Demand Estimation

To determine an appropriate Credit Demand estimation methodology, D&B India conducted primary and secondary research that included the study of reports prepared by various committees (*constituted by RBI*), Diagnostic Study Reports prepared by various cluster implementation agencies, the Arjun Sengupta Committee report on unorganized sector and various other sources. In addition,

D&B India conducted a primary survey of enterprises in the 10 identified clusters. Below is a note on each source.

Nayak Committee

The Reserve Bank of India constituted a Committee under the Chairmanship of Shri P.R. Nayak, Deputy Governor during 1991 to examine the difficulties confronting the MSMEs in the country in securing finance. Of the broad contours set for the committee, one of the key requirement was to examine the adequacy of institutional credit for the MSE sector, particularly, with reference to the increase in the cost of raw materials and locking up of the available resources due to delay in the realization of sale proceeds from large companies and Government agencies. The committee was an extension of the earlier work done by Tandon/Chore committee.

In the process of examining the adequacy of institutional credit, the committee, outlined methods for estimating the credit gap through developing credible demand estimates for credit. While the committee stressed on strong quantitative methods for Working Capital credit estimation, the term credit estimation was fairly qualitative in nature.

For estimation of working capital, the committee suggested using the *forecasted sales approach. 25% of the forecasted sales for the enterprises would be considered as requirement for working capital. The working capital bank credit would be 80% of the estimated working capital requirements.*

Arjun Sengupta Committee Report

D&B India also studied the report prepared by the [1]National Commission for Enterprises in the Unorganized Sector (NCEUS) under the chairmanship of Dr. Arjun K Sengupta. The Government of India had setup the commission to recommend measures for bringing about improvements in the non-farm unorganized sector. The commission defined the non-farm unorganized units as, "all unincorporated private enterprises owned by individual or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers."

The commission was setup with the objective of recommending necessary measures so as to improve the productivity of these enterprises, generate large scale employment opportunities on a sustainable basis, particularly in the rural areas, enhance the competitiveness of the sector in the emerging global environment, linkage of the sector with institutional framework in areas such as credit, raw material, infrastructure, technology up-gradation, marketing and formulation of suitable arrangements for skill development.

[1] Financing of Enterprises in the Unorganized Sector and Creation of a National Fund for the Unorganized Sector (NCEUS, Nov 2007)

This commission had written a report on the financing needs of the unorganized sector wherein they had calculated and commented upon the credit gap that exists in the financing of enterprises in the unorganized sector. Under this method, the average credit needs of the unorganized units were obtained from a survey. Average credit need was then multiplied by the total number of estimated unorganized units to obtain the Total Credit Demand.

While the commission's method was most effective for estimating credit requirements of unorganized enterprises (mostly micro proprietary units), extrapolated estimates of credit demand are prone to outliers in the sample surveyed. Existence of detailed diagnostic studies on the clusters and a detailed survey among a limited but representative sample enabled D&B India to rely on the 'Forecasted Turnover Approach' for estimating WC requirements and its own method (explained below) for estimating Term Loan requirements, separately.

D&B India Survey

D&B India conducted a sample survey across 10 identified clusters, in discussion with GIZ and SIDBI stakeholders. At least 50 MSME respondents (*enterprises*) were identified for each cluster and well distributed across micro, small, and medium enterprises. The questions in the questionnaire included queries on financial information (*such as assets, turnover, profit etc.*), nature of credit requirement, and perception/experience with the banking system.

Step-wise Credit Demand Estimation Method

D&B India proposes to use two methods for estimation of credit demand[2]. They are

- *Forecasted Turnover Methodology for* ***Working Capital Demand*** *based on Nayak Committee Report*

1. Cluster Turnover was estimated on the basis of the D&B India Survey of 50 enterprises in each cluster. Turnover of the enterprises within the sample were extrapolated using the number of micro and small enterprises in the cluster. The number of enterprises was taken from the Cluster Diagnostic Study (*DS*) Reports[3]

2. The above values (*calculated in 1.*) were then projected to *2011-12* level using average growth in Index of Industrial Production (IIP)[4] for the corresponding industry

[2] Credit Demand includes both working capital and term capital demand

[3] DS turnover estimates haven't been considered as the figures correspond either for year 2008 or earlier, thus preventing significant deviation. Number of micro and small units though have been taken from DS reports

[4] Latest National IIP figures – Statement II in "MOSPI Press Release on IIP Estimates", Aug, 2011

3. Using Nayak Committee guidelines (*20% of projected turnover as working capital funding requirement*), working capital estimates were arrived for micro and small units

To estimate the ***Term Credit Demand***, the following steps were employed

1. D&B India Survey was used to obtain "Investments in Plants & Machinery" for the sample number of units covered for MSEs

2. Annual Survey of Industries (ASI) statistics[5] was used to obtain the growth rates in Fixed Capital for different industries state-wise. Subsequently, this was used to forecast population estimates obtained in step 1

3. The difference in values for *2011-12* (*projected; calculated in step 2.*) and *2010-11* years is taken as Term Credit requirement and 80% of the same is termed as *Term Credit Funding requirement*

Credit Supply Estimation

According to 4th All India Census of Micro, Small, and Medium Enterprises-MSME (*2006-07*), only 11.2% of the registered units availed institutional finance, while only 4.8% of the unregistered units had limited access to bank finance. Most of the MSMEs, for their credit needs, depend on self-finance, borrowed funds from friends, relatives, and moneylenders charging high interest rates.

With the motive of effective implementation of social objectives, RBI implemented lead bank scheme in year 1969 as per a recommendation from SKF Nariman and Prof. Gadgil. Under the scheme, one of the commercial banks in the district functions as a lead bank and acts as consortium leader for coordinating the efforts of all financial institutions operating in the district. The lead bank is expected to take the lead role in identifying the potential areas for banking and banking development and expanding credit facilities in the district. There is reporting hierarchy under which lead bank has to provide key lending statistics of the financial institutions to District Level Committees (DLCCs) and then further to State Level Banking Committees (SLBCs).

[55] ASI estimates on Fixed Capital for different industries within a state – MOSPI ASI Report

Step-wise Credit Supply Estimation Method

Enterprise turnover is one of the important criteria for loan appraisal process and it can be safely assumed that credit supply to the cluster is correlated with the turnover generated. Thus, D&B India proposes to use a method involving the "Proportion of Cluster Turnover to Industry State Turnover" to arrive at cluster level credit supply. The methodology steps are:

1. Obtain state industry level advances from RBI – Basic Statistical Returns available till March 2010 [6]

2. Obtain state industry turnover (*ASI*)[7]and cluster turnover

3. Forecast both the advances (*obtained in 1.*) and turnover (*obtained in 2.*) to the current level (March 2011)

    a. Using state total advances growth rate, obtain the state industry level advance (SIA) to current level (*2011*). State Total Advances is available for the period ending Mar, 2011[8]

    b. Using National IIP growth rates[9], forecast the state industry turnover (SIT)and cluster turnover (CT)to the current level (*2011*)

4. Obtain the proportion (P1 = CT: SIT) of cluster turnover to state industry turnover (obtained in 3.)

5. Calculate the credit supply at Project cluster level using the above proportion (Cluster Level Credit Supply-CLCS = P1*SIA)

6. Credit supply from major non-SCB (SFCs, SIDBI, and Cooperatives) institutions is added to the above credit supply to get the supply level at the cluster level

7. Further, total credit supply was broken down into Term Credit and Working Capital using "State Level Advances – Working Capital Advance and Term Loan Advance (SE) to Small

[6]Table 4.9- Annual-Basic Statistical Returns of Scheduled Commercial Banks, Mar '2010

[7] Table 3 – Annual Survey of Industries (ASI), Government of India, MOSPI

[8] Statement 9: RBI Quarterly-Basic Statistical Returns of SCB, Mar '2011

[9]Latest National IIP figures – Statement II in "MOSPI Press Release on IIP Estimates", Aug 2011

Enterprise (SE)"[10]. Term loan advance proportion to total advance (obtained above) is termed as P2

a. Working Capital supply is then arrived at using formula (1-P2)*CLCS

b. Term Capital supply is P2*CLCS

D&B India also contacted various Lead Banks for the identified district clusters under the current study and obtained aggregated (*of financial institutions*) credit supply data at district level. The estimates for Credit Supply Outstanding for each cluster computed by D&B India were matched with Lead Bank data on Outstanding Total Advances, Priority Sector Advances and MSE Advances, in order to ensure consistency.

The Lead Bank supply data included data from Scheduled Commercial Banks (SCBs), State Finance Corporation (SFC), SIDBI, and Co-operative Banks. However data of SFC, SIDBI, and Co-operative Banks was available for only few districts as provided by lead bank. Further, there were qualitative discussions with lead bank manager to get an estimate of credit supply at cluster level in each district.

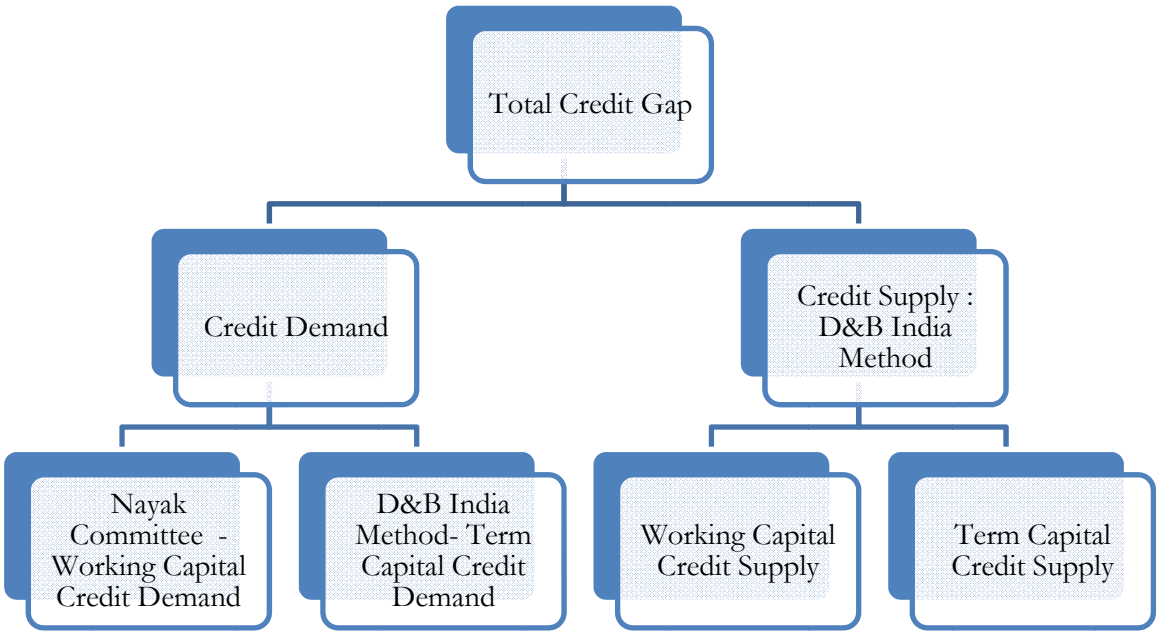
Credit Gap in the MSE Sector

The methodology discussed above has been applied to all identified clusters (MSEs) for credit gap estimation. The various end statistics reported for different clusters are:

- Working Capital Demand obtained from Nayak Committee Approach
- Term Capital Demand from D&B India Approach
- Working Capital Credit Supply from D&B India Approach
- Term Capital Credit Supply from D&B India Approach
- Lead Bank data on District Level Advance (Total, Priority Sector, MSEs)

After obtaining Credit Demand and Supply figures, Credit Gap was accordingly obtained and validated against lead bank data for each cluster. Below is the schematic representation of the Credit Gap estimation process.

[10]Table 6.1, Statistical Tables Relating to Banks in India, 2009-10ss



Further, D&B India has provided qualitative inputs on credit supply and demand for each cluster in the individual cluster reports.

As mentioned earlier, MSEs face greater financial exclusion compared to medium-sized enterprises. Credit Gap estimation for different clusters are obtained only for MSEs using above methodology. However, the methodology can be extended to MSMEs and as well as to clusters (*not undertaken in the current study*) for credit gap estimation.

Kolkata Leather Cluster

Overview

West Bengal is one of the states that have long been associated with the leather industry having two major industry clusters in Kolkata and Shantiniketan. The Kolkata leather cluster houses 4000 units (including organized and unorganized) and provides direct employment to close to 62,000 people. The turnover generated by the MSE units in the cluster, based on D&B India survey estimates, amounts to ₹ 2,880 crore. This cluster produces a diverse range of products such as-

- *Finished leather*
- *Leather goods such as bags, wallets etc.*
- *Footwear*
- *Industrial gloves*

Kolkata leather cluster's share in India's export basket for leather goods remains at 60 per cent. The local industry comprises of various sub-sectors which operate in different stages of the value-chain, with major sub-sectors being tanning, leather goods, industrial products and footwear as listed in the exhibit below.

Exhibit 6: Kolkata Cluster Information

Sub-Sectors	Locations	Category	No. of Units	Employment
Tanneries	Bantala	Tanneries	224	8,450
Leather goods like bags, wallets etc.	Kasba, Topsia and Tangra	Manufacturer cum exporter	236	23,600
		Merchant exporters	96	1,920
		Fabricator cum manufacturer for the local market	1200	3,600
Footwear	Batanaga, Nungi, Janbazar, Rajabazar, College Street area and Bentick Street	Large scale manufacturing units (Bata)	1	3,000
		Small and medium enterprise manufacturers	19	1,000
		Manufacturer cum exporter	6	
		Fabricator and household units	2000	10,000
Industrial gloves	Beleghata	Manufacturer cum exporter	31	4,650
		Merchant exporter	11	220
		Fabricator	200	6,000

Source: Diagnostic Study Report on Kolkata Leather Cluster prepared by Entrepreneurship Development Institute of India (EDI)

Due to the importance of the leather industry to West Bengal, the Government of Bengal had setup the Calcutta Leather Complex on the eastern fringe of Kolkata in Bantala. It is envisaged to house all activities related to the leather industry. With the tanning capacity of close to 1,000 tons of raw hides per day, it is estimated that this complex when fully functional will generate approximately ₹ 5,000 crore worth of exports and provide employment to nearly 10,000 people. Though the leather complex was started with much fanfare, of late the complex has been plagued by infrastructure issues, which has led to some of the tanneries moving out of the complex.

Besides this various Government of India ministries in collaboration with multilateral aid agencies such as United Nations Development Program (UNDP), United Nations Industrial Development Organization (UNIDO), Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH under MSME-FDP from time to time launch various projects for upliftment of units and workers engaged in these enterprises.

