MSME: The opportunity knocks
PREFACE

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

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

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

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

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

Sau. Usha Dahapute
Chairperson, Varhad Capital

Prasad Dahapute
Managing Director, Varhad Capital

Sachin Gupta
Director, Varhad Capital

June 2013
ABOUT VARHAD INVESTMENT MANAGERS

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

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

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

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

Prasad Dahapute
Director, Varhad Investment Managers
ABOUT VARHAD CAPITAL

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

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

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

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

Sachin Gupta
Director, Varhad Capital
MSME: The opportunity knocks

ABOUT VARHAD FCS

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

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

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

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

Sau. Usha Dahapute
Director, Varhad FCS
FOREWORD BY DICCI

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

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

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

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

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

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

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

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

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

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

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

20% GDP contribution by MSME by FY20

INR 28 tn PPP opportunity in FY20

INR 17 tn incremental SME opportunity over FY14-20

INR 3.4 tn incremental SC/ST SME opportunity over FY14-20

INR 10 tn incremental investment in fixed asset required over FY14-20

INR 3 tn incremental working capital required over FY14-20

140 m incremental employment creation over FY14-20

2x spurt in employee productivity
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EXECUTIVE SUMMARY

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

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

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

We have developed proprietary models to assess the opportunity and expect the public procurement in India through MSMEs to reach INR33tn in FY20. Incremental cumulative opportunity for MSMEs should be INR17tn during FY14-20, of which, a cumulative opportunity worth INR3.4tn would be earmarked for SC/ST owned SMEs. The implementation of the PPP policy would also trigger an incremental fixed asset requirement of INR10tn and working capital needs of INR3tn for MSMEs.
MSME Definition in India
According to the MSME Act, 2006, an SME is an entity engaged in the production of goods and services involving an investment of above INR1m but below INR100m.

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

Source: Dept of MSME, Govt. of India

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

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

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

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

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

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

<table>
<thead>
<tr>
<th>Country</th>
<th>PPP policy for SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>India</strong></td>
<td>In 2009, only 5% of the Central Government and PSUs procurement came from SMEs. However, with the PPP bill 2012, 20% is set aside for MSMEs (4% from SC/ST) to be achieved in 3 years.</td>
</tr>
<tr>
<td><strong>Australia</strong></td>
<td>The government is committed to source at least 20% of its purchases by value from SMEs.</td>
</tr>
<tr>
<td><strong>Brazil</strong></td>
<td>The state buys from SMEs while simultaneously providing technical assistance to businesses involved in procurement.</td>
</tr>
<tr>
<td><strong>EU</strong></td>
<td>The EU has no regulation related to setting aside procurement from SMEs. However, in France and Germany, procurement from SMEs ranges from 15%-25% through the active support policy.</td>
</tr>
<tr>
<td><strong>JAPAN</strong></td>
<td>High degree of support policy for SMEs. In 2002, public procurement through SME was 47%, amounting to JPY 5.6tn.</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>In the UK, it is proposed to award 25% of public contracts to SMEs along with the transparency agenda, according to which, all government spending, up to a specified limit, is published online.</td>
</tr>
<tr>
<td><strong>USA</strong></td>
<td>The US has been most active in terms of SME procurement programmes with acts such as Competition in Contracting Act (1984), the Federal Acquisition Streamlining Act (1994), the Federal Acquisition Reform Act (1996) and the Buy America Act (which requires only such articles, materials, and supplies as have been mined or produced or manufactured in the United States to be acquired for public use unless federal agencies shall determine it to be inconsistent with the public interest or the cost to be unreasonable). In the US, 23% of the Federal government’s procurement is reserved for SMEs. In 1995, procurement from SMEs reached 33% of the total procured amount amounting to USD 1.5tn.</td>
</tr>
</tbody>
</table>

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

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

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

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

Exhibit 5: Incremental fixed investment in Indian SME sector to reach INR10tn over FY14-20, propelled by PPP
Exhibit 6: Working capital needs of MSMEs if PPP is implemented (production grows at a CAGR of 14%)

Source: Varhad Research

SME policy roadmap for India

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

- Increase entrepreneurship & raise employment contribution to 80% by 2020
- Provide better financing avenues
- Establish training for upgrading skill & technologies
- Increase rural participation in the SME growth
- Provide linkage with, and to be a source of raw materials to large scale industries
- Strengthen technological base of the industrial sector and the economy
- Create base for adoption of appropriate technology for SMEs
- Provide funds for adoption of modern technologies
- Provide policies for the growth of SMEs
- Increase procurement of goods & services from SMEs (from 20% to 50% by 2030)
- Provide transparency in procurement process through E-procurement
- Provide export credit for SMEs

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

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

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

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

1. **Economic Contribution**

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

2. **Enterprise Creation**

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

3. **Employment Generation**

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

4. **Export Earnings**

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

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

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

Steps for a successful SME Procurement Policy

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

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

<table>
<thead>
<tr>
<th>Policy</th>
<th>Goal</th>
<th>Potential effects (advantages &amp; disadvantages)</th>
</tr>
</thead>
</table>
| **Technical assistance** | ▪ Increasing awareness  
▪ Promoting SMEs  
▪ Supporting SMEs   | **Advantages**  
▪ Less interventionist  
▪ Rewards SME efficiency  
▪ Optional feature  |
| ▪ Goal setting and advocacy  
▪ Advice and marketing assistance  
▪ Cooperatives  
▪ Community participation – donor-financed procurement | **Disadvantages**  
▪ Interest group capture  
▪ Information problems  
▪ Conflicting public policies  
▪ Costly to government  
▪ Problematic goals |
| **Training** | ▪ Human capital development  
▪ SME managers  
▪ Government administrators | **Advantages**  
▪ Relatively cheap  
▪ Develops skills |
| | | **Disadvantages**  
▪ One size fits all  
▪ Administrative costs  
▪ May not be enough  
▪ Need for local focus  
▪ Potential for abuse |
<table>
<thead>
<tr>
<th>Policy</th>
<th>Goal</th>
<th>Potential effects (advantages &amp; disadvantages)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assistance and subsidies</td>
<td>Increase level of SME participation in public and private markets</td>
<td>Advantages</td>
</tr>
<tr>
<td>- Financing</td>
<td></td>
<td>• Sustains demand on SMEs</td>
</tr>
<tr>
<td>- Bond/guarantee</td>
<td></td>
<td>• Similar to set-sides</td>
</tr>
<tr>
<td>- Reform/assistance</td>
<td></td>
<td>• De-links some political interplay</td>
</tr>
<tr>
<td>- Prompt payment reform</td>
<td></td>
<td>• Second-best trade policy</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Disadvantages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Costs and inefficiency</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Implicit political market</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Hard to dismantle</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Price preferences</strong></td>
</tr>
<tr>
<td></td>
<td>Targeted assistance in procurements</td>
<td><strong>Advantages</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Direct SME assistance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Awards to SMEs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Disadvantages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Very likely inefficient</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• May reward inefficient SMEs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Implicit political market</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Poor incentives</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Hard to dismantle</td>
</tr>
</tbody>
</table>

Source: World Trade Organization, Varhad Research
1. **MSMEs– The critical factor to India’s holistic development**

MSMEs play a crucial role in the socio-economic development of India. The sector contributes about 12%-13% of the country’s GDP while accounting for 45% of India’s manufacturing output and 40% of its exports. The sector employs nearly 73m people in 31m units, producing over 6,000-8,000 products. With the Government’s increased focus on development of MSME sector, we expect them to contribute 20% of the GDP by FY20 and generate 67m additional employment.

1.1 **MSMEs: Sustaining India’s socio-economic balance**

With a growth rate of over 8%, IMF expects India to be the third largest economy in the world after the US and China by 2050. India’s MSMEs are likely to play a greater role than before in its holistic development.

Micro, small and medium enterprises are also referred to as Small and Medium enterprises (SMEs), and small and medium-sized businesses (SMBs) and small scale industries (SSIs) in some countries.

Worldwide, the micro and small enterprises or MSEs have been accepted as the engine of economic growth and equitable development. The MSEs constitute over 90%¹ of total enterprises in most of the economies and are credited with generating highest rates of employment growth, besides accounting for a major share of industrial production and exports. Historically seen, every major industrialised nation in the world had experienced a shift from the agrarian economy to the industrial economy through the rise of small scale enterprises.

Unlike in other developed/emerging countries where manufacturing played a key role in the economic development, in India, the economic growth was led by a sharp rise in the services sector while manufacturing growth remained muted (currently both contributing 85% of the GDP-Services at 60% in 2011 vs. 44% in 1991, manufacturing at 25% in 2011 vs 27% in 1991).

Even though the growth of MSMEs always outplayed the economic growth rate, it stands a long way from achieving its true potential. MSMEs are contributing 12%-13%² to the GDP of India, a trend that is likely to accelerate further in coming years as the government increases focus on MSMEs and manufacturing.

The growth of MSMEs in the last decade has not only lifted India’s share in global merchandise exports from less than 0.6% in 2000 to 1.6% in 2010³, but has

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¹ MSME Ministry, Government of India
² Government of India data; media reports
³ IMF and WTO Data
emerged as a role model in other countries in the manufacturing as well as services sectors.

As per WTO, India currently accounts for 1.44% of global exports (SMEs contribute 40% of the export) and 2.12% of imports for merchandise trade (3.34% of exports and 3.31% of imports for commercial services).

**Box1: MSMEs – The definition in India**

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

<table>
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</thead>
<tbody>
<tr>
<td>Manufacturing Enterprises</td>
<td>Service Enterprises</td>
</tr>
<tr>
<td><strong>Micro</strong></td>
<td>Upto INR2.5m (USD50 thousand)</td>
</tr>
<tr>
<td><strong>Small</strong></td>
<td>Above INR2.5m (USD50 thousand) up to INR50m (USD1m)</td>
</tr>
<tr>
<td><strong>Medium</strong></td>
<td>Above INR50m (USD1m) up to INR100m (USD2m)</td>
</tr>
</tbody>
</table>

Source: MSME Ministry data

1.1.1 **MSME contribution to GDP to go up to 20% by FY20**

India’s GDP by 2020, according to IMF, is expected to reach INR200tn-250tn (USD4-5tn) from the current INR85tn (USD1.7tn). SMEs account for 95% of industrial units and contributing about 45% on the value addition in the manufacturing sector. The SME contribution to India’s GDP is likely to reach 20% by 2020 from the current 12%-13%, according to Varhad Capital estimates. The rise in share would be amplified with the successful implementation of the public procurement policy which is likely to provide INR17tn of additional business opportunity over FY14-20.