One of the biggest government initiatives has been the Integrated Development of Leather Sector (IDLS) scheme. The scheme is aimed at enabling existing tanneries, footwear, footwear components and leather products units to upgrade leading to productivity gains, right-sizing of capacity, cost cutting, design and development simultaneously encouraging entrepreneurs to diversify and set up new units. The financial assistance under the scheme is an investment grant to the extent of 30% of cost of plant and machinery for MSEs and 20% of cost of plant and machinery for other units (i.e. non small scale units) subject to ceiling of ₹ 50 lakh for technology up gradation /modernization and/or expansion and setting up a new unit. The rate of assistance is @ 20% for all units (both MSEs and Non-MSEs) above ₹ 50 lakh subject to ceiling of ₹ 2 crore. Also, obtaining bank loan without collateral has been one of the main problems of small entrepreneurs. Besides, banks find lending to small enterprises as risky proposition. To take care of this problem, the Credit Guarantee Fund Trust Scheme for Micro and Small Enterprises (CGTMSE) was introduced by the Government (Ministry of Small Scale Industries) in May 2000 with the objective of making available credit to small scale industrial units, particularly micro units (with investment in plant and machinery less than ₹ 25 lakh) for loans up to ₹ 10 lakh without collateral/ third party guarantees. The scheme is being operated through the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) set up jointly by the Government of India and the Small Industries Development Bank of India (SIDBI). The loan limit under the scheme, which was ₹ 10 lakh per borrower, has since been enhanced to ₹ 25 lakh per borrower.

Even though the IDLS & CGTMSE schemes are some of the biggest initiatives undertaken by the government to support the leather sector and the MSE sector respectively in the country, but based

on our interactions we found out the benefits of the schemes are not reaching the enterprises, especially the micro and small units in the Kolkata leather cluster.

Sources of Demand for Credit

Procurement and Primary Processing

Most of the tanneries procure the raw hides and skins from traders / local suppliers who source the skins from different places in the state and also from places as far as Bihar and Uttar Pradesh. In most of the cases it has been seen that the slaughter houses supplying raw hides lack proper modern infrastructure for collection of dead animals. Thus there is significant wastage in finished leather because of damages caused by rough handling at the slaughter houses.

To overcome the problem of wastages and to ensure quality and timely supply of finished leather, some of the larger manufacturing units such as Kalpataru International **run their own tanneries**. On certain occasions, **tanneries are also available on rent** where the manufacturers can process their own leather. In either case, there is a need for credit emanating from the tanning process.

Raw Material Procurement

Arranging raw material is one of the prime concerns of almost all the product manufacturing firms in this cluster since the nearly 2/3rd of the product constitutes of leather cost. The manufacturers get credit period of up to 30 days for the raw material that they buy and they need to extend credit period of up to 60 days to the buyers. This leads to an increased need for working capital.

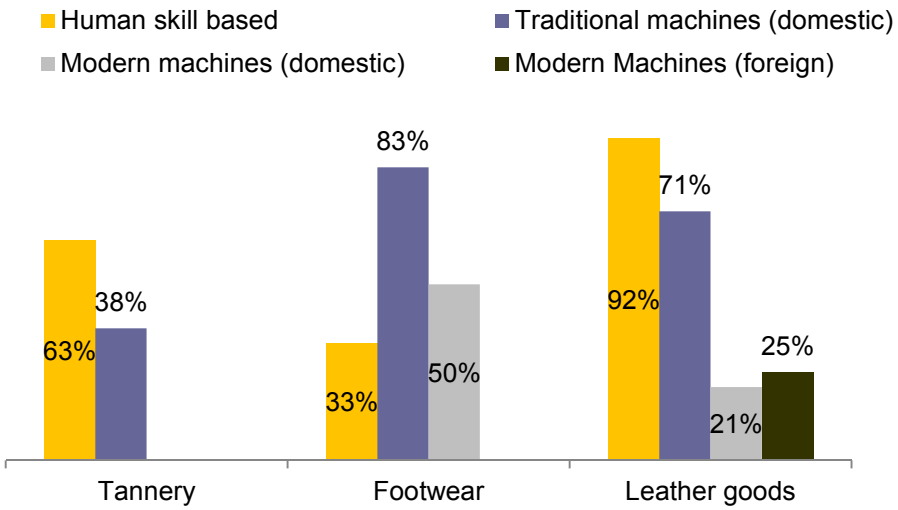
Nature of Technology Used

A significant chunk of units in the cluster are lagging behind in terms of adoption of modern technology and equipment. Majority of the tanneries have not upgraded their technology and still depend on human skills or older machines for carrying out the tanning process. It has sometimes also been alleged that some of the units employ child labor.

One of the primary reasons for using orthodox technology is the mindset of the owners who are not interested in latest technology trends or making any investments to upgrade their units. **Adoption of clean process technologies that consume significantly lower amount of harmful chemicals and water is a need in the cluster.**

In addition, the units also need to take care of the initial pretreatment processes that need to be carried out on the effluent before releasing it to the Common Effluent Treatment Plant (CETP).

Exhibit 7: Type of Technology Used across Various Firms



Note: The chart represents the current technology being used at the enterprises. For a particular technology, the numbers add up to 100% across enterprise categories.

Source: D&B Study on Skill Development among MSME Sector

The tanneries also need to invest in qualified staff who could advise them on the chemicals to be used in tanning to comply with the international regulations such as **REACH** (Registration, Evaluation, Authorization and Restriction of Chemicals). REACH is a European Union regulation which imposes restrictions on specific chemicals that can be used for tanning. Increasingly most of the foreign customers are insisting that the finished leather should be compliant with REACH regulations.

Lack of expertise and proper information avenues on technology have led to a major gap even at entrepreneurial level to ascertain the available technology. Hence, even adequate knowledge on what technology should be obtained and which of it is apt for own process is not known as well. Thus it can be categorically said that there is an urgent need for a more proactive approach especially from the tannery and footwear manufacturers' association to educate their members about the benefits of using modern technology.

The sustainability of the leather cluster requires adoption of modern and cleaner technologies and the consequent compliance to international regulations (such as REACH). This would require large capital investment by the leather units of Kolkata.

Sales Linkages

The finished leather produced by the small tanneries is primarily used by the domestic companies involved in manufacturing leather goods, footwear and industrial gloves. The tannery owners have well established customers who procure their entire output and thus these tanneries do not invest

much effort in marketing activities. The credit period extended by the tanneries to the manufacturing units ranges from up to 15-30 days for micro and small units to up to 60 for medium units.

The finished leather industry is also seasonal in nature, with demand being virtually non-existent during the monsoon months. In terms of forward linkages, majority of leather goods and industrial gloves manufacturers export their wares. While some of the firms have well established relationships and interact directly with foreign buyers, the rest are dependent on buyer seller meets for selling their products. The buyers generally demand a credit period of 30 days. Recently, The SIDBI-implemented MSME-FDP has enabled enterprises in Kolkata cluster to climb the value-addition ladder and manufacture high-end Fashion Gloves that yields a higher margin in the international market.

Leather footwear primarily caters to the domestic market and only a small quantity is exported. The bigger firms in the cluster such as Bata, Khadims and Sreeleathers have well established retail distribution network with majority of their production being outsourced to smaller units in the cluster.

Quality Management

A significant proportion of micro and small enterprises employ only **sensory quality checking** for their products. However the awareness level about European CE and other **standard quality norms** is quite good among the medium enterprises. The firms which are directly involved in exports also have good understanding of these norms. The owners of micro and the small units need to be made aware of quality standards and importance of formulating a standard quality process for the enterprise.

Also, while all the medium entrepreneurs are aware of the need for using pre-certified / tested raw materials, there is a gap in awareness among the micro and small units. Leather goods manufacturer must ensure that they use finished leather certified by Central Leather Research Institute (CLRI) or other agencies. In case of tanneries, the entrepreneurs must ensure that they use the proper chemicals as per international norms.

Financial Mismanagement

In the Kolkata Leather cluster the extent of sub-contracting is higher. Most of the firms in this cluster do not maintain proper books of accounts and state lower turnover in their books. This is done in order to save tax for the sub-contractor as well as the sub-contractee. The low turnover thus leads to lower working capital sanctions.

Supply of Credit to MSEs

Estimate of Outstanding Credit to MSEs in the Leather Cluster

The credit supply to the Kolkata Leather cluster is estimated to be ₹ 596 crore out of which ₹ 47 crore (8%) is term credit and ₹ 548 crore (92%) is working capital supply.

Enterprise turnover is one of the important criteria for loan appraisal process and it can be safely assumed that credit supply to the cluster is correlated to the turnover generated. Thus, D&B India proposes to use the "Cluster Turnover proportion to Industry State Turnover" method to arrive at cluster level credit supply.

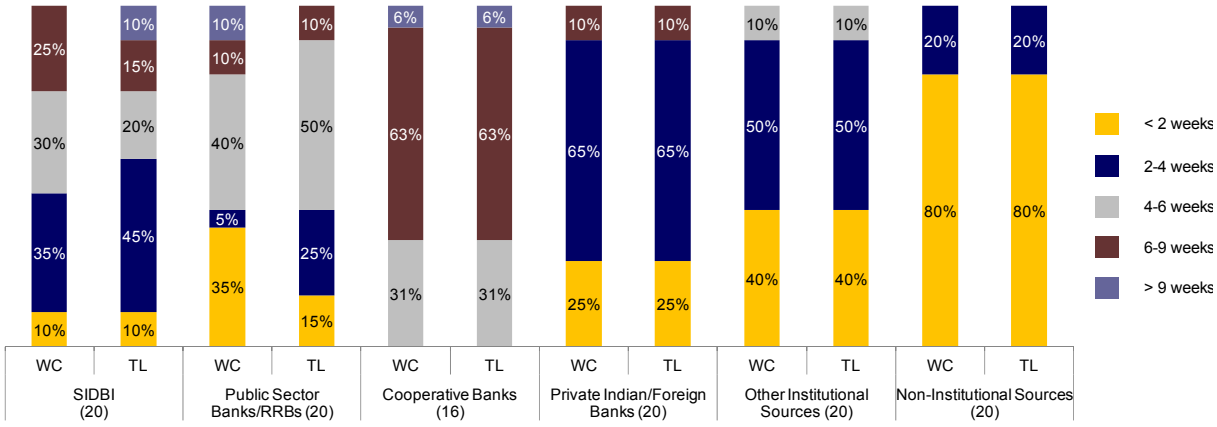
The steps for computation under the identified Methodology are detailed Annexure I.

For the Kolkata district the lead bank scheme of Reserve Bank of India is not implemented and hence there is no segregated information being maintained by banks.

Responses were taken from 20 SIDBI customers on the overall perception of SIDBI, as well as on attributes such as time taken for loan disbursement and collateral requirement. While the respondents believed that Public Sector Banks and Private and Foreign Banks take lower time to disburse loan than SIDBI, non-institutional sources would take the least amount of time. Also, cooperative banks are believed to take longest time to process and disburse loans.

The following exhibit depicts perception among respondents of time taken for loan processing and disbursement by various financial sources.

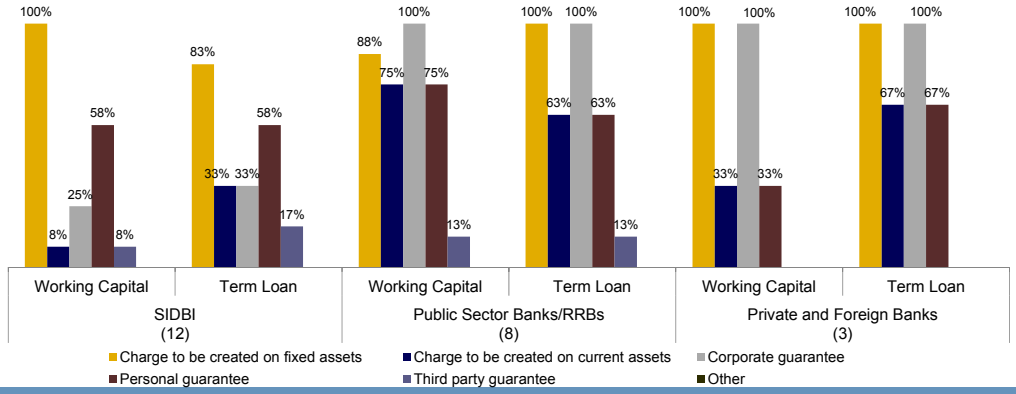
Exhibit 8: Perception of Time Taken for Loan Processing and Disbursement



Source: D&B India
Note: Figures in brackets show total number of respondents for each financial source

The following exhibit shows the nature of collateral requirements across various financial sources.

Exhibit 9: Nature of Collateral Requirements



Source: D&B India
Note: Figures in brackets show total number of respondents for each financial source

All financial sources are believed to have similar collateral requirements, and SIDBI term loans are believed to have significantly lower collateral requirements as compared to other sources.