**Exhibit 9: SME sector to contribute 20% of India’s GDP by FY20**

Source: MSME Ministry, Varhad Research

4DCMSME, Government of India
Moreover, it is the MSME sector which can help realize the Government its target of raising the share of manufacturing sector in the GDP from 16%\(^5\) at present to 25% through the National Manufacturing Policy by the end of 2022.

**Exhibit 10: MSME growth outperforms GDP growth over the past decade**

![Graph showing MSME growth outperforming GDP growth over the past decade](image)

Source: World Bank

1.1.2 SME production to grow at 14% over FY14-20

SMEs have outperformed IIP and GDP growth rates during the past decade. Between FY07 and FY11, the sector’s total output grew at a CAGR of 11.5\(^6\), indicating the substantial contribution of MSMEs to the Indian economy. In FY11, total production of MSMEs was equivalent to about 14.28% (INR 11tn) of India’s GDP (at the current market price).

During FY12, total production of MSMEs was projected to grow at 11.5\(^7\) compared to the industrial and GDP growth of 5-6%. Our proprietary model forecast of the Indian SME sectors revenue growth at 14% over FY13-20.

1.1.3 MSME remains major contributor to exports

MSME exports have been on the rise and account for nearly 40% of the total exports from India despite the increased cost of raw materials, sluggish global demand and stiff international competition. MSME products are being exported to nearly all major destinations in both developed and developing countries, qualifying the high quality criteria of these countries.

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\(^5\)MSME Ministry annual report, 2012  
\(^6\)MSME Ministry data and IMF  
\(^7\)Reserve Bank of India
1.2 India needs MSMEs to provide employment to its large work force

India, unlike most of the developed and developing countries, is not facing the archetypal challenge of an aging workforce in the near future. India’s rapidly growing young workforce is estimated to add 230m more people by 2030, according to a McKinsey report, creating a huge challenge for the government to provide employment to all.

Exhibit 14: India to add 230m new workforce by 2030

Source: McKinsey report
MSMEs in India are the second largest employer after agriculture, providing employment to 73m workers and accounting for nearly 40% of the total employment. The growth in the employment in this sector has been overwhelming, recording a growth of 13% in the past decade. Varhad Capital analysis shows that the MSME employment can grow at 12% over the next decade to reach nearly 140m workforce by 2020.

Exhibit 15: MSME employment grew by 13% over FY00-FY10

![Graph showing MSME employment growth from FY00 to FY11](image)

Source: MSME annual report, 2012

Exhibit 16: Indian SMEs stand low in employment creation when compared to the developed world

<table>
<thead>
<tr>
<th>Countries</th>
<th>SME as % of total industry</th>
<th>% of total employment in SME</th>
<th>Value added (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>95</td>
<td>40.0</td>
<td>45.0</td>
</tr>
<tr>
<td>France</td>
<td>98</td>
<td>60.5</td>
<td>56.0</td>
</tr>
<tr>
<td>Germany</td>
<td>98</td>
<td>60.4</td>
<td>53.6</td>
</tr>
<tr>
<td>Japan</td>
<td>99</td>
<td>69.0</td>
<td>53.0</td>
</tr>
<tr>
<td>South Korea</td>
<td>97</td>
<td>71.0</td>
<td>45.5</td>
</tr>
<tr>
<td>UK</td>
<td>98</td>
<td>54.0</td>
<td>51.0</td>
</tr>
<tr>
<td>USA</td>
<td>97</td>
<td>57.9</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: OECD; METI, Japan; DCMSME, Govt of India, Varhad Research

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8International Labour Organisation

9MSME Ministry, Government of India
1.2.1 SMEs to eradicate poverty through employment creation

SMEs are the creative leaders with an enormous potential to eradicate poverty through profits and enabling dignity and choice through markets. Such ventures have a potential to empower the bottom of the pyramid and ensure social upliftment.\(^\text{10}\)

Poverty is a global problem of huge proportions. One in five people in the world lives in abject poverty according to the United Nations as about 40% of the global population survive on less than USD2.00 a day. In India, 300m people live below the official definition of poverty (earning less than INR32 per day in urban and INR26 per day in rural India)\(^\text{11}\). In order to achieve objectives of the United Nation’s Millennium Development Goal of poverty reduction, by 2015, the Indian government will have to create 10-15m\(^\text{12}\) jobs each year from now onwards.

The SME sector worldwide makes a tremendous contribution to the economy. Such contributions have multiple facets and dimensions. SMEs generate new jobs in the economy and thus, contribute positively to employment generation and poverty reduction. In most of the OECD countries, 50%-60% of the total employment is generated by SMEs compared to 40% in India.

The SME sector acts as an engine for fuelling growth of employment in the economy. Between 1987-88 and 1993-94, the overall growth of employment was 2.43% while the same in the SME sector was close to 4%. Between 1993-94 and 1999-2000, the overall employment growth rate was 0.98% while the employment in SME sector grew at 3.9% per annum.

\(^\text{10}\) Study report on SME- International Labour Organisation

\(^\text{11}\)United Nations Study

\(^\text{12}\)Indian Planning Commission
However, during FY00-10, when the overall employment rate fell to 1.9%, SME employment rates held firm at around 5%. There is no denying to the fact that the small-scale sector absorbs a major proportion of the addition to the working age group.

During the 10th Five-Year Plan, it was expected that the SME sector in India would continue to drive new job opportunities for the swelling work force. While large enterprises were expected to create 1.43m new jobs, the SME sector was envisaged to create 3.86m new jobs.

The strong growth of 14-16% in the SME sector coupled with the introduction of the public procurement policy would, in our estimate, help the sector additionally employ 60m workers by FY20. Thus, the SME in India continues to be a major driver for employment in the economy.

Exhibit 17: SME sector in India to additionally employ 123m workers by end of FY20

Source: MSME Annual report, Varhad Research

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13MSME Ministry, Government of India
14Planning Commission of India
MSME: The opportunity knocks

The Varhad Group

Box 3: Example of successful SME initiatives in India
The United Kingdom's Department for International Development (DFID), UNIDO, together with the state government of Orissa, has developed a stone carving cluster support programme.

The programme had the following impact:

- Artisans in self-help groups and cooperatives were given low-interest loans that were invested in productive activities.
- Products of the cluster are sold in new markets; increased sales and prices for high-quality products have raised the income of both skilled and semi-skilled artisans.
- Productivity has increased by 15% to 20% while the product quality has gone up. However, the cost of production has decreased as mechanization made the work easier.
- Women artisans have been able to sell their own products and have gained greater self-confidence in doing so in markets within and outside the state.

Source: UN Industrial Development Organisation

1.3 SMEs to thrive if provided with suitable infrastructure

Despite its commendable contribution to the nation's economy, MSME sector generally operates out of poor infrastructure and limited access to finance. These companies face various hardships such as lack of technology, finance and basic infrastructure like transportation and communication, availability of power, proper roads, water supply, market for input and output, etc. Besides, in India, there is a lack of entrepreneurship in the society and first generation entrepreneurs have to go through the social stigma in case of failure.

Exhibit 18: Proprietary corporate structure makes it easier to setup units with minimal infrastructure

Source: Dun & Bradstreet
Unlike in major developed nations, India lacks in entrepreneur protection with the absence of bankruptcy protection laws and other regulations for flourishing entrepreneur culture. We believe that the pace of growth of SMEs could be accelerated if infrastructure improves, avenues of finance are made available and favourable entrepreneurship policies are implemented.

In this backdrop, we have discussed in detail the successful SME case study of Mr. A. Muruganantham, the maker of low cost sanitary napkins and machines. We also detail another case study of SME turned corporate, Su-kam Power Systems Ltd by Mr. Kunwar Sachdev, the man who revolutionised the inverter industry. Final case study is on Mr. Ashok Khade who rose against all odds of poverty and caste exclusion to build a successful offshore fabrication company called Das Offshore Engineering Private Limited.
Box 4:

Case Study: A. Muruganantham – The innovator behind Jayaashree Industries

After undertaking four years painful research, A. Muruganantham went on to design, create, test and implement a sanitary napkin-making machine that operates on a small scale. With a clear vision on women empowerment, he made the machine available at INR75,000 compared to INR45m by the competitors.

The successful journey of Jayaashree Industries began from the house of A. Muruganantham. Without any finances and technical support, a school drop-out went on to provide sanitary napkins at affordable costs to the rural and lower middle class women. Today, his product has uplifted their life besides giving means of income to them. With such an innovative thinking, he has tapped the INR20bn market, growing at a CAGR of 16%, once ruled by the big two giants, Proctor & Gamble and Johnson & Johnson.

Case Study: Su-kam Power Systems

Kunwar Sachdev, the founder of Su-kam, has created a market for the inverter industry armed with a capital of INR10,000 and an idea whose time had come. Though it all began with the determination to fix his troublesome inverter, he could smell a huge opportunity in the power back-up sector.

He started this research from a small garage, facing a number of challenges such as no brand name, manufacturing facility, testing instruments and funds to support. Given his minimal resources but backed by a clear vision, he has been able to convert his vision to a current INR6.5bn enterprise. Starting as an SME, at present Su-kam soon established itself as a medium sized corporate with 23 offices across India, employing more than 2,000 employees.

Case Study: Das Offshore Engineering Private Limited

The journey of Mr. Ashok Khade, founder of DAS Offshore, is very compelling. He fought against poverty and caste exclusion and built one of the most sought-after offshore fabrication companies in Mumbai. The sudden tug on the family’s pockets was the trigger that activated Mr. Khade’s entrepreneurial ambitions. With limited resources in hand, he went on to grab his first project worth INR18.2m, abandoned mid-way by the previous contractor.

At present, DAS Offshore has established itself with a turnover of INR1300m-1400m, employing around 4,500 people. It is a key vendor to Oil and Natural Gas Corporation Ltd, British Gas, Larsen & Toubro and NaftoGaz etc.
1.3.1 India needs to handhold more SMEs

By nature, the SME sector requires financial and tax related assistance from both the central and the state governments besides providing a local catchment area to sell products. It is of no surprise that states that have the fastest economic growth also have a high concentration of SMEs due to pro-industrial policies.

The SME sector accounts for about 45%\(^{15}\) of India’s manufacturing output and 40% of total exports, besides it provides employment to nearly 73m\(^{16}\), next only to agriculture. Due to the federal nature of Indian polity, apart from the Central government policy, each state in India maintains different set of policies for the MSME sector. Our analysis of the current situation reveals that more than 84% of MSME enterprises in India is located in ten major states, namely Maharashtra, Tamil Nadu, Gujarat, Punjab, Andhra Pradesh, Uttar Pradesh, Karnataka, NCR, Haryana and West Bengal.

Most of these states, particularly Gujarat, Andhra Pradesh, Maharashtra and Tamil Nadu have favourable industrial policies which attract SMEs.

The concentration of the SMEs in few states emphasises the fact that a proper industrial policy initiative for SMEs attracts small industries. There is a huge opportunity for the rest of the states in terms of luring MSMEs with better infrastructure and financial benefits.

Box 5: Case study –Govt. initiatives for SMEs in Tamil Nadu

The Government of Tamil Nadu has formulated an exclusive policy for the MSME sector to encourage agro-based industries. The policy includes formation of multi-storied and industrial estates for micro industries, liberal floor space index in plotted development of 1.5 to 1.75 for industrial sheds and 2.5 for multi-storied industrial units and 50% rebate on stamp duty and registration charges in industrial estates and industrially backward areas.

Exhibit 20: 84% SMEs are concentrated in just 10 states

Source: MSME Ministry data, Varhad Research

\(^{15}\) MSME Annual report 2012

\(^{16}\) Labour Ministry and MSME Ministry, Government of India
**Exhibit 21: States with higher SME concentration also have higher GDP**

Source: Planning commission of India, MSME Ministry data, Varhad Research

### 1.4 Implementation of Public Procurement in Public Private Partnerships to help rise of SMEs

In India, there are a number of states which have adopted Public Private Partnership (PPP) for efficient infrastructure and reducing government expenditure. It has been recognized that for creating a world class infrastructure, it is necessary to explore the PPP route in all segments of infrastructure. Government of India aims to have a 30% of the total infrastructural spend (road, rail, air, water transport, power, telecommunication, water supply, irrigation and storage) to come through private investments. States like Andhra Pradesh and Gujarat have institutionalized PPPs while different sets of frameworks have been adopted by various states in order to implement the private public partnership to the best possible extent, suited to respective governments.

According to the Finance Ministry, investments in the infrastructure sector during the Twelfth Five-Year Plan will go up to INR50tn (USD925bn), half of which is expected to come from the private sector. The allocation to the highways sector has been enhanced by 14% to INR254bn (USD4.7bn) for FY13 and the Government has set a target to create a length of 8,800km roads under the National Highways Development Project (NHDP) for this fiscal. A mandatory sub-contracting of public-private projects through the Public Procurement Policy (PPP) offers SMEs a huge opportunity in the infrastructure space. This will help SMEs source sub contracts and equipment sourcing/leasing contracts from various public-private partnership projects.
Some states have undertaken far more projects under private public partnerships than others. Similarly, some sectors have seen very high use of private public partnership than others. There have been 758 private public partnership projects in key sectors, having a total project cost of about INR3.9bn. Tamil Nadu and Maharashtra have also achieved some success in undertaking PPP projects by creating specialised sector specific agencies with private sector participation and by leveraging public funds to undertake private public partnership projects. Orissa has implemented a PPP policy and has a formal three-tier hierarchical mechanism for approving these projects.

Exhibit 23: Only four states have substantial PPP projects

Source: MoF, Govt of India
### Box 6: PPP Models supported by the Government of India

**User-fee based BOT models** - Medium to large scale PPPs have been awarded, mainly in the energy and transport sub-sectors (roads, ports and airports). Although there are variations in approaches, over the years, the PPP model has been veering towards competitively bid concessions where costs are recovered mainly through user charges (in some cases partly through VGF from the government).

**Annuity based BOT models** - In sectors/projects not amenable for sizeable cost recovery through user charges owing to socio-political-affordability considerations, such as in rural, urban, health and education sectors, the government harnesses private sector efficiencies through contracts based on availability/performance payments. Implementing annuity model will require necessary framework conditions such as payment guarantee mechanism by means of making available multi-year budgetary support, a dedicated fund and a letter of credit etc. The Government may consider setting up a separate window of assistance for encouraging annuity-based PPP projects. A variant of this approach could be to make a larger upfront payment (say 40% of the project cost) during the construction period.

**Performance based management/maintenance contracts** - In an environment of constrained economic resources, PPP that improves the efficiency will be all the more relevant. Thus, PPP models such as performance based management/maintenance contracts are encouraged. Sectors amenable for such models include water supply, sanitation, solid waste management, road maintenance etc.

**Modified Design-Build (Turn-key) contracts** - In traditional Design-Build (DB) contracts, private contractors are engaged for a fixed-fee payment on completion. The primary benefits of DB contracts include time and cost savings, efficient risk-sharing and improved quality. The Government may consider a Turn-key DB approach with payments linked to achievement of tangible intermediate construction milestones (instead of lump-sum payment on completion) and short period maintenance/repair responsibilities. Penalties/incentives for delays/early completion and performance guarantee (warranty) from private partner may also be incorporated. Subsequently, as the market sentiment turns around, these projects could be offered to private sector through operation-maintenance-tolling concessions.
**Exhibit 24: Private investment in infrastructure**

![Graph showing private investment in infrastructure from FY90 to FY08.](image)

Source: MoF, Govt of India

**Box 7: International experience**

**The United Kingdom**

"Partnerships UK" was set up in 2000 as a joint venture between public and private sectors with the latter holding the majority shareholding. It offers commercial expertise for the development and delivery of numerous Private Finance Initiatives (PFI) and other Public Private Partnerships projects.

Mostly, public sector projects (where they are likely to represent value for money, and where these meet the UK government's criteria for efficiency, equity and accountability) are considered for PFIs. The private sector in the UK makes a long-term commitment to maintain assets and provide services, and the UK government makes a long-term commitment to procure those services and pay for services or availability of facilities thus, a significant risk is transferred to the private sector.
2. **PUBLIC PROCUREMENT POLICY: UNLOCKING THE SME POTENTIAL**

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

### 2.1 PPP: Background and scope

#### 2.1.1 What is public procurement?

Procurement is the act of acquiring goods or services at the best possible quality, quantity, place, time and price for the direct benefit or use of the buyer. The Government procurement, also called public procurement, is the purchase of goods and services on behalf of a public authority, such as government agencies.

Public procurement facilitates the use of private sector enterprises, particularly MSMEs (Micro, Small and Medium Enterprises) for public sector goals and enables the development of the society at large.

Through public procurement, public sector organizations (Government departments, public sector units including banks and financial institutions and government undertaking companies) acquire goods (from stationary to machinery), services (consultation, ITES etc.) and works from private sector units, particularly SMEs. The quality, timeliness and appropriateness of the procured inputs, however, determine the success of the public procurement system.

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**Box 8: India’s public procurement currently at INR9tn; to reach INR28tn by FY20**

According to Varhad Capital estimates, the total public procurement (inclusive of the procurement of Central government departments and PSUs including banks and financial institutions) in FY12 amounted to INR9tn, having an annual growth of 17.95%. According to Varhad Capital’s proprietary model estimates, the public procurement would reach INR28tn by FY20 at a CAGR of 14.4%. MSME procurement is likely to increase to INR5.6tn from INR439bn in the said period.
2.1.2 Status of procurement system in India

India is yet to have an institutionalised system of procurement despite the acknowledged importance of such a facility. The Ministry of Finance (MoF) in the Central government is responsible for issuing basic guidelines on procurement policies and regulations. Central agencies, like the Central Vigilance Commission (CVC), supplement this effort by laying down vigilance benchmarks in the procurement system. However, individual ministries can also come out with their own rules and regulations while implementing their procurement policies. These manuals provide for preferential treatment to earmarked sectors such as MSMEs, khadi and village industries (KVIs), Kendriya Bhandar and co-operative sectors among others.

2.1.3 Existing guidelines on public procurements

The General Financial Rules (GFR), Delegation of Financial Powers (DFPR) and Manual on Policies and Procedures for Purchase of Goods contain detailed rules and instructions relating to the public procurement by the Central government. Norms in these books have to be followed in common by all departments under the Central government with the exceptions as provided therein.

However, major ministries such as Defense, Railways, Public Works, Directorate General of Supplies and Disposal (DGS&D) etc. have their own purchase procedures.

2.2 Public Procurement Policy - A giant leap for SMEs; to create demand worth INR17tn over FY14-20

The foundation of the Public Procurement Policy was laid in 2005 with the implementation of the General Financial Rules (GFR) containing certain yardsticks of fairness, integrity and transparency through competition, efficiency and economy to achieve the best results in public procurement. Public procurement has been envisaged to maximize public welfare (by providing quality services and products) and growth opportunities for the private sector. The public procurement accounts for a substantial part of the economy and often decides the standards that get adapted in an economy.

The new Public Procurement Bill 2012 is based on the report of the Prime Minister’s Task Force on the Micro, Small & Medium Enterprises, 2010, effective April 1, 2012. The Indian government has set an annual target of procuring a minimum of 20%. A sub-target of 20% (within the 20% reserved for SMEs i.e. 4% of the total public procurement) has been earmarked for procurement from SMEs owned by the Scheduled Castes (SC) and Scheduled Tribes (ST) entrepreneurs. Mandatory procurement from MSMEs includes procurement of all goods and services (from stationary to machinery) and sub-contracts to them. However, procurement related to defense has been exempted from the policy.
The PPP bill, according to our estimates, will help create an additional demand over FY14-20 to the tune of INR17tn for the entire MSME sector in general and INR3.4tn for SMEs owned by the SC and ST entrepreneurs.

Exhibit 26: Additional opportunity of INR17tn over FY14-20 to be created through PPP

Source: MSME annual report, Varhad Research

2.3 As per global experience, SME contribution to PPP to reach 50% by FY30

The Indian Public Procurement bill in its current form directs 20% mandatory procurement from the country’s MSME enterprises. Although it is a giant leap for SMEs, we do expect the contribution from SMEs to reach 50% by FY30. Our expectation is based on our detailed study of the public procurement systems around the world. We examined both developed and emerging economies to understand and find the best possible cases for India. Our study also reveals that SMEs are indispensable to large enterprises and most of the Indian large public and private companies procure 20-65% of their needs from SMEs.
The Central government’s purchase of goods and services (excluding salaries) varies significantly across countries, ranging between 3% and 12% of the GDP. A large part of it is represented by the expenditure in construction. Netting out construction, other purchases are in the range of 2.5%-8% of the respective country’s GDP.