Demand for Credit by MSEs

Estimate of Credit Demand by MSEs in the Leather Cluster

There are two methods that D&B India has followed to arrive at Total Credit Demand at cluster level, as mentioned in the methodology section. The methods involved are:

Nayak Committee-D&B India Approach

a. Working Capital Demand - Turnover Based Approach (Basis – Nayak Committee Guidelines)

b. Term Capital Demand - D&B India Approach (Basis – Growth in Fixed Capital)

Below are the highlights of the credit demand estimates in the cluster:

- Total number of Micro and Small units in the cluster is 4,023
- The turnover for the Kolkata Leather MSE cluster is pegged at ₹ 2,876 crore during 2010-11 from the D&B India survey at cluster level
- The turnover is estimated to rise by an annual average growth rate of 6.4% (IIP estimate) to ₹ 3,060 crore in the year 2011-12
- Working Capital Requirement (Basis-Nayak Committee Guidelines) is estimated to be ₹ 612 crore

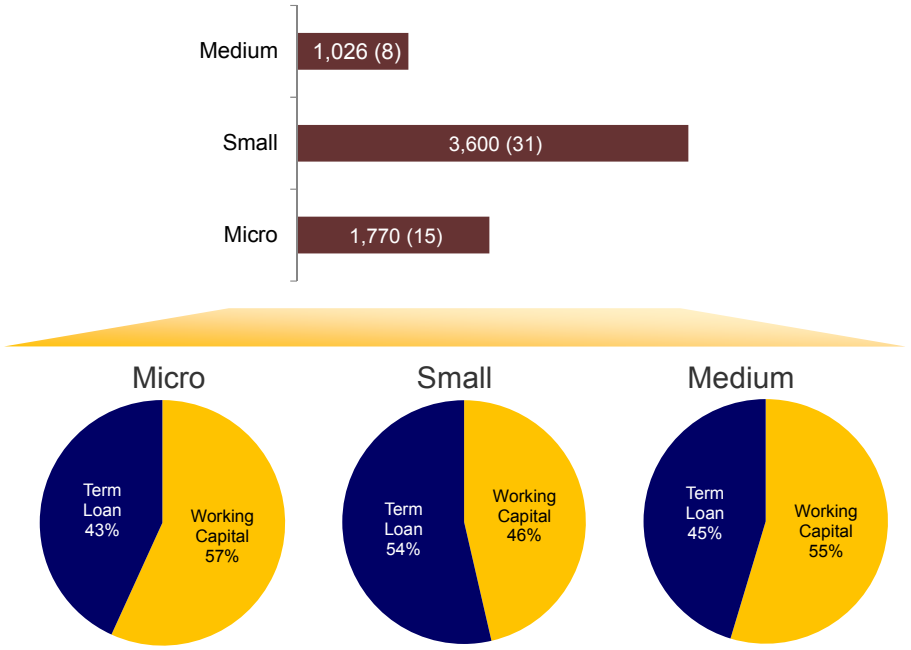
- Term Credit Requirement (Basis-Growth in Fixed Capital) is estimated to be ₹ 105 crore
- Total Credit Demand is thus obtained from above [(612) + (105)] and is ₹ 717 crore

Most banks including the lead bank have indicated that for appraisals of working capital loan requirements, Nayak Committee Recommendations are being followed. The equity margin expected from promoters as per the recommendations is 20% of the working capital loan. It was also observed from the survey across categories of Micro, Small and Medium Enterprises that the average margin requirement is as high as 65% as compared to the prescribed Nayak Committee Norm of 20%. The equity margin contribution indicated by a sample of 50 enterprises in Kolkata tells us that it is 65%, 59% and 64% for micro, small and medium enterprises respectively.

The primary reason for the high equity contribution among micro enterprises is because they are not able to provide adequate collaterals to support their financing needs and hence are required to provide a higher equity margin. Secondly, the nature of the product is seasonal and also faces risks of effluent treatment, animal skins etc. and hence banks are a little averse towards lending leather units and ask for higher equity contribution.

The following exhibit shows the composition of credit among the 54 respondents interviewed in the survey. While 57% of the total respondents were small enterprises, 28% were micro and 15% were medium enterprises. Major requirement in the cluster is for working capital loans, in micro and medium categories, whereas it is term loans in small category.

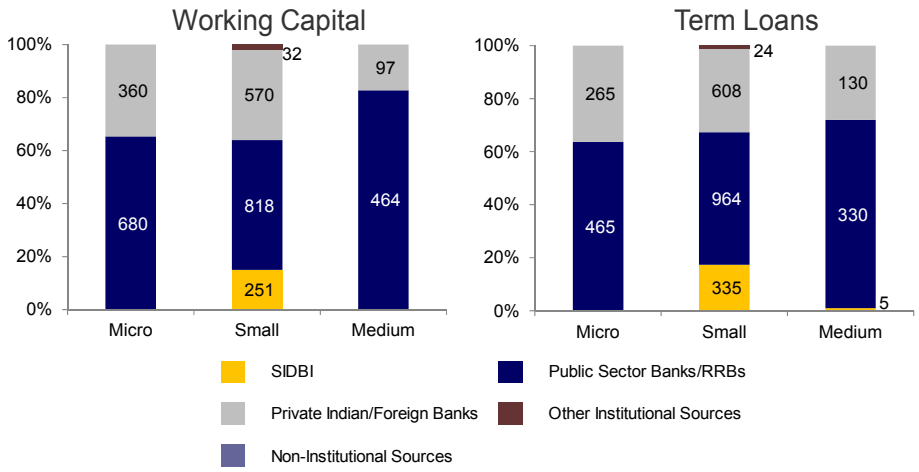
Exhibit 10: Break-up of Credit



Source: D&B India **(Amount in ₹ Lakh; number of respondents in parentheses)**

The following exhibit shows composition of working capital and terms loans for the 54 respondents by sources of finance, separately for micro, small and medium enterprises. In case of working capital and term loans, the major sources of finance for micro and medium firms are Public and Private Sector Banks, the small firms avail finance from SIDBI, Public Sector Banks and Private Sector Banks.

Exhibit 11: Sources of Finance (Amount in ₹ Lakh)



Source: D&B India

In summary, the total working capital credit across the surveyed 54 enterprises is around ₹ 30 crore while the term credit is also in the similar range. It is also important to note that SIDBI does not finance micro enterprises for working capital advances, while for term loans; it is actively financing small and also select medium enterprises.

Thus it can be concluded that there is a higher credit requirement for working capital needs. The following can be summarized as major reasons for the same:

- Largely seasonal and demand driven business involving in higher stocking of finished goods
- Relatively riskier are the tanneries while the leather industries are facing issues of effluent treatment and hence, the risk perception of bankers' for this cluster is higher
- Most of the enterprises have well-established backward linkages, however, the forward linkages depend largely on buyer-seller meets and hence, the sales realization is delayed

From the various methods employed and explained before, the demand and supply side estimations of the cluster have been provided in the next section.

Credit Gap in the MSE Segment

For the current study, D&B India considered the credit supply data of only scheduled commercial banks that form the major source of credit supply. The table below contains the estimated Credit Gap in the cluster on the basis of the two methods.

Method	Total Gap	Credit Supply	Total Credit Demand	Working Capital Demand	Term Capital Demand
Nayak Committee-D&B India Method (In ₹ crore)	**121**	596	717	612	105

Summary of Credit Gap Assessment

There exists a significant gap in the total credit supplied to the Kolkata Leather cluster. D&B India has through its primary and secondary research identified possible reasons for why the credit demand is not being met. A summary of our findings is mentioned below-

- The cluster is considered as a high-risk cluster by the bankers mainly because most of the units are still using traditional techniques of production. This has made the cluster units uncompetitive when compared to the new-technology driven enterprises producing similar products using better technology in other parts of the country
- The working capital need is higher because of most of units have to buy raw material on a month's credit, whereas they have to further extend credit period of up to 2 months. Raw material consists of significant chunk of their product costs, this leads to an increased need for working capital
- Since the extent of sub-contracting is higher, the firms do not tend to maintain proper books of accounts; neither do the small enterprises encourage the micro supplier to do so. This is largely done to save tax of both the parties, the sub-contractor as well as the sub-contractee. At times, the size of the order or the total turnover stated is lower, which leads to lower working capital sanctions
- Most of the units do not even approach the banks for their requirements with the apprehension of excessive documentation, site-audits and inspections, etc
- Quality standards are not followed which makes the product export-uncompetitive

Additionally, quality of credit received by various enterprises can be judged from three factors viz., time taken for loan processing, loan interest rate, and adequacy of credit. It has been observed that around 77-80% of the lending for Kolkata Leather Cluster is routed through SBI and other nationalized banks, the perception of other banks like the private Indian and foreign banks is that

they tend to take lower time for processing the loans. Also, most of the times the loan actually received is much lower than the loan required by the enterprises.

The leather industry based in Kolkata is one the oldest and established industry in the state. With the kind of focus and support that the central and state governments along with various multilateral aid agencies are providing if the enterprises can modernize themselves then they stand to gain a lot in the long term given it's well established linkages. For the cluster to reach such a state and be able to exploit it the banks and other financial institutions will have to play the role of enablers by providing them easy access to credit for day to day operations and also for technology up gradation and modernization. This shall go a long way in the growth of the cluster.

A Note on BDS Programmes Implemented under MSME-FDP in Kolakata Leather Cluster

BDS intervention in skill development training, under the MSME-FDP saw a total of 1799 candidates being trained, a total of 1295 candidates getting employed and skill up-gradation of 133 candidates. One of the major focus areas was the BPL and unemployed youth section where the number escalated to 1285. The growth in employment was measured to be 12.8%. There were 5 public and 8 private BDSPs involved in these skill trainings.

Value-added production saw its manifestation in the high-end fashionable gloves that helped the cluster find an answer to low-end technology, non-tariff barriers, stiff market competition, low profit margin and recession and had very high demand in the international market. At the same time the low-end industrial gloves that were exported were no longer serving their purpose, leading to a need for product diversification. In this regard, a Skill Up-gradation Training programme was organized for manufacturing the high-end leather gloves. Since there was no specialized trainer available in the country, a German consultant by the name of Werner Morbach was hired to train them. A 6 member consortium-based initiative in the name of United Creations Pvt. Ltd. saw the cluster eventually moving up the value-addition ladder with better price realization, shifting from price-based to quality-based competition, opening up doors for newer markets, niche product manufacturing and streamlining the supply chain by allotting task of making quality leather to local tanneries. The value-added Fashion Gloves saw western countries adorning it as a fashion accessory with a higher profit margin from 0.3 $ per pair of industrial gloves in 2010 to $ 2.26 per pair of fashion gloves in 2011.

Productivity Implementation saw 9 units benefiting by BDSP Business Analyst Group with productivity increasing by 22-26% due to introduction of lean manufacturing process and better management practices. Implementation of ERP has benefited 6 MSMEs leading to improvements in inventory management, sub-contracting practices, export execution and follow-up, production process, financial management, etc. It has also led to improvements in overall control and management efficiency.

Recommended Products and Delivery Channels

The Kolkata leather cluster is one of the oldest leather hubs in the country and currently consists of more than 4000 micro and small units besides some medium and large units. The Kolkata Leather cluster exports 60 per cent of the country's leather goods (bags, purses, wallets) and 90 per cent of hand gloves.

Requirement of Capital

The units in the Kolkata leather cluster primarily have a greater need of capital for the following reasons-

- Raw material procurement
- Technology up gradation

Since the raw material (leather) cost consists of nearly 60% of the total product cost, the majority of the units tend to buy raw material in bulk based on their demand so as to get competitive prices for the same. Also, due to ages old flaying, curing, storing and handling practices, a significant portion of the hides and skins become low grade by the time they reach the tanneries. Since high quality of leather is required for manufacture of products for export, the units are looking at importing leather from Africa and Latin America. The raw material is procured by traders who further sell it in the Indian market. This presents an opportunity, whereby industry associations can get together and procure raw material from abroad as well as procure raw material domestically thereby removing middlemen (traders) and thus leading to cheaper raw material for the units.

Also, there are lots of micro units in the cluster who find it very difficult to arrange for finances, for example shoemaking units in Janbazar, Kolkata. Absence of savings, lack of any tangible assets that could act as collaterals, and no formal work order in lieu of surety are the primary reasons for banks to refuse credit to the cluster. The artisans procure loans from local money lenders at usurious terms - 5 to 6 per cent rates of interest per month. This also presents an opportunity for the banks, self-help group and micro finance institutions to provide finance to the units.

Most of the units, tanneries as well as manufacturing units, currently are using dated/traditional technology. Tanneries in the cluster are still using human skill based processed for tanning while a small percentage of units use traditional domestic machines. In addition to this most of the tanneries don't have an ETP.

The adoption of technology is a little better in the leather products sector since a lot of units are exporting to customers abroad.

Kolkata is home to few major footwear manufacturers such as Bata, Khadim, Sree Leathers who are servicing both domestic as well as international markets. Since investing in own production facilities involve incurring many additional costs and results in less flexibility, the units have consciously encouraged sub-contracting to small enterprises. Owing to all this the adoption of technology among these small enterprises is rising but there is a long way to go before they adopt the best in class technology.

Working of Government Schemes

The Leather Industry in India was for long time reserved for small scale sector, due to which the level of investment in the leather sector has been very low. This has resulted in smaller production base and poor productivity. Given the significance of the leather industry to the overall health of the Indian economy and its employment potential, the Government of India introduced special schemes such as the Integrated Development of Leather Sector (IDLS) scheme to help the Indian leather industry and improve its competitiveness in the global market. Besides IDLS, the units can also avail collateral free loan under the Credit Guarantee Trust Scheme for Micro and Small enterprises (CGTMSE).

Integrated Development of Leather Sector (IDLS)

The present scheme is aimed at enabling existing tanneries, footwear, footwear components, and leather products units to upgrade leading to productivity gains, right-sizing of capacity, cost cutting, design and development simultaneously encouraging entrepreneurs to diversify and set up new units. The financial assistance under the scheme is an investment grant to the extent of 30% of cost of plant and machinery for MSEs subject to ceiling of ₹ 50 lakh for technology up gradation /modernization and/or expansion and setting up a new unit.

Although many units have availed of the facility, but it was felt after speaking to many stakeholders that the process of providing the subsidy under this scheme needs to made more transparent. It was felt by people engaged in the trade that units with greater lobbying power generally tend to land the subsidy. Another problem with the scheme was that units have to arrange for the margin money upfront for any equipment purchases since the money is disbursed by SIDBI only once the equipment is installed in the unit, which at times adversely impact the short term financing of the units.

Though there are some problems in the implementation of the scheme, but it was unanimously felt that the scheme is very beneficial for the sector and most of the units want the IDLS scheme to be extended beyond the current scheme period which expires on March 2012.

Credit Guarantee Trust Scheme for Micro & Small Enterprises (CGTMSE)

The Credit Guarantee Fund Trust Scheme for small industries was introduced by the Government in May 2000 with the objective of making available credit to small scale industrial units, particularly micro units (with investment in plant and machinery less than ₹ 25 lakh) for loans up to ₹ 25 lakh without collateral/ third party guarantees.

The banks, with their focus on profit maximization and risk mitigation, have been cagey while distributing funds under this scheme and have distributed funds to projects after carrying out a detailed evaluation taking into consideration factors such as viability of the project, promoters record, their payback capability etc. The banks insist that since CGTMSE scheme is an insurance product, it should be used in contingency situations.

Also, the banks charge a one-time fee (1.5% of the sanctioned amount) plus a yearly service fee (to the tune of 0.75% of sanctioned amount payable every year till the entire loan amount is paid back). This increases the net effective interest rate for enterprises making it more unattractive for them.

Bills Discounting

There are lots of units who are producing leather goods in this cluster for established businesses. These units make use of bill discounting facility for domestic as well as international trade. In international trade, trade bills drawn under Letters of Credit issued by banks are used to fund the receivables. This bill discounting facility is provided for a period of 3-6 months depending upon the tenor of the bill or Letter of Credit.

Descriptions of Products and Delivery Mechanisms

Reverse Factoring

The extent of sub-contracting in the cluster is quite high. A prime example of that are the large footwear manufacturers (Khadims, Bata and Sreeleathers) who outsource their production to smaller units in the cluster. Since most of the units are small banks are hesitant towards extending any factoring products to these units. In such a scenario, we can look at introducing Reverse factoring, where the bank purchases accounts receivables only from high-quality buyers. The bank only needs to collect credit information and calculate the credit risk for buyer (in this case a large transparent, internationally accredited firm). In Reverse Factoring, the credit risk is equal to the default risk of the high-quality customer, and not the risky MSME.