Public procurement has always been a major growth driver for SMEs across the world. In Japan, public procurement from SMEs was as high as 47% in 2008 amounting to JPY5.6tn. In the US, 23% of government procurement is from SME industries, amounting to USD900-1,000bn.

SMEs also tend to perform better in bidding for Central government contracts. It was estimated that in 2001, the proportion of the value of public procurement above EU thresholds secured by SMEs was between 29% and 43%. The median value of contracts awarded between 2002 and 2005 was in the range of

17 EU Monitor, 2006
EUR310,000-360,000. The equivalent figures for 2005 are 42% of value and 64% of contracts.

Although comparisons with the US are problematic due to lack of common definition of SMEs, it is estimated that small businesses (who may employ up to 500, and in certain sectors, 1000 or even 1500 people) supplied just 23% of the total value of Federal prime contracts in 2005 while they provided around half of private sector employment and gross value added.

Our research suggests that all developed economics (OECD) have 22-50% of their respective public procurement from SMEs while most of the emerging countries (Brazil, Russia, India, China and South Africa) do not have a definite procurement policy for procuring from SMEs but their procurement ranges between 10%-25%.

**Exhibit 29: PPP comparison with other countries**

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

Source: Government agencies, Varhad Research
2.4 States can formulate own procurement policies

Apart from the Central policy on public procurement, state governments can too form their own policies for public procurement. The total state government procurement in India may be INR10tn (assuming twice the procurement of the Central government) in 2011.

Most Indian states have high SME concentration and they account for a substantial portion of the state GDP. States lure SMEs by way of policies such as capital and interest subvention. A public procurement policy would help create a larger market for state SMEs besides attracting small and medium scale investments.

2.4.1 States with higher SC/ST population to follow Central model

Most of the states in India have a significant percentage of backward communities like SCs and STs. Although they are large in numbers, their contribution to state GDP remains significantly low. Public procurement policy developed by state governments can elevate these enterprises, securing public tenders thus promoting holistic socio-economic development.

Exhibit 30: States with high SC/ST population have low GDP contribution

<table>
<thead>
<tr>
<th>State</th>
<th>State GDP (INR Tn)</th>
<th>Contribution to India’s GDP</th>
<th>Total Population</th>
<th>SC population (%)</th>
<th>ST population (%)</th>
<th>Total SC&amp;ST Population (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chhattisgarh</td>
<td>1.35</td>
<td>1.80</td>
<td>20,833,803</td>
<td>11.6</td>
<td>31.8</td>
<td>43.4</td>
</tr>
<tr>
<td>Orissa</td>
<td>2.26</td>
<td>3.01</td>
<td>36,804,660</td>
<td>16.5</td>
<td>22.1</td>
<td>38.6</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>1.06</td>
<td>1.41</td>
<td>26,945,829</td>
<td>11.8</td>
<td>26.3</td>
<td>38.1</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>2.6</td>
<td>3.46</td>
<td>60,348,023</td>
<td>15.2</td>
<td>20.3</td>
<td>35.5</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>3.2</td>
<td>4.26</td>
<td>56,507,188</td>
<td>17.2</td>
<td>12.6</td>
<td>29.8</td>
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<tr>
<td>Punjab</td>
<td>2.7</td>
<td>3.60</td>
<td>24,358,999</td>
<td>28.9</td>
<td>0</td>
<td>28.9</td>
</tr>
<tr>
<td>Himachal Pradesh</td>
<td>0.6</td>
<td>0.80</td>
<td>6,077,900</td>
<td>24.7</td>
<td>4</td>
<td>28.7</td>
</tr>
<tr>
<td>West Bengal</td>
<td>5.5</td>
<td>7.33</td>
<td>80,176,197</td>
<td>23</td>
<td>5.5</td>
<td>28.5</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>6.7</td>
<td>8.93</td>
<td>76,210,007</td>
<td>16.2</td>
<td>6.6</td>
<td>22.8</td>
</tr>
<tr>
<td>Karnataka</td>
<td>4.7</td>
<td>6.26</td>
<td>52,850,562</td>
<td>16.2</td>
<td>6.6</td>
<td>22.8</td>
</tr>
<tr>
<td>Gujarat</td>
<td>6</td>
<td>7.99</td>
<td>50,671,017</td>
<td>7.1</td>
<td>14.8</td>
<td>21.9</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>6.7</td>
<td>8.93</td>
<td>166,197,921</td>
<td>21.1</td>
<td>0.1</td>
<td>21.2</td>
</tr>
<tr>
<td>Uttarakhand</td>
<td>0.78</td>
<td>1.04</td>
<td>8,489,349</td>
<td>17.9</td>
<td>3</td>
<td>20.9</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>6.3</td>
<td>8.39</td>
<td>62,405,679</td>
<td>19</td>
<td>1</td>
<td>20</td>
</tr>
<tr>
<td>Haryana</td>
<td>3.1</td>
<td>4.13</td>
<td>21,14,564</td>
<td>19.3</td>
<td>0</td>
<td>19.3</td>
</tr>
<tr>
<td>Assam</td>
<td>1.04</td>
<td>1.39</td>
<td>26,655,528</td>
<td>6.9</td>
<td>12.4</td>
<td>19.3</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>10.3</td>
<td>13.72</td>
<td>96,878,627</td>
<td>10.2</td>
<td>8.9</td>
<td>19.1</td>
</tr>
<tr>
<td>Jammu &amp; Kashmir</td>
<td>0.5</td>
<td>0.67</td>
<td>10,143,700</td>
<td>7.6</td>
<td>10.9</td>
<td>18.5</td>
</tr>
<tr>
<td>Chandigarh</td>
<td>0.2</td>
<td>0.27</td>
<td>900,635</td>
<td>17.5</td>
<td>0</td>
<td>17.5</td>
</tr>
<tr>
<td>Delhi</td>
<td>3.14</td>
<td>4.18</td>
<td>13,850,507</td>
<td>16.9</td>
<td>0</td>
<td>16.9</td>
</tr>
<tr>
<td>Bihar</td>
<td>2.1</td>
<td>2.80</td>
<td>82,998,509</td>
<td>15.7</td>
<td>0.9</td>
<td>16.6</td>
</tr>
<tr>
<td>Pondicherry</td>
<td>0.13</td>
<td>0.17</td>
<td>974,345</td>
<td>16.2</td>
<td>0</td>
<td>16.2</td>
</tr>
<tr>
<td>Kerala</td>
<td>2.7</td>
<td>3.60</td>
<td>31,841,374</td>
<td>9.8</td>
<td>1.1</td>
<td>10.9</td>
</tr>
<tr>
<td>Goa</td>
<td>0.3</td>
<td>0.40</td>
<td>1,347,666</td>
<td>1.8</td>
<td>0</td>
<td>1.8</td>
</tr>
<tr>
<td>India*</td>
<td><strong>75.07</strong></td>
<td><strong>1,22,33,474</strong></td>
<td><strong>16.2</strong></td>
<td><strong>8.2</strong></td>
<td><strong>24.4</strong></td>
<td></td>
</tr>
</tbody>
</table>

*include data of other states

Source: MSME Census 2011, Varhad Research
3. **Varhad Capital’s SME Vision FY20**

The Public Procurement Policy (PPP) will ensure an additional demand of INR17tn and fixed asset requirement of INR10tn for Indian MSMEs over FY14-20 thus creating a huge socio-economic development opportunity. Varhad’s SME Vision FY20 focuses on opportunities for SMEs, financial institutions and the society at large.

### 3.1 INR17tn additional demand over FY14-20

The introduction of PPP and making it mandatory for 20% of the total public procurement from MSMEs will, according to us, create an additional demand of INR17tn (USD325bn) for the Indian SME sector over FY14-20.

**Exhibit 31: MSME turnover to reach INR33tn in FY20, supported by public procurement of INR28tn**

![Chart showing SME Production and PSU Procurement from FY11 to FY20E](chart.png)

The public procurement policy targets 20% mandatory procurement from MSMEs from FY16 onwards. Thus, to forecast the demand created by the PPP opportunity and the incremental demand thereof, our base case estimates take into account a stable growth rate of 11.5% (average growth rate during last 5 years). Based on the above, the production is expected to rise to INR29tn by FY20. With the introduction of PPP, we estimate the production to grow to INR33tn in FY20 at a CAGR of~14%.
3.1.1 INR10tn of additional fixed investment needed over FY14-20

Fixed investment in the MSME sector over FY01-11 had gone up at a CAGR of 19.6% to INR7tn from INR1.5tn in FY01. We forecast the fixed investment in the Indian SME sector to grow at 13% over FY14-20 on the back of the sharp rise in public procurement and increased opportunity in domestic and export markets. Our calculation shows that for Indian SMEs, with every INR1bn of fixed investment, the output increases by INR1.42bn, indicating an asset turnover ratio of 1.42 times which is low when compared to 2.2 times in China and 1.8x in Brazil.\(^{18}\)

We estimate that with the increase in demand, the SME sector would require an additional fixed investment need of INR10tn over FY14-20 at a growth rate of 13%.

Exhibit 33: PPP to provide INR10tn of fixed investment opportunity over FY14-20

3.1.2 INR3tn of additional working capital funds needed over FY14-20

Working capital is considered as a part of the operating capital, needed to meet the day-to-day funding for its operations. This money is usually tied up in inventory or money that customers still owe to the company.

\(^{18}\)WTO and World Bank report
The working capital cycle can at best be explained from the following diagram:

**Exhibit 34: Working capital cycle**

The current working capital requirement of the MSME sector is INR 2.2tn. If the production continues to grow at the constant rate of 11.5%, as in the past, we forecast a working capital need of INR 2.5tn. However, with the advent of PPP, the production is expected to grow at 14% YoY, requiring an additional INR 3tn of working capital to meet the demand, making the total working capital need to INR 5.5tn over FY14-20.

**Exhibit 35: INR 3tn additional working capital needed over FY14-20**

3.2 **PPP to boost socio-financial development**

The Public Procurement Policy (PPP), according to us, will be a boon to MSMEs as well as support to socio-financial development of the nation. It will provide a platform to budding entrepreneurs, create mass employment which will help alleviate poverty and increase standard of living for the weaker sections of the society. Moreover, the rise in demand, due to PPP, will create more business opportunities across various sections of the industry.

3.2.1 **PPP focus to help build entrepreneurs; thrust on SCs, STs**

The opportunity of INR 17tn that PPP will create over FY14-20 will encourage more entrepreneurs and according to the official statistics, about 10m jobs will have to be created per year to absorb the rapidly rising young workforce in India which as per the present structure of employment leaves very little scope for absorption.
As per the MSME census, 21m MSMEs in India produce goods worth INR11tn at an average turnover of INR355k per enterprise per annum. In order to cater to the rapid market growth and high demand coupled with mass public procurement, India needs about 45-60m SMEs by FY20 thus providing a huge scope for upcoming entrepreneurs.

**Exhibit 36: Manufacturing, retail sectors contribute most to India’s employment**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Employment Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail trade</td>
<td>39%</td>
</tr>
<tr>
<td>Hotel and Restaurants</td>
<td>4%</td>
</tr>
<tr>
<td>Transport &amp; Storage</td>
<td>4%</td>
</tr>
<tr>
<td>Telecom</td>
<td>2%</td>
</tr>
<tr>
<td>Financial services</td>
<td>1%</td>
</tr>
<tr>
<td>Real estate</td>
<td>2%</td>
</tr>
<tr>
<td>Public admin &amp; Defence</td>
<td>2%</td>
</tr>
<tr>
<td>Education</td>
<td>2%</td>
</tr>
<tr>
<td>Health</td>
<td>2%</td>
</tr>
<tr>
<td>Social and personal services</td>
<td>8%</td>
</tr>
<tr>
<td>Other</td>
<td>3%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>26%</td>
</tr>
<tr>
<td>Mining</td>
<td>0.30%</td>
</tr>
<tr>
<td>Electricity, Gas, Water supply</td>
<td>0.20%</td>
</tr>
<tr>
<td>Construction</td>
<td>1%</td>
</tr>
<tr>
<td>Auto &amp; auto service</td>
<td>1%</td>
</tr>
</tbody>
</table>

Source: India stats, 2011

### 3.2.2 Dedicated market access to SC/ST entrepreneurs

The new Public Procurement Bill, 2012 has earmarked a sub-target of 20% within the 20% reserved for SMEs (i.e. 4% of the total public procurement) for Scheduled Caste (SC) and Scheduled Tribe (ST) entrepreneurs. This will create a definite market share for SC/ST entrepreneurs, which as per our proprietary model of demand is estimated to be INR3.4tn over FY14-20.

As of now, less than 10% of SMEs are owned by SC/ST. With the population expected to reach approx. 1.7bn by 2050 from 1.2bn presently representing CAGR of 1.6%. The SC/ST population is likely to see a higher growth in the said period. Presently, SC comprises 16.2% of the total population while ST around 8.2%; these may go up to about 17% and 9% by 2050 respectively.

The opportunity created by the rapidly growing Indian SME sector coupled with the PPP opportunity will help India’s large backward communities (mainly SCs and STs) to join the mainstream. This leaves a vast scope to build an entrepreneurial class among them by setting up MSMEs which will also give them access to dedicated SC/ST procurement market of INR3.4tn over FY14-20.

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Varhad Research estimate
Exhibit 37: Ownership of SC/ST remains sub-10% in all SME categories

Source: MSME Annual report 2012

Exhibit 38: SC/STs to account for over 26% of population by 2050

Source: Census of India, SC-ST Planning Commission, Varhad Research

Exhibit 39: PPP to create INR3.4tn opportunity for SC/ST SMEs over FY14-20

Source: Company Annual Reports, Varhad Research
3.2.3 Employment creation to drive India’s next surge

MSMEs have been major employment providers, next only to agriculture. Currently, MSMEs employ nearly 73 million skilled, semi-skilled and unskilled workers across 31 million units. With the rapidly rising availability of workforce, about 10 million jobs need to be created every year to absorb the entire quantum.

Exhibit 40: India to have a high young workforce by 2020

![Graph showing labor force by age group across years]

Source: International Labour Organisation

Given this demand surge, MSMEs will need a greater workforce that will lift the total employment to 140 million by 2020 at a CAGR of 14%.

Exhibit 41: Implementation of PPP to help employ an additional 17 million people over FY14-20

![Graph showing employment growth with and without PPP]

Source: MSME Annual Report, Varhad Research

3.2.4 SME productivity needs to improve 66% by FY20

The labour productivity in India is low when compared to the developed and developing world. India stands the lowest in terms of productivity among BRIC nations at USD8,900 per worker per year compared to China at USD14,200 and Brazil at USD13,700. The labour productivity in developed states are as high as USD68,200 in the US, USD44,600 in Japan, and USD43,300 in Germany. The per capita employment productivity in the Indian MSME sector is even lower at INR150,000 (USD2800) per worker per year as compared to China USD4,500 and

---

20METI, Japan
Brazil at USD3,800. The low productivity in India is being attributed to the high labour intensive nature of production and lack of modern manufacturing facilities.

The introduction of the Public Procurement Programme and renewed thrust of the government towards the SME sector will help the sector modernise its production process thus increasing employee productivity. We estimate the employment in Indian SMEs to reach around 140m by FY20 with a per employee productivity of INR250,000 (~USD4,700).

**Exhibit 42: Labour productivity in India the lowest among BRIC nations**

![Labour productivity chart](image)

Source: Deloitte Global Manufacturing Competitive Index 2013

### 3.2.5 Growth of MSMEs to help generate huge local employment opportunities

The trend of rising unemployment compounded by the existence of regional imbalances within the country has collectively spurred the phenomenon of labour migration, particularly from the BIMARU states (Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh).

Migration generally occurs when the region of origin lacks opportunities which the destination promises. It is inherently a combination of pull and push factors. Variation in economic development across regions is a primary motive for the migration to greener pastures.

**Exhibit 43: India’s unemployment rate to come down if SME sector develops**

![Unemployment rate chart](image)

Source: Labour Bureau, Government of India
According to the Census of 2001, out of the total migration of 98.3 m, around 16% was due to employment factors. The increase in migration is attributable mainly to regional differences in the population pressure on land, poor infrastructure, and lack of industrial development and modernization of agriculture. While migration enables workers from underdeveloped regions to find employment, its impact has been well documented by academics. Invariably, migrant labour is paid lower wages than the local labour even as the implementation of the Inter-State Migrant Workman (Regulation of Employment and Conditions of Service) Act of 1979 remains largely on paper.

Migrants from backward regions are willing to accept any distress wages that are offered as long as they have access to employment. In the bargain, they undercut employment prospects of local labour. Their excess supply also contributes to lower wage rates.

The huge amount of business opportunity that PPP creates would encourage states and local government to provide benefit schemes like special manufacturing zones, tax sops, capital benefits, etc. for the MSMEs in order to attract them to invest in respective regions. When this leads to infrastructure and industrial development within states, it is expected that there will be a drop in mobility of labour.

### 3.3 Varhad’s Vision FY20- A road map on SME future

SMEs are known to have a significant relevance to global economies. In most parts of the world, SMEs constitute about 80%-90% of all business enterprises. The strong intra-linkages with all large businesses established SMEs as drivers of every economy as well as engines of economic development worldwide.

In most European Union (EU) member states, public procurement is estimated at 10% to 15% of gross national product (GNP) or 25% to 30% of public expenditure\(^1\). The OAS\(^2\) estimates that within the free-trade region of the North American Free Trade Agreement (NAFTA), the total government procurement is close to USD1tn (OAS, 2005).

The central government’s share of all public procurement has been estimated at 35% in the United States, 30% in Canada, and 74% in Mexico\(^3\). Procurement in East Asian countries is estimated to be between 20% and 40% of GDP.

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\(^1\)European Union report on SMEs, May 2010

\(^2\)The Organization of American States

\(^3\)McKenna and Cuneo, NAFTA research paper, 1993
Box 9: The success of Taiwan’s SMEs –A guiding example.

National strategic plan and strategic policies on SMEs

Taiwan developed policies and strategies towards the strengthening of SMEs by creating a credit security fund for SMEs that allows beneficiaries to obtain the capital necessary for projects, using a guarantee provided by the government fund. This fund is complemented with a fiscal credit equivalent of up to a 20% tax credit so as to stimulate investments in SMEs.

Incentive for modernisation of SMEs

Taiwanese government, in order to make SMEs globally competitive, provided incentives for modernisation of production processes. Import incentives by way of reducing import duty were also provided for machineries from European countries, Japan and Australia.

Proper skill development

The government has set up training units for skill development of the SME workforce. These centers (similar to those in India) provide necessary training and development of workers in order to match the level of skill required for the modern production process.

Sector specific policy implementation

Taiwan permitted overseas investments in the information and technology space (mainly manufacturing) in order to strengthen linkages with the Silicon Valley in the USA. With the opening up of foreign investment, many foreign companies started outsourcing hardware manufacturing from Taiwan’s SMEs given the low cost of production and high quality work. The difficulty with the initial programmes was that only individuals were allowed to take advantage of the tax rebate. In 1991, the statute was revised to allow corporate investors the same rebate, and a dramatic increase in investments followed.

Export initiative

As export opportunities arose with the flourishing of world trade, the emerging SMEs filled the vacuum, targeting the international market without having to compete directly against domestic industrial giants. Taiwanese government provided export credits to SMEs helping SMEs to grow faster.

Case Study: ACER Inc.

Acer was founded by Stan Shih, his wife Carolyn Yeh, and a group of five others as Multitech in 1976, headquartered in Hsinchu City, Taiwan. It began with eleven employees and USD25,000 in capital. Initially, it was primarily a distributor of electronic parts and a consultant in the use of microprocessor technologies. It produced the Micro-Professor MPF-I training kit, then two Apple II clones; the Micro-professor II and III before joining the emerging IBM PC compatible market, and becoming a significant PC manufacturer.
For Indian SMEs to match their global peers, the government needs to support and create policies to encourage new SMEs. The government must also aid MSMEs in acquiring technologies besides creating better infrastructure and policies to become globally competitive. Such affirmative action on the part of the government will help Indian MSMEs increase their contribution to 20% of GDP, and account for 45% of India’s exports by FY20.