The buyers also stand to benefit from reverse factoring. By engineering a reverse factoring arrangement with a lender and providing its customers with working capital financing, the buyer may be able to negotiate better terms with its suppliers. For example, buyers may be able to extend the terms of their accounts payable to suit their convenience. In addition, the buyer benefits from

outsourcing its own payables management (e.g. the buyer can send a payment to one lender rather than many small suppliers).

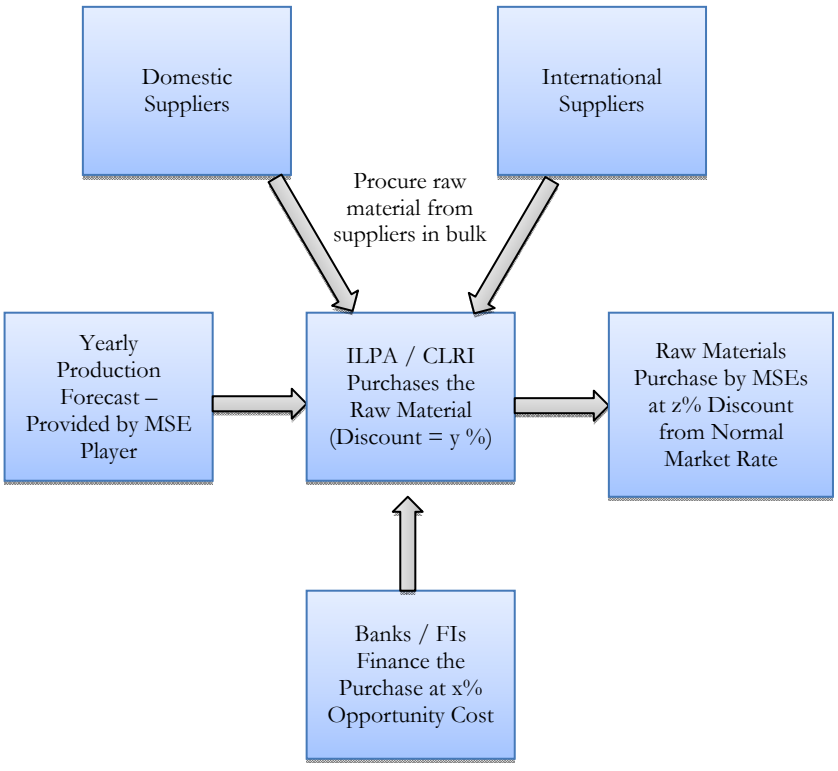
Raw Material Financing assisted by Industry Association

For leather industry the raw material cost consist of nearly 2/3rd of the product cost and hence it is essential for the enterprises to tie-up quality raw material at competitive rates.

One of the interesting ways to tackle the problem of raw material is to set up a raw material bank which will provide access to raw material to the leather units as per their requirement. In this scenario they do not have to buy and store raw material in advance, which typically impacts their cash credit cycle adversely.

In this scenario the industry association such as Indian Leather Products Association (ILPA) or the Central Leather Research Institute (CLRI) could play a larger role as being the implementing partner of the raw material bank. The individual units would provide/share their forecasted demand for raw material, which would be vetted by the association. The representatives of ILPA/CLRI would be better placed in assessing demand since they have a more minute understanding. Based on the total demand, the industry association would procure the raw material with financial institutions financing it. The raw material would serve as collateral and the industry association serving as facilitator / guarantor. The industry association could charge a nominal fee for providing this service.

Also, the quality of raw material available in India is poor and the domestic prices have also been rising steadily. In such a scenario, the raw material bank could look at also look at sourcing quality leather directly from the outside the country. This would not only help providing access to not only cheap but also quality raw material which would enable the manufacturers to convert it into better-quality products and move up the value chain.



For the loan facility to be economically feasible, the basic condition that may have to be checked at the cluster level would be (y%-z% > x %).

Up-scaling of Microfinance to Meet Credit Requirements of Micro enterprises

Microfinance has made significant inroads into West Bengal, which is one of the top 5 states in terms of microfinance clientele. The total number of microfinance clients in West Bengal (Credit Self Help Group (SHG) members and MFI Client put together) stood at roughly 1.1 crore in 2011, next only to Andhra Pradesh and Tamil Nadu. The various microfinance models have been tried, tested and have met with success, creating an overall conducive environment for microfinance. There are roughly 75 lakh credit SHG members in the state. Microfinance loans in West Bengal aggregated to ₹ 3,896 crore in 2011, with average loans outstanding per household standing at ₹ 9,365.

Of the 4000 leather units that form the Kolkata Leather Cluster, over 90% of the enterprises fall in the micro and unorganized category. These units are, typically, involved in tanning or work as sub-contractors to small, medium and large leather goods manufacturers. Most of these units do not even approach the banks for their requirements with the apprehension of excessive documentation, site-audits and inspections etc. There are a number of micro units engaged in production of leather goods and footwear that have working capital needs of less than ₹ 50,000. These units have no access to capital since they neither have any tangible assets which could act as collaterals nor any formal work order and hence banks refuse credit to the cluster.

Up-scaling MFIs would prove to a potent method to handle this issue. MFIs that upscale typically target the lower end of the MSME spectrum that have more features in common with their existing microfinance clients, as reflected by the average loan size of micro firms. For micro firms operating on the verge of informality, up-scaling of micro-finance seems to have great potential. In such cases, up-scaling would comprise offering financial services/products that cater to the special needs of a micro enterprise. The benefits of up-scaling may encourage a transition from an informal to a formal enterprise.

MFI active in and around the Kolkata-Shantiniketan Leather cluster can modify their microfinance business models to incorporate MSME operations by taking advantage of their market knowledge and network, and by adapting their microfinance methodologies.

Refinancing (or on-lending) and other support from development finance institutions, such as SIDBI, would be critical for helping MFIs adapt their current lending practices to serve the new clientele, as well as in building the MFIs' capacity in staff training and information management.

Further, a few issues need to be addressed before up-scaling of MFI can become a sustainable model:

- New Product Development

- Collection Cycle
- Recovery Mechanism
- Capacity Building for MFIs and Borrowers

Typically, MFIs have daily/weekly collection cycle, which calls for modification while serving micro and small manufacturing units. MFIs need to understand the borrower's business and particularly "Asset Conversion Cycle" and revise its credit collection cycle to suit the needs of borrowers and simultaneously ensure profitability of the lending business model. Suitable loan products and associated attributes (interest rate, tenure, and credit amount) need to be developed keeping in mind the nature of borrowers business. This shall be particularly important because the product and its attributes shall govern the efficacy of collections affecting top-line growth. Further, training would be needed both for MFIs and borrowing micro units on the business cycle, lending model, and practices adopted to ensure smooth implementation.

Historically, the MFI lending model had been successful despite the high borrowing rate of MFI from Banks. Companies in this space had built a sound base of foot-workers, creating an effective credit delivery and recovery mechanism and with the help of SHG/JLG model, they could cut down on transaction costs. This was a unique differentiator for MFIs compared to banks that did not have such effective mechanisms for credit delivery and reducing transaction costs. However, MFIs charged very high interest rate and allegedly followed coercive credit collection practices to make the lending model economically sustainable and these cast serious doubts on socially driven objective of MFIs. This has led to widespread criticism from different corners and threatened the very existence of MFIs. What followed was Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010 to regulate MFIs in the state and RBI Committee (Malegam Committee) Report on MFI sector detailing issues, concerns, and recommendations on the prevailing ill-effects of the MFI lending and recovery practices. The committee also reviewed the proposed Micro Finance (Development and Regulation) Bill 2010 and recommended few changes to it along with its own set of recommendations on MFI regulation.

Though, the recent MFI regulation in AP, and the more recent draft bill on MFIDR have put the MFI lending model under a scanner, the potential for such model to work effectively does exist.

Up-scaling MFI Lending – A Success Story under MSME-FDP

Under the GIZ portion of MSME-FDP, an innovative financial product and delivery model for the upstream apparel supply chain had been worked out in association with a Delhi-based MFI named Satin Creditcare Network Ltd (SCNL). SIDBI had sanctioned a line of credit to SCNL for onward lending to the MSEs in the apparel supply chain. Capacity building support involved:

A. Assistance to design and develop a special credit scheme with the following features:

1. Loan ticket size in the range of ₹ 50,000/- to ₹ 2,00,000/-;
2. Loan to be available for investment in machinery or for work capital needs;
3. Repayment period up-to 2 years;
4. Repayment in fortnightly/monthly installments instead of daily installments depending on cash flow of the borrower;
5. No collateral security;

B. Assistance in HR development for appraising and risk assessment of credit to MEs

C. Interactive sessions were held with apparel supply chain MEs to understand their needs followed by sensitization workshops to motivate them to borrow from SCNL. They were given an orientation course in accounting, finance, quality improvement and marketing after working hours.

The results of pilot intervention (started in late 2008) are as under:

1. SCNL granted loans to 60 MEs. Each ME, on an average, employed 40 workers and therefore this intervention impacted the lives of around 2400 families and around 12000 people at pilot stage
2. The enterprises financed under the scheme have shown much better financial discipline and have been repaying installments in time with no default

Lease Financing

A large proportion of tanneries in the cluster are using traditional forms of technology and are now looking at investing in plant and machinery as well as ETP's. Product manufacturing companies are also looking at investing in new machinery to improve their productivity and quality of merchandise.

The Government of India is running multiple schemes, where in a certain percentage of the equipment cost for technology up-gradation or setting up of an Effluent Treatment Plant is provided as subsidy. In some cases the units are found ineligible for the government grant.

In such cases, the formal financial institutions can help these units by financing their equipment purchase under lease financing. Based on promoter's record, the business's future potential in addition to unit's proven track record, banks can do lease financing for the acquisition of plant, machinery and the equipments for these units.

The typical term for the lease would be 3-5 years. The units would pay rentals to the bank for the period till when they have successfully repaid the cost of the equipment. The banks could also charge a processing fee and a lease management fee for the same.

The major advantage of lease financing is that it enables the lessee (manufacturing unit) to plan its cash flows properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.

Annexure I Estimation Method for Credit Supply

ESTIMATION OF CREDIT SUPPLY TO THE KOLKATA LEATHER CLUSTER			
	Item	**Mar, 2011 Estimate**	**Remarks/Assumptions**
1	Estimated West Bengal leather Industry Advances Outstanding - March, 2011 (₹ crore, Projected at an expected annual growth rate of 12%)	1,010	Expected growth rate is estimated from State Level Advances (SLA) growth Rate using SLA figures ending Mar, 2010 & Mar, 2011) Source - Table 4.9- Annual-Basic Statistical Returns of SCB, Mar '2010 Source - Statement 9: RBI Quarterly-Basic Statistical Returns of SCB, Mar '2011
2	Estimated West Bengal Leather Industry Turnover - Mar, 2011 (₹ crore, Projected at an expected annual growth rate of 10% and 11% for Year 2009-10 and 2010-11)	4,370	Expected growth rate is estimated from National IIP growth rates Source - Table 3 - ASI, Government of India, MOSPI, 2009 Source - Latest National IIP figures – Statement II in "MOSPI Press Release on IIP Estimates", Aug 2011
3	Cluster Sample Turnover (MSEs), Sample Size - 46 units in MSEs Sector (₹ crore)	136	D&B India Survey
4	Total Number of MSE units (4,023) in Kolkata Leather Cluster		From Kolkata Leather Cluster Diagnostic Study (DS) Report
5	Estimated the Cluster Total Turnover (MSEs, ₹ crore) using (3) & (4) for year ending Mar, 2011	2,876	
6	Estimated Proportion (P1) of Cluster Turnover to State Industry Turnover using (2) and (5) [P1 = (5) / (2)]	65.8%	
7	Estimated the Cluster Level Credit Supply [(1) * (6)] - ₹ crore	596	
8	State Level Advances – Term Loan Advance (Small Enterprise - SE) to Total Advance (SE) Proportion (P2)	8%	Estimation based on RBI's Statistical Returns-SCB Source - Table 6.1, Statistical Tables Relating to Banks in India, 2009-10
9	Using (7) and (8) Working Capital Supply is [(1-P2)*(7)].	548	
10	Using (7) and (8) Term Credit Supply is [(P2)*(7)].	47	

Annexure II Estimation Method for Credit Demand

ESTIMATION OF CREDIT DEMAND IN THE KOLKATA LEATHER CLUSTER					
	Method		**Item**	**Mar, 2012 Estimate**	**Remarks/Assumptions**
	Nayak Committee Approach - Working Capital	1	Cluster Sample Turnover (MSEs), Sample Size - 46 units in MSEs Sector		D&B India Survey
		2	Total Number of MSE units (4,023)		Kolkata Leather Cluster Diagnostic Report
		3	Estimated the Cluster Sample Total Turnover (MSEs, ₹ crore) for year ending Mar, 2011	43	D&B India Survey
		4	Estimated the Cluster Total Turnover (MSEs, ₹ crore) - Mar, 2012, Expected growth rate of 6.4%	3,060	Expected growth rate is estimated from National IIP growth rates Source- Latest National IIP figures – Statement II in "MOSPI Press Release on IIP Estimates", Aug, 2011
		5	Basis Nayak Committee Guidelines, Working Capital Funding Requirement is 20% of Projected Turnover calculated in (3)	612	
	D&B India Approach - Term Capital	6	Cluster Sample "Investments in Plant & Machinery", Sample Size - 46 in MSE Sector (₹ crore)	30	D&B India Survey
		7	Total Number of MSE Units (4,023)		Kolkata Leather Cluster Diagnostic Report
		8	Estimated the Cluster Total "Investments in Plant & Machinery" (MSEs, ₹ crore) using (1) & (2) for year ending Mar, 2011	874	
		9	Value in (8) projected to Mar, 2012 level using moving average growth rate of fixed capital for Industry-state wise (15%)	1,005	Source - Annual Survey of Industries (ASI) estimates on Fixed Capital for different industries within a state – MOSPI ASI Report, 2009-10
		10	(9) - (8) gives the growth in fixed capital	131	
		11	80% of (10) is estimated to be Term Credit Funding Requirement	105	
	Total Credit Demand	12	Total Credit Demand [612 + 105] calculated above in [(5) and (11)]	717	

Chennai Leather Cluster

Overview

Tamil Nadu is one of the largest contributors to the Indian leather industry contributing nearly 60% of the output. Of this the Chennai cluster accounts for 25% of the state's production and 15% of national output. United Nations Industrial Development Organization (UNIDO) in its Industrial Development Report 2009 identified the Chennai leather cluster as one of the 10 most dynamic industrial locations in the world.

Most of the firms in this cluster have graduated slowly from trading & exporting raw hides & skin, subsequently moved up the value chain trading semi – finished leather and finally on to product manufacturing over the period of the century.

The leather and leather products cluster of Chennai is closely integrated with global value-chains due to convenient access to large raw material, tannery base and port facilities. The Chennai cluster is estimated to contribute over ₹ 1, 000 crore in terms of leather exports. The major export clienteles include orders from all the sophisticated world market including Germany, France, Italy, Spain, UK etc. The cluster is estimated to have about 1140 units in the micro and small segment and about 60 units in medium sector.

The following exhibit summarizes the information about the leather cluster,

Exhibit 12: Chennai Cluster Information

Particular	No. of Units	Employment (nos.)
Finished Leather (Tannery)	150	15,000
Product Manufacturer	300	25,000
Goods & Components (Micro Units)	700	
Large Integrated Units	4	

Source: Diagnostic Study Report on Chennai Leather Cluster prepared by Entrepreneurship Development Institute of India (EDI)

The turnover generated by the MSE units in the cluster, based on D&B India survey estimates, amounts to ₹ 3,060 crore.

Since the leather industry in Tamil Nadu generates sizeable turnover and provides employment opportunities to lot of people directly and indirectly, the State Government and various Government of India ministries in collaboration with multilateral aid agencies such as United Nations Development Program (UNDP), United Nations Industrial Development Organization (UNIDO), Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) from time to time launch various projects for upliftment of units and workers engaged in these enterprises.

One of the biggest government initiatives has been the Integrated Development of Leather Sector (IDLS) scheme. The scheme is aimed at enabling existing tanneries, footwear, footwear components and leather products units to upgrade leading to productivity gains, right-sizing of capacity, cost cutting, design and development simultaneously encouraging entrepreneurs to diversify and set up new units. The financial assistance under the scheme is an investment grant to the extent of 30% of cost of plant and machinery for MSEs and 20% of cost of plant and machinery for other units (i.e. non small scale units) subject to ceiling of ₹50 lakh for technology up gradation /modernization and/or expansion and setting up a new unit. The rate of assistance is @ 20% for all units (both MSEs and Non-MSEs) above ₹ 50 lakh subject to ceiling of ₹ 2 crore.

Also, obtaining bank loan without collateral has been one of the main problems of small entrepreneurs. Besides, banks find lending to small enterprises as risky proposition. To take care of this problem, the Credit Guarantee Fund Trust Scheme for Micro and Small Enterprises (CGTMSE) was introduced by the Government (Ministry of Small Scale Industries) in May 2000 with the objective of making available credit to small scale industrial units, particularly micro units (with investment in plant and machinery less than ₹ 25 lakh) for loans up to ₹ 10 lakh without collateral/ third party guarantees. The scheme is being operated through the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) set up jointly by the Government of India and the Small Industries Development Bank of India (SIDBI). The loan limit under the scheme, which was ₹ 10 lakh per borrower, has since been enhanced to ₹ 25 lakh per borrower.

The MSME Development Institute and SIDBI have been raising awareness among manufacturers and financial institutions alike about these programs (IDLS & CGTMSE) in the Chennai leather cluster. But during our interactions with various stakeholders, we have found out that the financial institutions especially banks are forthcoming to extend support to the micro and small units.

Sources of Demand for Credit

Procurement and Primary Processing

The tanneries source raw hides from hide merchants/ commission agents and slaughter houses located in and around the cluster.

The slaughter houses supplying raw hides lack proper modern infrastructure for collection of dead animals. Thus there is significant wastage in finished leather because of damages caused by rough handling at the slaughter houses. The tanneries generally get 1 months credit from their suppliers.

Raw Material Procurement

Most of the times the micro and small enterprises need to buy raw material either by paying cash or they get a credit period of at most 15-30 days. The raw material costs consist of 60-70% of the product cost. Further, the entire cash realization cycle for the enterprises ranges from 3-6 months for units with foreign clients. This leads to an increased need for working capital.

Nature of Technology Used

Environment is a major concern for the tanning industry as lots of chemicals are used in the tanning process. On top of that the tannery sector is still predominantly dependent on traditional technology for the tanning process. The effluent that is released from the traditional tanning process contains high chrome content and other harmful chemicals. Central Leather Research Institute (CLRI) has developed several cleaner processing technologies but the adoption rate for these is very low among the tanneries. There is urgent need to train tannery staff and owners about clean process technologies which would reduce their effluent discharge, energy and water consumption. In addition there is a lack of knowledge about the initial pretreatment processes that need to be carried out on the effluent before releasing it to the Common Effluent Treatment Plant (CETP).

Even among the manufacturing/production units in the Chennai cluster, the adoption rate of modern technological tools is minimum and most of the units are using dated technology and now need to make upgrade their technology in order to remain competitive in the market.

Progress on adoption of energy efficiency, water conservation and cleaner production fronts has been made under the SIDBI-implemented MSME-FDP in recent years.

Sales Linkages

Forward linked firms include domestic market traders, merchant exporters/importing agents. Increasingly many MSMEs and practically all large firms do not make use of this channel and directly

export to their international clients. In such a scenario, these units need to invest a lot towards building direct sales linkages with their international clients which requires a lot of capital.

The smaller product manufacturers largely cater to the domestic market through traders while the bigger ones employ all three channels – some directly exporting, some indirectly through agents and others catering to the domestic market through traders.

Quality Management

A significant proportion of micro and small enterprises employ only **sensory quality checking** for their products. However the awareness level about European CE and other **standard quality norms** is quite good among the medium enterprises. Also, while all the medium entrepreneurs are aware of the need for using pre certified / tested raw materials, there is a gap in awareness among the micro and small units.

The Chennai leather cluster is mainly an export hub with significant number of units in the cluster directly involved in exports. These units are becoming aware of these norms such as REACH, ISO etc. and are now looking at investing at aggressively looking at adopting technology, since a large majority of international buyers insist that the production units should comply with the same certifications.

Financial Mismanagement

In the Chennai Leather cluster sub-contracting is quite higher, with most of the medium and even some small units are sub-contracting their work to other micro and small enterprises. Most of the firms in this cluster do not maintain proper books of accounts and state lower turnover in their books. This is done in order to save tax for the sub-contractor as well as the sub-contractee. The low turnover thus leads to lower working capital sanctions.

Supply of Credit to MSEs

Estimate of Outstanding Credit to MSEs in the Leather Cluster

The credit supply to the Chennai Leather cluster is estimated to be ₹ 588 crore out of which ₹ 135 crore (23%) is term credit and ₹ 453 crore (77%) is working capital supply.

Enterprise turnover is one of the important criteria for loan appraisal process and it can be safely assumed that credit supply to the cluster is correlated to the turnover generated. Thus, D&B India proposes to use the "Cluster Turnover proportion to Industry State Turnover" method to arrive at cluster level credit supply.

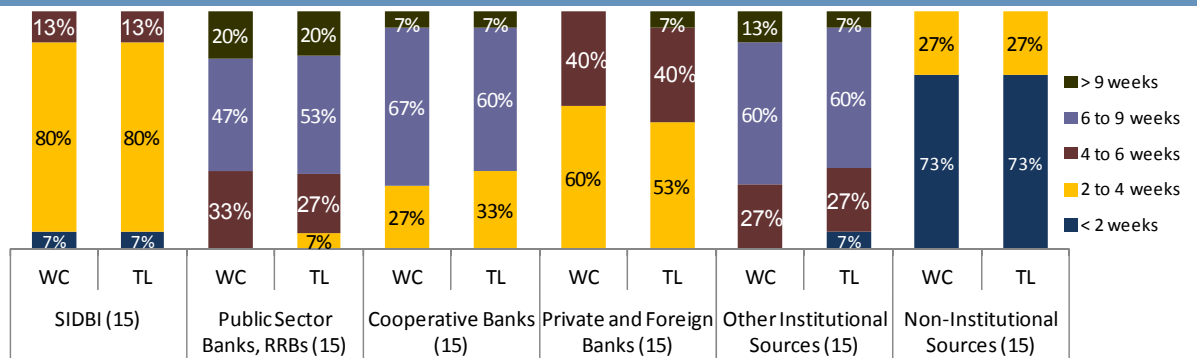
The steps for computation under the identified Methodology are detailed Annexure I.

For the Chennai district the lead bank scheme of Reserve Bank of India is not implemented and hence there is no segregated information being maintained by banks.

37 MSMEs were interviewed on the overall perception of their association with various institutional (including SIDBI) and non-institutional sources w.r.t to time taken for loan disbursement and collateral requirement.

The following exhibit depicts perception among respondents of time taken for loan processing and disbursement by various financial sources,

Exhibit 13: Perception of Time Taken for Loan Processing and Disbursement



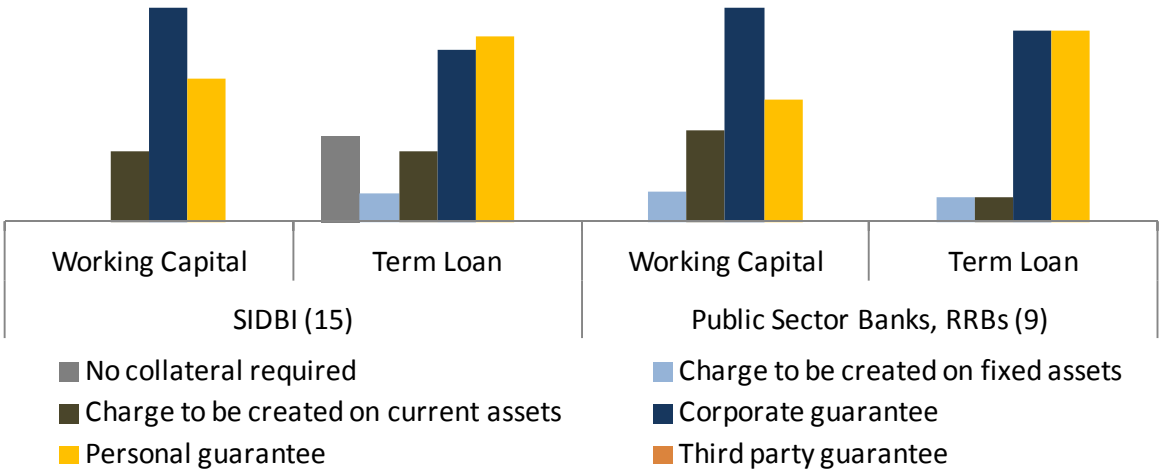
Source: D&B India
Note: Figures in brackets show total number of respondents for each financial source

SIDBI is predominantly perceived to process and disburse loans within 4 weeks, and a smaller proportion of respondents believe that it may up to 6 weeks. Private and Foreign Banks are also believed to disburse loans within 6 weeks. The perception associated with Public Sector Banks is that they may take longer than SIDBI and Private and Foreign Banks – up to 9 weeks. Non-institutional

sources of finance are believed to be the fastest in terms of loan disbursal, with over 70% of the respondents saying that funds are made available within 2 weeks' time.

The following exhibit shows the nature of collateral requirements across various financial sources.

Exhibit 14: Nature of Collateral Requirements



Source: D&B India
Note: Figures in brackets show total number of respondents for each financial source

A majority of the respondents in the cluster claimed that they are asked for corporate and personal guarantees for loans. A relatively smaller proportion is also asked for a charge on fixed and current assets. The proportion of such respondents is similar for SIDBI customers as it is for other public sector banks and RRBs.

Demand for Credit by MSEs

Estimate of Credit Demand by MSEs in the Leather Cluster

There are two methods that D&B India has followed to arrive at Total Credit Demand at cluster level, as mentioned in the methodology section. The methods involved are:

Nayak Committee-D&B India Approach

a. Working Capital Demand - Turnover Based Approach (Basis – Nayak Committee Guidelines)

b. Term Capital Demand - D&B India Approach (Basis – Growth in Fixed Capital)

Below are the highlights of the credit demand estimates in the cluster:

- Total number of Micro and Small units in the cluster is 1,140
- The turnover for the Chennai Leather MSE cluster is pegged at ₹ 3,060 crore during 2010-11 from the D&B India survey at cluster level
- The turnover is estimated to rise by an annual average growth rate of 6.4% (IIP estimate) to ₹ 3,256 crore in the year 2011-12
- Working Capital Requirement (Basis-Nayak Committee Guidelines) is estimated to be ₹ 651 crore
- Term Credit Requirement (Basis-Growth in Fixed Capital) is estimated to be ₹ 211 crore
- Total Credit Demand is thus obtained from above [(651) + (211)] and is ₹ 862 crore

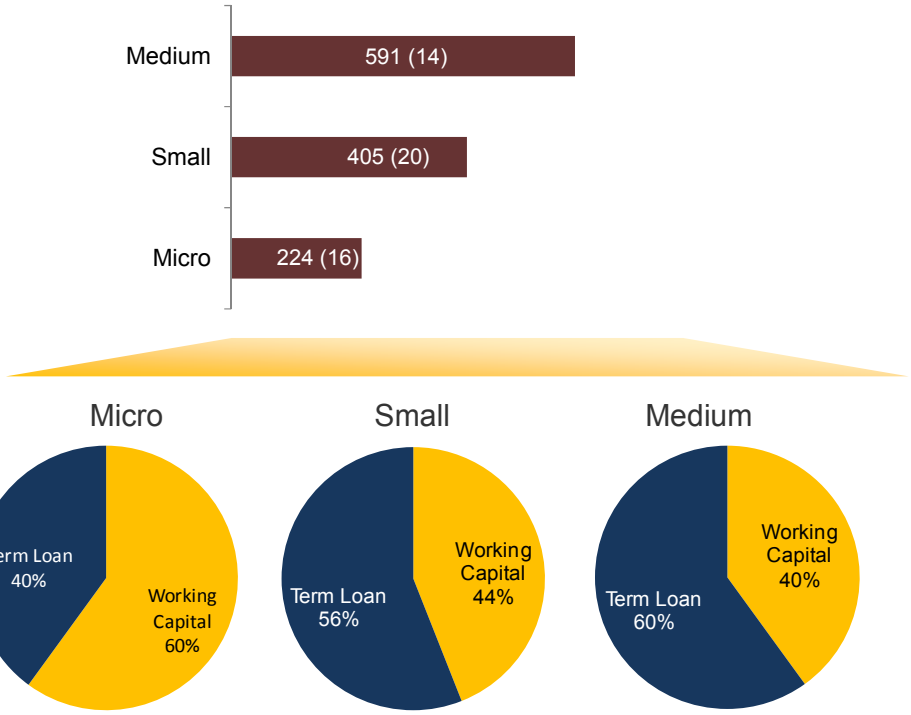
Most banks have indicated that for appraisals of working capital loan requirements, Nayak Committee Recommendations are being followed. The equity margin expected from promoters as per the recommendations is 20% of the working capital loan. In Chennai's case it was observed from the survey that the equity contribution varies from 28% for medium enterprises, to 33% for small enterprises and is the highest for micro enterprises at 40%.