**Roadmap of a strong and sustainable SME sector in India**

Exhibit 44: Varhad Capital’s SME policy roadmap for India

- Increase entrepreneurship & raise employment contribution to 80% by FY20
- Provide better financing avenues
- Establish training for upgrading skill & technologies
- Increase rural participation in the SME growth
- Provide linkage with, and to be a source of raw materials to large scale industries
- Large pool of skilled & competent SMEs supplying to large industries
- Strengthen technological base of the industrial sector and the economy
- Create base for adoption of appropriate technology for SMEs
- Provide funds for adoption of modern technologies
- Provide policies for the growth of SMEs
- Technology driven production of goods and services
- Increasing procurement of goods & services from SMEs (from 20% to 50% by 2030)
- Provide transparency in procurement process through E-procurement
- Provide export credit for SMEs
- Creating strong and globally competitive SME sector

Source: Varhad Research
Exhibit 45: SMEs have high agility as well as low cost advantage when compared to large enterprises

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

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

Note: The results were calculated by scoring in order of ranking: 3 points for first, 2 points for second and 1 point for third.
**Box 10: The fundamental growth target for the SME sector as India aspires to be one of the leading economies in the world by 2020**

### 1. Economic Contribution

<table>
<thead>
<tr>
<th>FY11</th>
<th>Varhad Capital Vision-FY20</th>
</tr>
</thead>
<tbody>
<tr>
<td>The overall economic activities of SMEs in India estimated at less than 13% of the country’s GDP</td>
<td>Contribution of SMEs to GDP is projected to rise to 20% by FY20</td>
</tr>
</tbody>
</table>

### 2. Enterprise Creation

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

### 3. Employment Generation

<table>
<thead>
<tr>
<th>FY11</th>
<th>Varhad Capital Vision-FY20</th>
</tr>
</thead>
<tbody>
<tr>
<td>India’s official unemployment rate was 3.8% in FY12 with urban areas showing higher share than rural areas. The SME sector has emerged as the second largest employment creator, employing 73m thus curbing unemployment and improving the per capita income.</td>
<td>Employment generated by the Indian SMEs to reach around 140m by 2020 with a per employee productivity of INR 250,000 (~USD4,700).</td>
</tr>
</tbody>
</table>

### 4. Export Earnings

<table>
<thead>
<tr>
<th>FY11</th>
<th>Varhad Capital Vision-FY20</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSME exports account for nearly 25% of the total output, growing at 16% CAGR over the last decade.</td>
<td>SME exports are expected to reach nearly 55% of total exports at a CAGR of 25% over 2014-20.</td>
</tr>
</tbody>
</table>
Box 11: NMSDC in USA helped MBEs grow to USD100bn

The establishment of National Minority Supplier Development Council, Inc. (NMSDC) in 1972 provided a direct link between corporate America and minority-owned business enterprises (MBE). It helped minority-owned businesses in procurement and creating business opportunities.

In addition to being an intermediary between corporates and minority businesses, it hosts business fairs as well as provides contract financing to NMSDC-certified minority businesses. It helps MBEs network by conducting various training programmes, seminars and conferences to bridge the gap with corporates.

Due to their active role in MBE development, member corporation purchases from minority businesses exceeded USD100bn from USD86m in 1972. Currently, minority businesses represent 21% of total businesses, 7% of gross receipts—and 3% of total corporate purchases.
3.3.1 NSIC, SME Chamber of India act as NMSDC to SMEs

Presently, National Small Industries Corporation (NSIC) and SME Chamber of India (SMECI) are working to promote aid and foster growth of micro, small and medium industries in the country. They help new and existing entrepreneurs in effectively managing and growing their businesses by providing them with proper information and guidance. NSIC and SMECI conduct various seminars, conferences, workshops and training programmes to educate and create awareness amongst SMEs.

NSIC and SMECI have also conducted varied exhibitions, trade fairs, etc. to provide exposure to all areas of business operations such as business skills development, identification of appropriate technology, and hands on experience on working projects, project/product selection and opportunity guidance including commercial aspects of business. They give MSMEs an online platform by providing a portal to market their products and services globally.

3.3.2 DICCI to play NMSDC for SC/ST entrepreneurs

The Dalit Indian Chamber of Commerce and Industry (DICCI), like NMSDC, is actively involved to instil the spirit of entrepreneurship among the SC/ST youth to develop business leadership. It has been at the forefront to encourage entrepreneurship amongst the socially and economically backward people belonging to SC and ST by helping them spot solution for problems, working for the deprived and making business models to uplift them from economic and social backwardness.

DICCI also provides learning and enrichment through networking and knowledge exchange. It organises business trade fairs, seminar and workshops like DICCI Expo; facilitates interaction with the industry and government and shares information on latest trend and opportunities. More than 1,000 entrepreneurs as well as professionals have benefited from such programmes.

Box 12: DICCI spearheaded by Padmeshri Milind Kamble

Padmeshri Milind Kamble has been the instrumental man behind founding Dalit Indian Chamber of Commerce and Industry (DICCI). A strong believer in the principles laid down by Dr. Babasaheb Ambedkar, Mr. Kamble has worked hard for the upliftment of SC/ST entrepreneurs throughout his career.

He started his entrepreneurial career with Milind Kamble Civil Engineers and Constructions in 1995 and later founded Fortune Construction in 2005 which acted as an exemplary model for upcoming entrepreneurs. Striding on the path of success he became a mentor for the budding entrepreneurs. He envisions developing and encouraging an entrepreneurial class among Dalits through DICCI. He is actively involved in providing them a global platform through guidance, which may be by providing a road map for their businesses; directing them to the proper sources to raise funds; business developments through networking; etc.
4. ACCELERATING SME CAPITALISM

Indian MSMEs are armed with the additional Public Procurement Policy demand of INR17tn over FY14-FY20 that will need a huge amount of funding for their green and brown field expansions. Opportunity for the investor community in terms of fixed asset investment is INR10tn besides a working capital investment of INR3tn by FY20.

4.1 SME Funding: A wakeup call for investors

With the implementation of Public Procurement Policy, we estimate a market of INR17tn will be created for the Indian SMEs over FY14-FY20 including INR3.4tn for the SC and ST owned SMEs.

Our proprietary model on fund requirement estimates that an additional fixed investment of INR10tn and working capital of INR3tn will be needed over FY14-FY20 implying a CAGR of 14% in order to meet the huge demand created through PPP.

Exhibit 47: SMEs would need INR10tn of funding in fixed assets over FY14-20

![Graph showing fixed investment with and without PPP from FY07 to FY20E]

Source: MSME Ministry Annual report 2012, Varhad Research
Exhibit 48: SME financing options

- **Debt**
  - Working capital loan
  - Overdraft
  - Factoring
  - Term Loans
  - Commercial Papers
  - Syndicate loans
  - Project finance
  - Debentures
  - Inter-corporate loans
  - External Commercial Borrowing

- **Equity**
  - Angel Investor
  - Strategic tie-up
  - Venture capital
  - Private Equity
  - Capital Market

- **Hybrid**
  - Warrants
  - FCCBs
  - Pref. Shares
  - Conv. Bonds
  - Mezzanine
  - CCDs
  - CCPs

Source: Varhad Research

### 4.1.1 Debt funding to remain the key source of capital

Debt funding has always been the preferred source of financing for SMEs. Typically mature SMEs in India have a debt to equity ratio of 0.7-1.1 times whereas new SMEs have a debt to equity ratio as high as 2.2-3 times which indicates their high leverage positions. We estimate in order to fulfill the additional demand from the public procurement, Indian SME sector will need a total of INR10tn of additional fixed investment over FY14-20, mostly sourced through debt funding.

Exhibit 49: Currently, PSUs dominate banking preference for SMEs

Source: Dun & Bradstreet

In the past, the total outstanding credit by banks to MSMEs in India stood at INR4.85tn, grown at a CAGR of 39.8% during FY06-11. Public and private sector banks have registered an impressive growth of 35.28% and 36.14% in MSE lending in 2011, majorly driven by public sector banks (PSBs).
During 2010-11, total priority sector advances provided by PSBs grew by 19% YoY to INR10.3tn as against INR8.7tn in FY10.

Advances to MSME formed around 37% of the total priority sector advances of PSBs (vs. 32% in FY10). Total advances provided by PSBs to the MSE sector in FY11 grew by 35.3% YoY to INR3.76tn. Moreover, the share of MSE credit to net bank credit stood at 9.9% in FY11 against 13.4% in FY10. Production of the MSME sector has been improving significantly over the last five years growing at 11% CAGR with fixed investment and employment growing consistently in the past couple of years. This is a direct indication of the efforts in the sector to integrate the work force with technological enhancements to increase the production.

**Exhibit 50: Priority sector lending by SCBs**

![Exhibit 50: Priority sector lending by SCBs]

**Exhibit 51: Credit to SME sector by SCBs**

![Exhibit 51: Credit to SME sector by SCBs]

We further estimate that out of the total of INR12tn (fixed investment plus working capital); around INR6-8tn will be sourced mostly through banks (majority of public sector banks and local co-operative banks) and other financial institutions like Small Industries Development Corporation of India (SIDBI).
4.1.2 PEs, VCs can become the equity resource for MSMEs

An additional route for medium enterprises could be funds from Private Equity (PE) players or Venture Capital (VC) firms. Along with the capital funding, they can lend SMEs with their enormous experience and expertise in the field besides connecting them with other markets through their network.

Venture capital is often considered a more appropriate financing instrument for high-growth-potential and start-up SMEs. Although MSMEs commonly use traditional debt, this type of financing is not accessible for fast-growth or start-up firms. Firms, typically, look for venture capital to provide them with the financing they need to expand or break into new markets and grow faster. Thus, the ability of MSMEs (especially those involving innovations and new technologies) to access alternative sources of capital like venture funding capital needs to be enhanced considerably. Small Industries Development Bank of India (SIDBI), in our view, is currently the biggest source of financing for SMEs.
The advantage of having a PE investor is that such funds promote entrepreneurship and bring domain expertise from companies in their respective portfolios, previous industry experience and network. It can also provide access to new customers through board access, portfolio firms or networks.

Apart from providing internal expertise, PEs bring in external knowledge of best demonstrated practices across industries. PEs help improve the corporate governance by driving independence of boards and help increase transparency and reporting standards.

The private equity players also gain from investing in high IRR business of Indian SMEs. Typically Indian SMEs with their high growth prospects have an IRR\textsuperscript{24} of 30-45% depending upon the sector in which they are present in besides the value added activities.

Total PE investments were up at USD9.4bn across 477 deals in 2011 as against USD7.7bn across 374 deals in 2010. On the other hand, exits were at USD2.9bn in 2011 against USD4.4bn in 2010.