The primary reason for a higher margin contribution demand from banks is because micro enterprises are not able to provide adequate collaterals to support their financing needs. Secondly, the nature of the product is seasonal and also faces risks of effluent treatment, animal skins etc. and

continuous agitations related to the same. Also, innovative and competitive products are available in the country at cheaper costs thereby making the units in the cluster less competitive.

The following exhibit shows the composition of credit among the 37 respondents from the leather clusters that were interviewed in the survey. While 43% of the total respondents were micro enterprises, 37% were small and 20% were medium enterprises. Major demand among micro units is for working capital loans, and among small and medium units is for term loans.

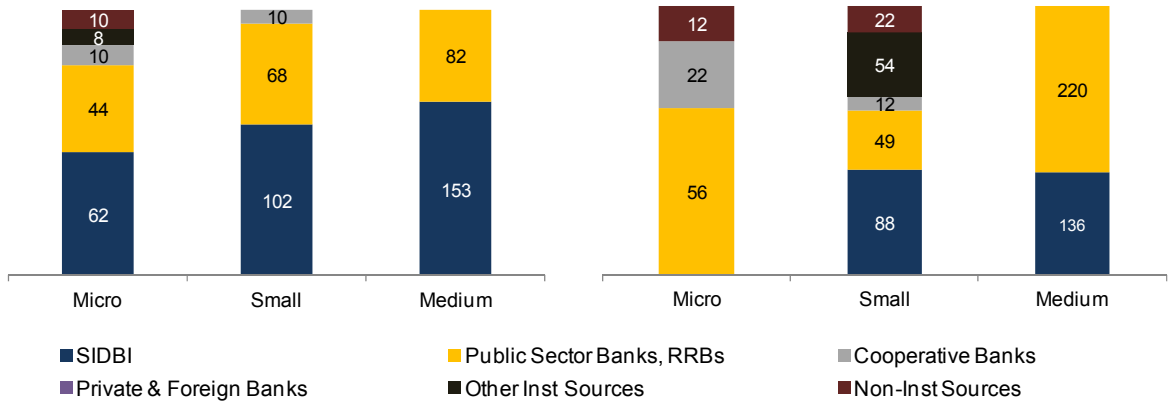
Exhibit 15: Break-up of Credit



Source: D&B India **(Amount in ₹ Lakh; number of respondents in parentheses)**

The following exhibit shows composition of working capital and terms loans for the 37 respondents by sources of finance, separately for Micro, Small and Medium enterprises. In case of working capital, SIDBI and Public Sector Banks come out to be the major sources of finance for all enterprises. In case of term loans, while micro firms largely avail the facility from Public Sector Banks and Cooperative Banks, small and medium firms avail the facility largely from SIDBI and Public Sector Banks.

Exhibit 16: Sources of Finance (Amount in ₹ Lakh)



Source: D&B India

A higher requirement for working capital is observed in Chennai. The following can be summarized as major reasons for the same:

- Most of the times, the manufacturers need to pay cash or at most get 15-30 days credit. Raw materials constitute 60-70% of the product cost.
- Relatively riskier are the tanneries while the leather industries are facing issues of effluent treatment and hence, the risk perception of bankers' for this cluster is higher.
- Most of the enterprises have well-established backward linkages, however, the forward linkages depend largely on buyer-seller meets and hence, the sales realization is delayed

From the various methods employed and explained before, the demand and supply side estimations of the cluster have been provided in the next section.

Credit Gap in the MSE Segment

For the current study, D&B India considered the credit supply data of only scheduled commercial banks that form the major source of credit supply. The table below contains the estimated Credit Gap in the cluster on the basis of the two methods.

Method	Total Gap	Credit Supply	Total Credit Demand	Working Capital Demand	Term Capital Demand
Nayak Committee-D&B India Method (In ₹ crore)	**274**	588	862	651	211

Summary of Credit Gap Assessment

The working capital need among the micro and small units in the Chennai Leather cluster is higher as compared to term credit need, which also translates into a significant gap in working capital credit. D&B India has, through its primary & secondary research, identified possible reasons for why the credit demand is not being met, despite the fact that there are ample financial institutions in the district. A summary of the findings are mentioned below:

- The working capital need is higher because of most of units have to buy raw material on very less or almost no credit, whereas they have to further extend credit period of up to 3-6 months. Since raw material consist of 60-70% of their product costs, this leads to an increased need for working capital
- Since the extent of sub-contracting is higher, the firms do not tend to maintain proper books of accounts; neither do the small enterprises encourage the micro supplier to do so. This is largely done to save tax of the parties, the sub-contractor as well as the sub-contractee. At times, the size of the order book or the total stated turnover is lower which leads to lower working capital sanctions
- The cluster is considered as a high-risk cluster by the bankers mainly because most of the units are still using traditional techniques of production. This has made the cluster units uncompetitive when compared to the technology driven enterprises producing similar products using better technology in other parts of the country
- Lastly, the extent of manufacturing and engineering activity in Chennai is relatively higher thereby most of the focus of the banking credit is directed towards these activities
- Some of the micro and small players also in need of term loans for technology up gradation

Additionally, quality of credit received by various enterprises can be judged from three factors viz., time taken for loan processing, loan interest rate, and adequacy of credit. Qualitative interactions have indicated that private sector banks and certain cooperative banks require lower time for processing. The extent of NBFC based financing is also larger in Chennai, typically led by loans backed by gold (personal collaterals). It can be clearly concluded that enterprises tend to borrow from the private banks or other institutional sources mainly because of shorter processing time taken by these institutions.

The adequacy of credit can also be judged by the extent of equity margin contribution that the enterprises need to bring in for availing the loans, which in Chennai's case is high and ranges between 28-40% for micro and small enterprises.

Chennai leather cluster is one of the leading leather clusters in India and is growing at 10-15% yoy, but the entrepreneurs in this cluster feel that if get proper support from financial institutions in form of working capital and term loans, they could grow at a much faster rate.

A Note on BDS Programmes Implemented under MSME-FDP in Chennai Leather Cluster

The MSME-FDP, as a first step, introduced multipronged measures to control input and manufacturing cost:

- Introduction of energy efficiency methods: Energy efficiency measures were implemented in 15MSMEs had resulted in saving of energy to the tune of 15 to 20% (₹ 20.25 lakh in value) per year
- Methods to obtain raw materials at the lowest cost: Common bulk purchase of dyes and chemicals through SPV at ₹ 260/kg as against ₹ 400/kg has registered 30% gain in material procurement
- Introduction of lean manufacturing methods: Implementation of Lean Manufacturing in 4 units resulted in increase in production of about 50% to 75%, Improved machinery utilization by 50%; reduction in rework level by 12% to 4% and Overall operation cost reduced about 10% to 5%

Adoption of Cleaner Production Technology in 2 tanneries resulted in saving in water by 20% valued at ₹ 1.12 lakh/year/unit, recovery and re-use of chemicals leading to a saving of ₹ 14.40 lakh/year/unit apart from reduction in effluent discharge.

Simultaneously the Project focused in introducing SA 8000 certification among 11 MSMEs. This is to achieve the commitment of employer to social accountability, increased productivity and reduced absenteeism, response from workforce increased and Increase in safety consciousness.

The use of MIS has also been introduced to MSMEs to ensure scientific and sustained control of business parameters leading to cost control and efficiency. Training was given on latest TALLY version.

The third area of focus of the project has been in setting up three specialized SPVs/agencies to ensure sustainability of the actions demonstrated by this Project. A SPV, PTCCPL, was formed for procurement of dyes and chemicals. A New Association AFCAMMI formed for components and accessories to bridge the missing gap. Energy efficiency cell was established at BMO (PTIETC) to carry out Energy Audit to 167 tanners.

The Fourth area of focus has been to help MSMEs get a larger market share by having their own websites. Over 50 MSMEs are using this facility without project support.

The project impact is demonstrated by the fact that, 22 MSME registered a turnover of more than ₹ 20 crore in 2010-11 as against just 8 units 2008-09. Similarly 20 units showed a turnover of ₹ 3 to 5 crore in 2010-11, compared to only 11 units in 2008-09.

The MSME classified based on the export performance during 2008-09 to 2010-11 indicate that 22 units have registered more than ₹ 20 crore worth of export in 2010-11 as against just 7 in 2008-09. In the same way 13 MSME did exports of more than ₹ 5 crore in 2010-11 compared to 8 units in 2008-09. This trend has clearly demonstrated that the MSME are in the process of enhancing their exports year after year.

The sustainability of the Project initiatives is ensured as by the end of the project 2010-11, 90% of the MSME have appreciated the utility of BDS Programme and remaining are in the process of utilizing the BDS Programme.

The project had a direct impact on poverty alleviation as 20% of the participants of the training programs were from the lower income group. This skill development training improved their employability as well as wage earning capacity. This sector employs persons below poverty line and the average employment per MSME which was 130 in 2009-10 and has increased to 137 in 2010-11. In case of men, the percentage increase is 4% over the two years as against 6% for women.

Recommended Products and Delivery Channels

The Chennai leather cluster, which is also a major export hub, currently consists of 1140 micro and small units besides some medium and large units.

Requirement of Capital

The units in the Chennai leather cluster have a greater need of working capital financing as compared to term loan financing. The specific need of capital arises out of the following-

- Raw material procurement for manufacturers
- Technology up gradation
- Complying with certifications (such as REACH, ISO)
- Investments on marketing and development services

Since the raw material (leather) cost consists of nearly 60% of the total product cost, the majority of the units tend to buy raw material in bulk based on their demand so as to get competitive prices for the same. Also, due to ages old flaying, curing, storing and handling practices, a significant portion of the hides and skins become low grade by the time they reach the tanneries. Since high quality of leather is required for manufacture of products for export the units are looking at importing leather. The raw material is procured by traders who further sell it in the Indian market. This presents an opportunity, whereby industry associations can get together and procure raw material from abroad as well as domestically leading to cheaper raw material costs to the units.

Most of the units, tanneries as well as manufacturing units, currently are using dated/traditional technology. To comply with the government and client dictates (Effluent Treatment Plant) and to remain competitive (as compared to other international players) the units are now investing in technology.

The Chennai leather cluster is an export hub of leather goods and a big chunk of units in the cluster are producing for international markets either directly or indirectly. Most of these units need to comply with a host of certifications such as REACH, ISO etc. as the clients insist on the same. So the manufacturing units need to continuously keep upgrading their process to comply with the certifications.

The small scale players who are looking at working independently and sell in export markets need spend a significant amount of money on marketing and development services so as to build permanent sales linkages.

Most of the units have already leveraged their fixed assets previously and hence find it difficult to arrange for collateral for the loans. For working capital finance, the banks can look at look at developing a product based on their current assets (inventory of raw material & finished products) to better suit the needs of the units in the cluster.

Similarly, the units that comply with the quality certifications need to continuously update their process which also requires investment on part of the units. The banks could come up with loan product where the units could get a loan preapproved from the bank and avail of the loan in small chunks through the year. This would serve the needs of the units arising out of adhering to quality standards and expenses made towards marketing and development services.

Working of Government Schemes

The Leather Industry in India was for long time reserved for small scale sector, due to which the level of investment in the leather sector has been very low. This has resulted in smaller production base and poor productivity. Given the significance of the leather industry to the overall health of the Indian economy and its employment potential, the Government of India introduced special schemes such as the Integrated Development of Leather Sector (IDLS) scheme to help the Indian leather industry and improve its competitiveness in the global market. Besides IDLS, the units can also avail collateral free loan under the Credit Guarantee Trust Scheme for Micro and Small enterprises (CGTMSE).

Integrated Development of Leather Sector (IDLS)

The present scheme is aimed at enabling existing tanneries, footwear, footwear components, and leather products units to upgrade leading to productivity gains, right-sizing of capacity, cost cutting, design and development simultaneously encouraging entrepreneurs to diversify and set up new units.

The financial assistance under the scheme is an investment grant to the extent of 30% of cost of plant and machinery for MSEs subject to ceiling of ₹ 50 lakh for technology up gradation /modernization and/or expansion and setting up a new unit.

After speaking to various stakeholders, from representative of PIU's such as CLRI to units ultimately benefiting from the scheme, it can be safely said that the IDLS scheme has been very well accepted by the enterprises, though it must be said that much more awareness needs to be raised about the

scheme among the micro units. The benefit under the scheme is that a unit with multiple product lines can take subsidy for all the product lines separately.

One of the problems which units face with the IDLS scheme is that the units have to arrange for the margin money upfront for any equipment purchases since the money is disbursed by SIDBI only once the equipment is installed in the unit, which at times adversely impact the short term financing of the units. This represents a product opportunity for banks to provide for a short term loan around the margin money.

Based on the feedback received from units and the feedback received by CLRI on the scheme, it can be said that the units want the IDLS scheme to be extended beyond the current scheme period which expires on March 2012.

Credit Guarantee Trust Scheme for Micro & Small Enterprises (CGTMSE)

The Credit Guarantee Fund Trust Scheme for small industries was introduced by the Government in May 2000 with the objective of making available credit to small scale industrial units, particularly micro units (with investment in plant and machinery less than ₹ 25 lakh) for loans up to ₹ 25 lakh without collateral/ third party guarantees.

The banks, with their focus on profit maximization and risk mitigation, have been cagey while distributing funds under this scheme and have distributed funds to projects after carrying out a detailed evaluation taking into consideration factors such as viability of the project, promoters record, their payback capability etc. The banks insist that since CGTMSE scheme is an insurance product, it should be used in contingency situations.

Also, the banks charge a one-time fee (1.5% of the sanctioned amount) plus a yearly service fee (to the tune of 0.75% of sanctioned amount payable every year till the entire loan amount is paid back). This increases the net effective interest rate for enterprises making it more unattractive for them.

Bills Discounting

The small enterprises in the Chennai leather cluster are making use of bill discounting facility for domestic as well as international trade. In international trade, trade bills drawn under Letters of Credit issued by banks are used to fund the receivables. This bill discounting facility is provided for a period of 3-6 months depending upon the tenor of the bill or Letter of Credit.