\textsuperscript{24}Internal Rate of Return (IRR) is the discount rate that makes the net present value of all cash flows from a particular project equal to zero.
Box 13: SIDBI, the biggest source of capital for India’s SMEs

Small Industries Development Bank of India (SIDBI) is an independent financial institution aimed to aid the growth and development of micro, small and medium-scale enterprises (MSME) in India. SIDBI begun as a refinancing agency to banks and state level financial institutions for their credit to small industries is currently the biggest source of direct credit to the SMEs through more than 100 branches in all major industrial clusters in India. It is the Principal Financial Institution for the Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector and for co-ordination of the functions of the institutions engaged in similar activities.

SIDBI has been playing the development role for SMEs in several ways such as support to micro-finance institutions for capacity building and on lending. Recently it has opened seven branches christened as Micro Finance branches, aimed especially at dispensing loans up to INR500,000.

SIDBI has also floated several other entities for related activities such as

A) Credit Guarantee Fund Trust for Micro and Small Enterprises which provides guarantees to banks for collateral-free loans extended to SME,

B) SIDBI Venture Capital Ltd, a venture capital company focused on SMEs,

C) SME Rating Agency of India Ltd. (SMERA) provides composite ratings to SME, and

D) ISARC - India SME Asset Reconstruction Company, specializing in NPA resolution for SMEs.

Exhibit 54: India still is a preferred destination for PEs

4.1.3 Hybrid financing opportunity

Hybrid financing is a mix of debt and equity and includes warrants, preference shares, convertible debentures and bonds.
**Warrants:** A derivative security which gives the right to purchase equity at a specific price within a specific time frame. Warrants are issued by the company and require only a small amount to be paid up front.

**Preference Shares:** Preference shares offer their owners preferences over ordinary shareholders. There are two major differences between ordinary and preference shares:

i. Preference shareholders are often entitled to a fixed dividend even when ordinary shareholders are not.

ii. Preference shareholders cannot normally vote at general meetings.

**Foreign Currency Convertible Bond (FCCB):** Debt instruments in foreign currency with equity conversion option. Only publically listed companies in India can raise FCCB.

**Convertible bonds or debentures:** A hybrid security with debt and equity-like features. It usually has a low coupon rate but the holder is compensated with the ability to convert bond to common stock.

i. **Compulsory Convertible Debentures:** A type of debenture where the whole debentures can be converted into equity at a predetermined price.

ii. **Optionally Convertible Bonds:** Bonds which can be converted into shares at the option of the owner (at a predetermined price). They may or may not be redeemable by the issuer prior to maturity.

iii. **Convertible Preference Shares:** It is similar to the above with lower seniority than the bond in the capital structure.

### 4.2 Capital market opportunities

Capital market involves both the debt and the equities market opportunities for raising funds and provide exist opportunity to the PE/VCs.

#### 4.2.1 Corporate debt markets opportunities

The Corporate Debt Market (DCM) in India is currently at a nascent stage in terms of an efficient price discovery mechanism as well as market participation. India has been distinctly lagging behind other emerging economies in developing its long-term debt market (LTDM), be it corporate or municipal bonds. Primary corporate debt market is dominated by finance companies and relatively a very small amount of funds are raised by manufacturing and other service industries through this market. Traditionally, larger corporates have used bank finance, equity markets and external borrowings to finance their needs. Small and medium enterprises face significant challenges in raising funds for growth. An efficient bond market would help corporates reduce their financing costs and allow them to structure their asset-liability profiles better. A well-developed corporate bond market is also necessary for long term financing of corporates.
In India, the long-term debt market largely consists of mostly the government securities (G-Secs). The market for corporate debt papers is mainly traded in short term instruments such as commercial papers (CPs) and certificate of deposits (CDs) issued by banks as well as long term instruments such as debentures, bonds, zero coupon bonds, step up bonds etc.

The size of the outstanding issue of Government securities was close to INR29tn (USD537bn) in 2011. However, the outstanding issue size of corporate bonds was close to INR10tn (USD167bn) while the turnover in corporate debt in 2011 was roughly INR6tn (USD110bn) compared to the equity market turnover of nearly INR50tn (USD925bn).
4.2.2 Comparison with other countries

The size of the Indian corporate debt market is very small in comparison to both developed markets, as well as some of the major emerging market economies. In India, the proportion of bank loans to GDP is approximately 36% as of 2010, while that of corporate debt to GDP is only 4% or so. In contrast, corporate bond outstanding in USA is 70% of GDP, in Germany it is 147%, in Japan it is 41%, and in South Korea it is 49%. In these countries, the share of corporate bonds is close to 87% for corporates that are graded above BBB. South Africa, Brazil, China and Singapore, are 57% and 33% for corporates rated above BBB and those rated at BBB or below respectively.

Indian debt market (including public-sector debt) could grow nearly four-fold by 2020. The overall market capitalization of the Indian bond market would touch USD1tn by FY20 from current USD40bn. This growth could result in increased access to debt markets for Indian corporates.
4.3 Exploring capital market opportunities via SME listing

In the case of start-ups, particularly a SME, either the promoters use their own funds or get the help of financial investors such as private equity funds and venture capitalists to start the venture. Here, promoters have an option of adding debt which also helps improve the overall return on equity, but the cost of raising debt for SMEs is relatively higher. High interest expense put pressure on the profitability of a growing company. Thus, in order to fund the next stage of growth without excessive interest cost burden, companies look to access equity funds via capital markets. This is where listing on an exchange comes into the picture.

While an SME can also list on a main exchange, there are some advantages of listing on a dedicated SME exchange. First, listing norms are written to specifically suit SMEs. Second, the initial public offer (IPO) process for SMEs is simplified and this means that time taken to prepare for an IPO is much less (than for listing on a main exchange). Third, it helps the SME get attention of the investor eager to invest in a SME.
MSME: The opportunity knocks

Exhibit 59: Value of share trading world-wide of SME stocks

Source: World Federation of Exchanges

Box 14: Alternative Investment Market

Alternative Investment Market (AIM), a part of the London Stock Exchange (LSE), is the most successful growth market in the world and was formed to help smaller and growing companies in raising capital for expansion. Since its launch in 1995, over 3000 SMEs across the world got benefited from it.

AIM, according to a Grant Thornton survey 2009, had made a substantial contribution to the UK economy in generating around GBP21bn of capital for its listed companies and creating 570,000 full-time jobs through direct, supply chain and multiplier effects.

The medium size organisations can list themselves in exchanges dedicated for SMEs like AIM.
**Exhibit 60: SME exchanges in India gaining popularity**

<table>
<thead>
<tr>
<th>SME Exchange</th>
<th>Currently listed</th>
<th>Forthcoming</th>
</tr>
</thead>
<tbody>
<tr>
<td>BSE SME Exchange</td>
<td>• Bronze Infra-Tech Ltd&lt;br&gt;• Anshu’s Clothing Ltd&lt;br&gt;• Jupiter Infomedia Limited&lt;br&gt;• Jointeca Education Solutions Ltd&lt;br&gt;• BCB Finance Limited&lt;br&gt;• Comfort Commmotrade Ltd&lt;br&gt;• Eco Friendly Food Processing Park Ltd&lt;br&gt;• Esteem Bio Organic Food Processing Ltd&lt;br&gt;• Max Alert System Limited&lt;br&gt;• RCL Retail Ltd&lt;br&gt;• Sangam Advisors Limited&lt;br&gt;• SRG Housing Finance Limited&lt;br&gt;• Kavita Fabrics Limited&lt;br&gt;• Bothra Metals and Alloys Limited&lt;br&gt;• Ashapura Intimates Fashion limited&lt;br&gt;• Channel Nine Entertainment Limited&lt;br&gt;• GCM Securities Limited&lt;br&gt;• HPC Biosciences Limited&lt;br&gt;• Lakhota Poly&lt;br&gt;• Looks Health&lt;br&gt;• Samridhi Realty&lt;br&gt;• Sunstar Realty Development Limited</td>
<td>• Finshore Management Services Ltd&lt;br&gt;• Subh Tex (India) Limited</td>
</tr>
</tbody>
</table>

Source: BSE

**Box 15: Varhad Investment Managers**

Varhad Investment Managers (VIM) is the asset management arm of Varhad Group. VIM is also the investment managers for Dalit Indian Chamber of Commerce and Industries’ (DICCI) INR5bn (USD100m) fund dedicated for funding the SC and ST owned SME enterprises. VIM also plans to launch various sectoral funds to cater the high funding needs of the vibrant Indian SME sector, an area which is unattended by the major funds.
5. **Steps for a Successful SME Procurement Policy**

Collusion and corruption are distinct challenges within the public procurement. The anti-competitive issues arising due to the problem of corruption would pose a serious question mark on the grass root benefit of the PPP.

5.1 **Policy changes – Best practices**

The kind of legal instrument that will be required to implement SME assistance programme will also depend on the manner in which such programmes are implemented in a country. SME programmes, according to the International Labour Organisation (ILO), are typically implemented via a legislation or a law promulgated by a legislature in the form of a statutory code. Depending on the legal system, regulation may or may not require authorization in legislation or in a constitution. In some states, SME programmes may be implemented solely by an executive branch of the government through circulars, guidance or executive orders with or without a bare minimum of legislative authority.

5.1.1 **Policies to support SMEs in India**

The Government of India supports the growth of SSIs (Small Scale Industries) as a matter of policy, which has been an important and permanent feature of the Government’s long-standing industrial policy. There has always been an emphasis on the establishment of new SSIs, particularly in industrially backward areas, and a concern for their viability and continued growth. From time to time, the Government has initiated assistance programmes to achieve its broad objectives. These include providing land at concessional rates or free of cost for establishing new SSI units and an easy credit at lower than prevailing commercial rates for procuring plants and machinery. Exemptions from certain statutory duties and levies like excise duty and sales tax are generally granted to SSIs.

The Government has also created institutional support to guide and help SSIs, through the National Small Industries Corporation (NSIC) and the Director of Industries of States. State governments have separately and independently extended similar benefits to SSIs located in their territory. However, they created no independent organizations. Work at the state level is performed by the state’s administrative machinery itself under Director of Industries.