Packing Credit

Many small enterprises who are dealing with international clients directly in the Chennai cluster are making use of this product. The units take loan for manufacturing, processing, purchasing or packing of goods meant for export against a firm order or Letter of Credit. There are however some difficulties that these players may face while trying to obtain such facilities from their bankers for several reasons, e.g. the exporter may be relatively new to export business, the extent of facilities needed by him may be out of proportion to the equity of the firms or the value of collateral offered by the exporter may be inadequate.

Descriptions of Products and Delivery Mechanisms

Purchase Order Finance

It has been generally seen that most of the units are over leveraged and do not have any collateral based on which they can take the loan. In this scenario, they can make use of their orders placed by their clients by taking a loan based on the purchase order to address the problem of working capital financing.

Purchase Order Finance (POF) is one such pre-shipment finance product, wherein a manufacturing unit is able to receive working capital funds from its bank based on the order placed by any credit worthy buyer. More importantly, it allows the unit to take on multiple orders and deliver them successfully. The POF mechanism works in the following way:

- The client/customer sends across the purchase order to the manufacturing unit (seller) with all documents
- The seller then submits the purchase order to its bank for POF
- The bank makes a partial advance to the manufacturing unit on the value of the purchase order. The advance is made to the unit or directly to its supplier to cover the costs of materials, trade goods and/or services
- The supplier delivers the materials, goods and/or services to the seller for production of the product or assembly of the trade goods to fill the order
- The manufacturing unit produces or assembles the goods and ships the products to the buyer

- The unit then prepares and submits an invoice for the sale. Depending on the agreement, the invoice will go to the client/buyer or directly to the bank (or factoring company)
- The client pays the invoice according to the payment terms, usually directly to the bank
- When the bank receives payment on the invoice from the client, the bank withholds the amount it advanced to the seller unit as repayment on the POF loan, and also deducts the agreed amount of interest and fees. The balance is then remitted to the seller

The short terms of POF coupled with the transaction specific nature of this type of financing, the high leverage (typically with POF, only 10-40 percent of the total transaction value is advanced), and the resulting diversification of the lending portfolio help lower overall risk and provides greater flexibility. Loans can be structured in a variety of ways including to match payments to the borrower's cash flow cycle.

Raw Material Financing assisted by Industry Association

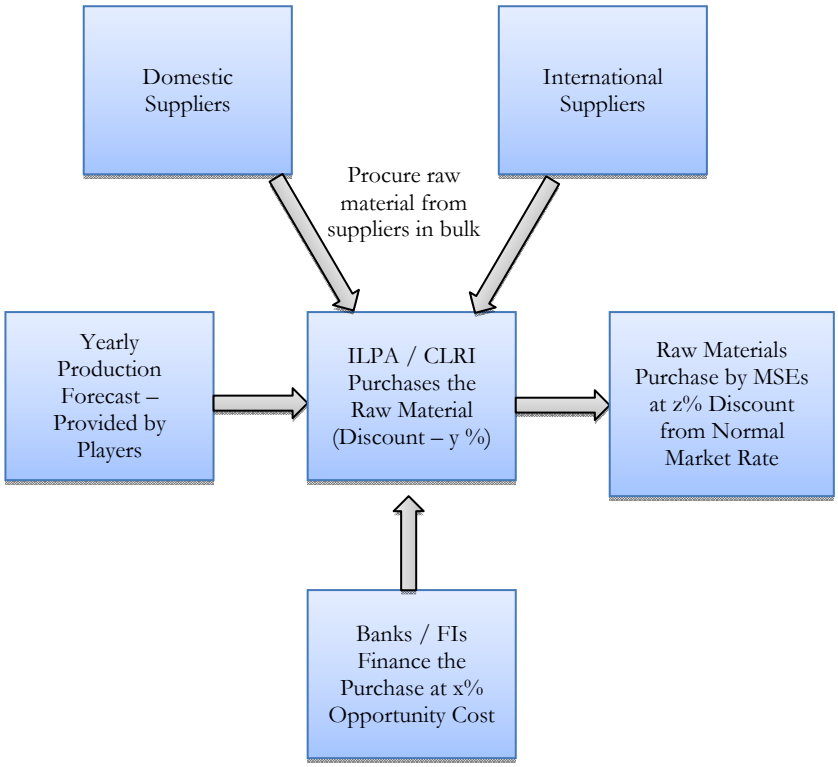
For leather industry the raw material cost consist of nearly 2/3rd of the product cost and hence it is essential for the enterprises to tie-up quality raw material at competitive rates.

One of the interesting ways to tackle the problem of raw material is to set up a raw material bank which will provide access to raw material to the leather units as per their requirement. In this scenario they won't have to buy and store raw material in advance, which typically impacts their cash credit cycle adversely. Bulk purchase has already been successfully tried for dyes and chemicals in the cluster through a SPV (PTCCPL), under the SIDBI-implemented MSME-FDP BDS programmes, as described above.

In this scenario the industry association such as Indian Leather Products Association (ILPA) or the Central Leather Research Institute (CLRI) could play a larger role as being the implementing partner of the raw material bank. The individual units would provide/share their forecasted demand for raw material, which would be vetted by the association. The representatives of ILPA/CLRI would be better placed in assessing demand since they have a more minute understanding. Based on the total demand, the industry association would procure the raw material with financial institutions financing it. The raw material would serve as collateral and the industry association serving as guarantor. The industry association could charge a nominal fee for providing this service.

Also, the quality of raw material available in India is poor and the domestic prices have also been rising steadily. In such a scenario, the raw material bank could look at also look at sourcing quality leather directly from the outside the country. This would not only help providing access to not only

cheap but also quality raw material which would enable the manufacturers to convert it into better-quality products and move up the value chain.



For the loan facility to be economically feasible, the basic condition that may have to be checked at the cluster would be (y%-z% > x %).

Lease Financing

Majority of the units in the cluster are using outdated technology in their tanning as well as manufacturing processes. The units are now looking at upgrading their technology but the major problem facing these units is that of arranging the finance for the same.

The Government of India is running multiple schemes, where in a certain percentage of the equipment cost for technology up-gradation or setting up of an Effluent Treatment Plant is provided as subsidy. In some cases the units are found ineligible for the government grant.

In such cases, the formal financial institutions can help these units by financing their equipment purchase under lease financing. Based on promoter's record, the business's future potential in addition to unit's proven track record, banks can do lease financing for the acquisition of plant, machinery and the equipments for these units.

The typical term for the lease would be 3-5 years. The units would pay rentals to the bank for the period till when they have successfully repaid the cost of the equipment. The banks could also charge

a processing fee and a lease management fee for the same. Till the time the entire amount has been paid back, the equipment/machinery would stand as the primary security. The possession of the equipment will remain with the borrower, while the bank would enjoy the full legal title. The equipment would become the property of the unit as soon as the debt is paid.

The major advantage of lease financing is that it enables the lessee (manufacturing unit) to plan its cash flows properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.

Annexure I Estimation Method for Credit Supply

ESTIMATION OF CREDIT SUPPLY TO THE CHENNAI LEATHER CLUSTER			
	Item	**Mar, 2011 Estimate**	**Remarks/Assumptions**
1	Estimated Tamil Nadu Leather Industry Advances Outstanding - March, 2011 (₹ crore, Projected at an expected annual growth rate of 22%)	2,592	Expected growth rate is estimated from State Level Advances (SLA) growth Rate using SLA figures ending Mar, 2010 & Mar, 2011) Source - Table 4.9- Annual-Basic Statistical Returns of SCB, Mar '2010 Source - Statement 9: RBI Quarterly-Basic Statistical Returns of SCB, Mar '2011
2	Estimated Tamil Nadu Leather Industry Turnover - Mar, 2011 (₹ crore, Projected at an expected annual growth rate of 28% and 18% for Year 2009-10 and 2010-11)	11,078	Expected growth rate is estimated from National IIP growth rates Source - Table 3 - ASI, Government of India, MOSPI, 2009 Source - Latest National IIP figures – Statement II in "MOSPI Press Release on IIP Estimates", Aug 2011
3	Cluster Sample Turnover (MSEs), Sample Size - 37 units in MSEs Sector (₹ crore)	173	D&B India Survey
4	Total Number of MSE units (1,140) in Chennai Leather Cluster		From Chennai Leather Cluster Diagnostic Study (DS) Report
5	Estimated the Cluster Total Turnover (MSEs, ₹ crore) using (3) & (4) for year ending Mar, 2011	3,060	
6	Estimated Proportion (P1) of Cluster Turnover to State Industry Turnover using (2) and (5) [P1 = (5) / (2)]	27.6%	
7	Estimated the Cluster Level Credit Supply [(1) * (6)] – ₹ Crore	588	
8	State Level Advances – Term Loan Advance (Small Enterprise - SE) to Total Advance (SE) Proportion (P2)	23%	Estimation based on RBI's Statistical Returns-SCB Source - Table 6.1, Statistical Tables Relating to Banks in India, 2009-10
9	Using (7) and (8) Working Capital Supply is [(1-P2)*(7)].	453	
10	Using (7) and (8) Term Credit Supply is [(P2)*(7)].	135	

Annexure II Estimation Method for Credit Demand

ESTIMATION OF CREDIT DEMAND IN THE CHENNAI LEATHER CLUSTER					
	Method		**Item**	**Mar, 2012 Estimate**	**Remarks/Assumptions**
	Nayak Committee Approach - Working Capital	1	Cluster Sample Turnover (MSEs), Sample Size - 37 units in MSEs Sector		D&B India Survey
		2	Total Number of MSE units (1,140)		Chennai Leather Cluster Diagnostic Report
		3	Estimated the Cluster Sample Total Turnover (MSEs, ₹ crore) for year ending Mar, 2011	173	D&B India Survey
		4	Estimated the Cluster Total Turnover (MSEs, ₹ crore) - Mar, 2012, Expected growth rate of 6.4%	3,256	Expected growth rate is estimated from National IIP growth rates Source- Latest National IIP figures – Statement II in "MOSPI Press Release on IIP Estimates", Aug, 2011
		5	Basis Nayak Committee Guidelines, Working Capital Funding Requirement is 20% of Projected Turnover calculated in (3)	651	
	D&B India Approach - Term Capital	6	Cluster Sample "Investments in Plant & Machinery", Sample Size – 37 in MSE Sector (₹ crore)	33	D&B India Survey
		7	Total Number of MSE Units (1,140)		Chennai Leather Cluster Diagnostic Report
		8	Estimated the Cluster Total "Investments in Plant & Machinery" (MSEs, ₹ crore) using (1) & (2) for year ending Mar, 2011	607	
		9	Value in (8) projected to Mar, 2012 level using moving average growth rate of fixed capital for Industry-state wise (43%)	872	Source - Annual Survey of Industries (ASI) estimates on Fixed Capital for different industries within a state – MOSPI ASI Report, 2009-10
		10	(9) - (8) gives the growth in fixed capital	264	
		11	80% of (10) is estimated to be Term Credit Funding Requirement	211	
	Total Credit Demand	12	Total Credit Demand [651 + 211] calculated above in [(5) and (11)]	862	

Annexure A.1 Summary: Recommneded Products/Delivery Mechanisms

Scheme, Purpose & Benefits	Implementation Process	Clusters Where Applicable		Pre-requisites
Scheme for Financing of Raw Material Procurement ✓ Raw materials need to be purchased in bulk during certain months of the year ✓ Bulk purchase enables MSEs to benefits from discounted prices	↓Group of banks catering to cluster form a consortium and enter into a common MoU with an implementation agency ↓Forecast of annual production of MSE units and annual raw material requirements to be prepared basis inputs from MSEs, industry associations (say, MCCIA in Pune), large sub-contracting industrial buyers (say, Khadims / Sreeleathers in Kolkata), cluster sector-specific research institutions (say, Central Leather Research Institute – CLRI in Chennai) ↓Implementation agency to procure the raw material with MoU banks / FIs financing the purchase ↓Raw material procured to serve as collateral with implementation agency serving as facilitator / guarantor ↓Implementation agency becomes the primary raw material supplier. Discount obtained by acquiring the raw material in bulk may be passed on to MSEs after deducting fee towards costs of provision of the service by implementation agency	Pune Fruit and Vegetables - Through Agriculture Produce Market Committee		👍Implementation agency should be an existing integral stakeholder in the raw material procurement process or an agency implementing a cluster-specific government scheme 👍Interest charged by the bank for financing will be the predominant cost of service. For the raw material financing scheme to be economically viable, the costs of service must be less than or equal to the difference in procurement price and sale price to MSEs
		Ludhiana Knitwear - Through Knitwear Club / KAMAL / LAKMA		
		Rourkela Engineering - Through Orissa State Industrial Corporation (OSIC)		
		Kolkata Leather	Through Indian Leather Products Association (ILPA) / Central Leather Research Institute	
		Chennai Leather		
Factoring (or reverse factoring) ✓Reliance on CC while there is high proportion of receivables in working capital cycle and sales/cash flows fluctuations, leads to intermittent over / under financing ✓Factoring involves extension of working capital finance on ongoing basis against invoices raised by MSEs on buyers ✓Factoring ensures : • Improved cash flows • Fixed assets freed up for collateralization elsewhere • Benefit of sales ledger management • Ability to extend open account terms • Better receivable days & current ratio	↓'Factor' (bank / FI offering service) obtains control over the sales ledger of the client. In effect, the entire receivables management is taken over by the factor ↓Client make an application to factor with last 3 years' statements Factor conducts the client's appraisal and approves/disapproves ↓Credit line is based on financial strength of borrowing client's debtors, as well as on the borrower's own financial strength ↓Client submits sales ledger of customers to factor Sanction limit is assigned based on the quality of customers ↓Factor sends notification to client buyers. Upon acceptance, a factoring agreement is signed between the client and factor ↓Based on the invoices, factor makes advance prepayments (up to 80% of invoice value) and subsequently manages the client's ledger and sends due reminder to client customers	Rajkot and Coimbatore Engineering Clusters Hyderabad Pharmaceutical Cluster Kolkata Leather Cluster		👍Strong inter-linkages and sub-contracting of manufacturing activities exist 👍Open account sales are preferred between larger buyers and smaller sellers 👍If factors are hesitant to offer services to MSEs (as the case may be for Kolkata Leather and Hyderabad Pharmaceutical clusters), 'Reverse Factoring' can be looked at as an alternative , where banks purchase accounts receivables only from high-quality buyers

Scheme, Purpose & Benefits	Implementation Process	Clusters Where Applicable	Pre-requisites
Pre-approved Collateral-free Equipment Finance Scheme ✓Would enable quick acqusition of critical equipment. MSEs often face situations where suppliers are offering a discount or where the equipment is required for complying with a norm within a deadline ✓Would enable acquisition of a number of small-value equipments through the year. Formal application processes are considered tedious with no certainty of sanction. Hence, either costly unsecured loans are sourced or WC credit is employed	↓A bank / financial institution will enter into an MoU with a local industry association, which is truly representative of the cluster MSMEs ↓The local industry association will be responsible for processing of loan applications, conducting appraisals, recommending limits as per prescribed norms and providing them to banks / financial institutions, as well as verifying the pro-forma invoice, ensuring margin payment, asset value, etc ↓A collateral-free line of credit is sanctioned to enterprises, which can avail this facility any time during the year, either in full or in parts, for purchasing equipment ↓Disbursals can be made within 2-3 days on a pre-approved loan ↓Loans, when availed, can be repaid through PDCs either in the form of EMIs. If required, repayment can be staggered/ ballooned with gestation period	Rajkot and Coimbatore Engineering units - for upgrading technology Hyderabad Pharmaceutical cluster units - implementation of technology-intensive Good Manufacturing Practices (GMP) Ahmadabad Dyes and Chemicals cluster - compliance with state pollution control norms, that involve acquisition of ETPs	👍Industry association should be representative of the cluster with a lerge member base 👍Units should not be spread far and wide, as such an intervention may not be operationally feasible 👍Units should share information on products and processes among themselves
Purchase Order Financing ✓Absence of appropriate collateral common reason for loan applications to be rejected. Many MSEs over leveraged and lack collateral for fresh loans ✓POF is pre-shipment finance that enables an MSE to receive WC funds based on orders placed by their credit worthy buyers ✓Allows seller to receive funds far sooner than if it had to wait for buyer to pay and even sooner than if invoice is discounted ✓POF allows the unit to take on multiple orders and deliver them successfully	↓Buyer send PO to seler and furnishes comfort letter to bank detailing seller information and credibility ↓Seller then submits PO to bank for POF. Bank advance is made to the unit or directly to its supplier to cover the costs of materials, trade goods and/or services ↓Seller produces or assembles the goods and ships the products to the buyer ↓Seller submits invoice directly to bank and buyer pays according to payment terms, usually directly to the bank ↓Bank receives payment from buyer, withholds amount advanced to seller as repayment on POF loan, and also deducts agreed amount of interest and fees. The balance is then remitted to the seller	Rajkot and Coimbatore Engineering Clusters Hyderabad Pharmaceutical Cluster Kolkata Leather Cluster	👍Strong linkages exist between large and established buyers and a host of small and medium enterprises that carry out sub-contracted work 👍Payment discipline on the part of large establsihed buyers

Scheme, Purpose & Benefits	Implementation Process	Clusters Where Applicable	Pre-requisites
Working Capital Term Loan (WCTL) ✓CCs & ODs assist MSMEs through transitory (fluctuating) WC requirements. WCTLs cover core (permanent) part of WC ✓MSMEs possess lower control over WC and lack expertise in managing loan funds intended for meeting WC requirements; hence WCTL as more appropriate	↓If MSMEs extend credit of > 120 days to clients (like in Ludhinana), it ties up the WC finance. In many cases, credit limit set by the banks in the cluster is often insufficient for units to cover their WC expenses ↓Such shortages of credit in the Ludhiana cluster could be provided through a Working Capital Term Loan (WCTL) accounts ↓Although this arrangement is presently applicable to borrowers having working capital requirement of Rs.10 crores or above, this service can extended to small enterprises with needs less than Rs. 10 crores as well	Ludhinana Knitwear Cluster - Orders booked at buyer-seller meets, but payments realized after goods are sold in end-markets	👍Requirement of credit in excess of sanctioned limit, often for seasonal bulk raw material procurement 👍Expenses financed through WCTL should be permannent component of WC and not transitory
Receivables-linked Bridge Financing Scheme ✓Factor inhibiting Bills Discounting is lack of payment discipline amongst buyers. MSEs are often unable to procure future orders ✓Bridge Financing enables temporary loan that maps sales receivables cycle to future order procurement to facilitate continuous operation of MSEs ✓Can be used to maintain liquidity in the scenario of anticipated cash inflows.	↓MSEs deliver the previous order goods to customers ↓Bills Receivables created on the executed order ↓MSEs procures next order ↓FIs finance to MSEs for new order based on Bills Receivables as collateral ↓New order execution starts after bank finance ↓At around the same time, bank may be repaid out a payment received by MSE from an earlier transaction	Small units, such as those in the Rourkela Engineering Cluster, would find this as an effective method for overcoming difficulties with the current bill-discounting schemes	👍Continuity in terms of execution of past orders, receipt of fresh orders and payments on earlier transactions, is a must
Up-scaling of Micro Finance Programs ✓Can prove potent for unorganized micro units that do not approach banks due to required documentation, site-audits and inspections etc. ✓Many do not have any tangible assets which could act as collaterals nor any formal work order and hence banks refuse credit ✓May encourage transition from informal to formal enterprise.	↓MFIs can target lower end of SME spectrum that have features in common with existing clients - Average loan size of micro firms (say ~INR 1.0 L) ↓MFI can modify microfinance business models to incorporate SME operations by taking advantage of their market knowledge and network, and by adapting their microfinance methodologies ↓Reasons for the recent MFI regulation in AP, and draft bill on MFIDR 2011 that have put MFI lending model under scanner to be taken into consideration	Unorganized micro enterprises in the Coimbatore, Rourkela and Kolkata clusters that carry out sub-contracted work for larger enterprises Microfinance has made significant inroads into Tamil Nadu, Orissa and West Bengal.	👍Refinancing / on-lending and other support from DFI, etc crucial for helping MFIs adapt current practices to serve MSEs 👍Following to be addressed: • Development of suitable loan products and attributes • MFI collection cycle and recovery mechanism to adapt to MSEs Asset Conversion Cycle • Capacity Building / Training for MFIs and Borrowers

Annexure A.2 Financial Inclusion Initiatives under MSME-FDP

By achieving integration of BDS market development with 'access to finance' initiatives, a greater multiplier effect can be unleashed. Every cluster has different financial needs and look for customized products and services. The terms and conditions of granting loans need to be suitably amended as well depending on the profile of cluster firms. It is felt that momentum can be rendered to the mission of enabling access to finance by attending to this through BDS approach.

MSME Financing and Development Project

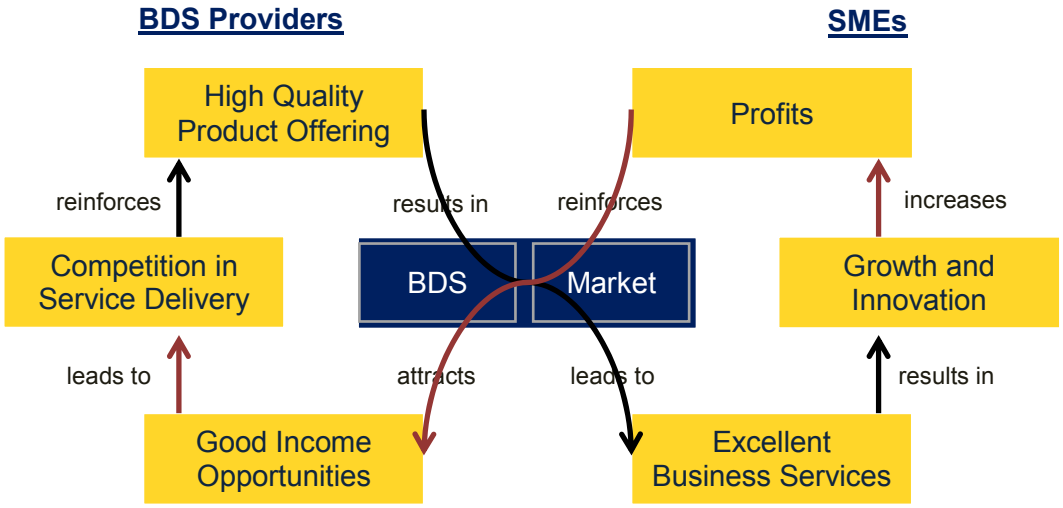
SIDBI is the implementing agency for the MSME Financing and Development Project (MSME-FDP) involving the World Bank, DFID, UK and GIZ, Germany as partners. The project attends to demand and supply side needs of MSMEs through judicious provision of financial and non-financial services. It has reached out to around 1 lakh beneficiaries, which are largely MSMEs & stakeholders.

By fostering Business Development Services (BDS) in 19 clusters, project has given new dimensions to cluster development by acting as market enabler. This systemic change has been brought about by developing sustainable & technically competent - locally relevant experts, 450 BDS providers -both individual/ Institutional which also include BDS Providers(BDSPs) in area of Skill development, Technology, Quality, Marketing, Finance and so on. This has not only enabled national/ international compliances by MSMEs in clusters but also fostered competitiveness by enabling markets to work for MSMEs. Financial BDS have given reference for linkages to Banking fraternity for around ₹ 3.94 billion.

The BDS market development believes in the theory that once BDS are capacitated and are successful in satisfying the appetite of MSMEs, the market rejuvenates. By using services, MSMEs get growth impetus and subsequent profit. They seek more services of BDS and as profitability of service provider goes up, it attracts other players. The market attributes get imbibed in form of a self-sustaining loop (exhibited below – courtesy OTF USA and Cluster Pulse) which brings in innovation, cooperation and competition.

At the very early stage, project realized that the main problem in clusters is not the availability of the finance but the lack of awareness about its availability and how to approach lenders. Project has not only created awareness programme to enhance the knowledge of MSMEs in the area but also hand hold them to get to the finance from various Banks/FIs. A total number of 874 enquiries for ₹ 394

Crore were generated through the programs and an amount of ₹ 242 Crore availed by 412 MSMEs across various clusters.



Project has worked with various models and took various initiatives which have acted as catalysts. Major models which project have adopted are:

- **BDS centric model**

In BDS centric model, individual BDS providers were strengthened to provide better services to cater the customized needs of MSMEs in various clusters. MSMEs were sensitized and grouped together to avail BDS services at affordable prices. Efforts have been made to facilitate their initial transactions through voucher support to showcase the demonstrative effect in the clusters. Later some of the BDS formed consortia have to provide one stop shop services to MSMEs.

- **MFI centric model**

In this model to reach the enterprise at the bottom of pyramid, assistance was provided on pilot basis to a MFI. Besides sanctioning a credit limit, capacity building support in form of handholding support was extended. Project also piloted a downscaling model (doing small loan profitably) by roping in a consultancy agency of international experience. Later it is planned to scale up this model for wide replication.

- **BMO led model**

In this model, BMOs capacity was build and they were promoted as BDSP for financial linkages. This enabled the strengthening of credit delivery channel for the financial linkages with the Bank.

The primary responsibility of due diligence rested with the BMOs which formed a separate SPV to create awareness among MSMEs. Few other bankers have joined the initiative with the BMO. Further this initiative is being replicated by SIDBI at another state also. Few other BMOs have evinced interest to adopt the model.

Along with facilitation of credit in the clusters project has also focused towards Credit Dispensation and Supplementation. For Credit Dispensation, it has channelized over USD 444 mio to 7750 MSMEs through Environment and Social Risk (E&S) aligned facilities for which 140 plus credit officials of 45 branches have been trained. For credit supplementation, it has supported piloting of Risk Sharing Facility (through CGTMSE) which has been institutionalized, setting up of SME commercial Bureau in CIBIL (database has grown from 0.04 mio to 6.4 mio with 0.3 mio reports accessed), SME Rating Agency (emerged sustainable through 14000 plus ratings and launch of Green ratings etc.), and capacity building of strategic institutions in Risk Capital, Technology Access etc.

Annexure A.3 List of Documents Reviewed

1. Survey of Past Committee Reports
   (http://dcmsme.gov.in/publications/comitterep/creport.html)
   - Nayak Committee Report, 1991
   - Abid Committee Report on Small Enterprises, 1997
   - Kapur Committee Report on Credit Flow to SSI Sector, 1998
   - Gupta Committee Report on Development of Small Enterprises, 1999
   - Chakraborty Committee Report on Re-habilitation of Sick SMEs, 2008
2. Report on Prime Minister's Task Force on MSMEs, 2010
   http://msme.gov.in/PM_MSME_Task_Force_Jan2010.pdf
3. Financing of Enterprises in the Unorganized Sector & Creation of a National Fund for the Unorganized Sector (NCEUS, Nov 2007)
   http://msme.gov.in/
4. RBI Guidelines for Priority Sector Lending
5. RBI Annual Publications, Basic Statistical Returns, Quarterly Publications, Branch Banking Statistics
   http://www.rbi.org.in/scripts/publications.aspx
6. RBI – Functions and Working
7. SIDBI Annual Report, 2009-10
   http://www.sidbi.com/notices/SIDBI%20Annual%20Report%202009-10.pdf
8. IDBI Annual Report, 2009-10
   http://www.idbi.com/pdf/AnnualReport_2009-2010.pdf
9. Annual Survey of Industries (ASI), Government of India
   http://mospi.nic.in/mospi_new/upload/asi/ASI_main.htm?status=1&menu_id=88
10. Handbook of Indian Economy Statistics
    http://www.rbi.org.in/scripts/publications.aspx
11. Fourth All India Census of MSMEs, 2006-07
12. State Level Bankers Committee Reports
13. World Bank Report on "Finance For All – Policies and Pitfalls in Expanding Access", 2008
    http://econ.worldbank.org/
    Diagnostic Study Reports for 10 identified clusters (http://www.MSME-FDP.net/Dignostic_Study.aspx)
    - Faridabad Auto Components and Engineering Cluster

- Coimbatore Engineering Cluster
- Rajkot Engineering Cluster
- Rourkela Engineering Cluster
- Ahmedabad Dyes and Chemicals Cluster
- Hyderabad Pharmaceuticals Cluster
- Ludhiana Knitwear Cluster
- Chennai Leather Cluster
- Kolkata Leather Cluster
- Pune Fruits & Vegetable Processing Cluster

14. Report of the Working Group on Discounting of Bills by Banks (1999) http://www.rbi.org.in/scripts/publications.aspx
15. The SME Banking Knowledge Guide, IFC Advisory Services (2009) http://www.ifc.org/ifcext/gfm.nsf/AttachmentsByTitle/SMEBankingGuidebook/$FILE/SMEBankingGuide2009.pdf

Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

MSME Umbrella Programme

B-5/1, Safdarjung Enclave,
New Delhi 110 029, India
T: +91 11 4949 5353
F: +91 11 4949 5391
E: giz-indien@giz.de
I: www.giz.de