5.1.2 **Financial assistance policies In India**

There are a number of financial concessions provided to SMEs. These include providing and at concessional rates or free of cost for establishing new SMEs, and relaxed credit terms at lower than prevailing commercial rates for the acquisition of plant and machinery. Exemptions from certain statutory duties and levies like excise duty and sales tax are generally granted to SMEs.
To further provide financial support to SMEs, the Indian Government has issued a notification allowing 24% equity participation in SMEs by other industrial units. This opens up another avenue of financing for SMEs in addition to promoter’s capital, bank loans and government loans. The domestic commercial banks are expected to enlarge credit to priority sector and ensure that priority sector advances (which include the small enterprises sector) constitute 40% of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.

**Box 16: Financial assistance policies in India**

In order to ensure that credit is available to all segments of the Small Enterprises sector, the Reserve bank of India has recommended that:

a. 40% of the total advances to small enterprises sector should go to micro (manufacturing) enterprises having an investment in plant and machinery up to INR500k and micro (service) enterprises having investment in equipment up to INR200k;

b. 20% of the total advances to small enterprises sector should go to micro (manufacturing) enterprises with an investment in plant and machinery above INR500k and up to INR2.5m and micro (service) enterprises with an investment in equipment above INR200k and up to INR1m (Thus 60% of small enterprises advances should go to the micro enterprises).

**Composite loan:** A composite loan limit of INR10m can be sanctioned by banks to enable SSI entrepreneurs to avail off working capital and term loan requirement through a Single Window.

**Collaterals:** The limit for all SSI borrowal accounts for collateral security is INR5 thousand. Banks may on the basis of good track record and financial position of the SSI units increase the limit of dispensation of collateral requirement for loans up to INR2.5m (with the approval of the appropriate authority).

Source: Reserve Bank of India
5.1.3 Price preferences in tender bidding for SMEs

Governments across the world have traditionally used margins preference to provide assistance to SMEs. Typically, a Government allows a price preference margin of $y\%$ in favour of SMEs (suppose a large firm offers a price of 100 and an SME offers a price larger than 100 but smaller than 100(1+$y\%$) for the same item.)

The government will then purchase the item from the SME, in spite of the fact that the price is higher, if it has established $y\%$ as a margin of preference in the procurement. For purposes of transparency, this margin of preference will be clearly identified in the invitation for tenders and the criteria for its application, as set forth in the invitation will be followed by the procuring entity.

In India, MSMEs are entitled to a price preference of up to 15% on merit when competing with a large-scale unit. This price preference is permitted even when they compete with a state-owned enterprise. Price preferences have been considered necessary because there are cases where SMEs cannot stand on their own in competition with large-scale sector hence need some protection.

**Box 17: Preferences given to SMEs internationally**

**United States:** Various preference programmes have been formulated to render support to MSMEs, the most notable of which is the Buy American Act that was enacted in 1933. For goods, the Act requires that procuring entities apply a duty or premium on bids and proposals that offer foreign goods. The margin is 6% generally and 12% if the domestic firm is small. The Department of Defense sets its margins at 50%.

**In Brazil,** locally manufactured telecommunications and informatics products receive a preferential treatment in government procurement while foreign firms may only bid to provide technical services if there are no qualified Brazilian firms.

**Paraguay** government agencies must give a preference of 15% to local bidders for construction of public works or the supply of services to the public sector.

Source: World Trade Organization
<table>
<thead>
<tr>
<th>Policy</th>
<th>Goal</th>
<th>Potential effects (advantages &amp; disadvantages)</th>
</tr>
</thead>
</table>
| **Technical assistance**     | • Goal setting and advocacy  
                              | • Advice and marketing assistance  
                              | • Cooperatives  
                              | • Community participation – donor-financed procurement | • Increasing awareness  
                              | • Promoting SMEs  
                              | • Supporting SMEs | Advantages  
                              | • Less interventionist  
                              | • Rewards SME efficiency  
                              | • Optional feature  
                              |
|                              |                                                                      | Disadvantages  
                              |                                                                      | • Interest group capture  
                              |                                                                      | • Information problems  
                              |                                                                      | • Conflicting public policies  
                              |                                                                      | • Costly to government  
                              |                                                                      | • Problematic goals  
                              |
| **Training**                 | • Human capital development  
                              | • SME managers  
                              | • Government administrators | Advantages  
                              | • Relatively cheap  
                              | • Develops skills  
                              |
|                              |                                                                      | Disadvantages  
                              |                                                                      | • One size fits all  
                              |                                                                      | • Administrative costs  
                              |                                                                      | • May not be enough  
                              |                                                                      | • Need for local focus  
                              |                                                                      | • Potential for abuse  
                              |
| **Financial assistance and subsidies** | • Financing  
                              | • Bond/guarantee  
                              | • Reform/assistance  
                              | • Prompt payment reform | • Increase level of SME participation in public and private markets | Advantages  
                              | • Sustains demand on SMEs  
                              | • Similar to set-sides  
                              | • De-links some political interplay  
                              | • Second-best trade policy  
                              |
|                              |                                                                      | Disadvantages  
                              |                                                                      | • Costs and inefficiency  
                              |                                                                      | • Implicit political market  
                              |                                                                      | • Hard to dismantle  
                              |
| **Price preferences**        | • Targeted assistance in procurements | Advantages  
                              | • Direct SME assistance  
                              | • Awards to SMEs  
                              |
|                              |                                                                      | Disadvantages  
                              | • Very likely inefficient  
                              | • May reward inefficient SMEs  
                              | • Implicit political market  
                              | • Poor incentives  
                              | • Hard to dismantle  
                              |

Source: World Trade Organization
5.1.4 MSMEs need tax incentives for growth

The MSME sector which accounts for about 45% of India's manufacturing output, 40% of the total exports of the country and employing 73m, is, however, not completely recognised and rewarded under our present system of taxation. Hardly any tax incentives for MSMEs are provided by the government in the current direct as well as indirect tax regime.

Under the present direct taxation system, small units located in backward, hilly and tribal areas enjoy tax holidays for 5-10 years. Also, there exists a provision for computing profits and gains from business and profession on a presumptive basis where the turnover limits do not exceed INR10m for business income and INR2.5m for professional income. Similarly, under the indirect tax laws, the small-scale units are exempt from payment, until their value of clearances or taxable services do not exceed INR40m and INR1m for excise duty and service tax respectively.

Recently, the government has come up with reform in taxation for MSMEs by inserting a section which provides relief from the long term capital gains tax to an individual or an HUF on sale of a residential property (house or a plot of land) in case of re-investment of sale consideration in the equity of a new start-up SME company in the manufacturing sector or which is utilised by the company for the purchase of new plant and machinery. More such incentives including an encouragement by providing accelerated and higher deduction compared to others for expenses related to scientific research, preliminary expenses, etc. need to be provided to MSMEs in manufacturing as well as other sectors. Also, scrapping the cumbersome compliance requirements for exempted units would reduce administrative costs for SMEs and the Government alike.

There is a need to have a single definition for MSME under all taxation laws so that they can avail benefits under direct as well as indirect tax laws. In terms of tax structuring too, we need to develop a special scheme for MSME as in other countries. In addition, there has to be differential tax slabs or tax holidays in the initial years to encourage SMEs to set up new business undertakings.
Exhibit 61: Reduced rates of Corporation Tax for small companies in select countries

<table>
<thead>
<tr>
<th>Country</th>
<th>CIT Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>Standard rate: 30%</td>
</tr>
<tr>
<td></td>
<td>Progressive 10%, 20% and 30%</td>
</tr>
<tr>
<td>Belgium</td>
<td>Standard rate: 33.39%</td>
</tr>
<tr>
<td></td>
<td>Progressive 25%, 30%, 35%, and 50%</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Standard rate: 30%</td>
</tr>
<tr>
<td></td>
<td>Progressive 10%, 20%, and 30%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Progressive rates of: 10%, 20% and 30%</td>
</tr>
<tr>
<td>Japan</td>
<td>Standard rate: 30%</td>
</tr>
<tr>
<td></td>
<td>Progressive: 22% and 30%</td>
</tr>
<tr>
<td>Korea</td>
<td>Progressive rates: 13% and 15%</td>
</tr>
<tr>
<td>South Africa</td>
<td>Standard rate: 29%;</td>
</tr>
<tr>
<td></td>
<td>Progressive 10% and 29%</td>
</tr>
<tr>
<td>Spain</td>
<td>Standard rate: 32.5%;</td>
</tr>
<tr>
<td></td>
<td>Reduced rates depending on type of business or entity: 10%, 20%, 25% and 30%</td>
</tr>
<tr>
<td>United States</td>
<td>Progressive rates up to an income threshold: 15%, 25%, 34%, 39%, 34%, 35%, and 38%; If income is above threshold: flat 35% on all</td>
</tr>
</tbody>
</table>


5.2 Transparency through technology - Need of the hour

Enacting a public procurement policy with fairness, integrity and transparency is indeed a Herculean task. The process of procurement is an excessively tedious process involving complex procedures, long approval time periods, inspections, etc. which can raise concerns of bureaucratic hassles. The elements of kickbacks, disclosure of L1 price and high handedness in supplier selection and procurement decision cannot be ignored. The issue of corruption being a rampant problem can also be gauged in terms of outside influences, political interventions and so on etc. According to a World Bank survey, the frequency of corruption in the process of procurement is 70% in South Asia, the highest amongst all.

Exhibit 62: Corruption is deterrence for SMEs in India

Source: Kaufmann, World Bank (2006)
In the public procurement system, to bring about the goal of fairness, competition and economic value are paramount. To achieve this goal, effective and efficient procurement processes must be established. This includes incorporating adequate controls to promote competition and minimize the risk of fraud, corruption, waste, and mismanagement of public funds. In this context, transparency is considered to be one of the most effective tools to deter corruption and ensure value for money.

**Box 18: Defining transparency in procurement system**

Transparency in procurement can be achieved by following practices such as advance publication of procurement plans, advertisement of tender notices, disclosure of evaluation criteria in solicitation documents, publication of contract awards and prices paid, establishing appropriate and timely complaint or protest or dispute mechanisms, implementing financial and conflict of interest disclosure requirements for public procurement officials, and publishing supplier sanction lists. Open standards, open protocols, open formats, open source, and several similar concepts need to be implemented for a transparent system.

Transparency is considered to be a prerequisite for ensuring the accountability of public officials and in this regard, there is broad agreement that the effectiveness of transparency can be further strengthened by empowering monitoring and oversight organizations within the civil society to scrutinize procurement, as they can play an important role as watchdogs for public sector integrity. Such oversight practices could be effective in raising questions on a timely basis, reducing risks in complex contracts, strengthening procurement and contracting practices, holding public officials accountable and in general, strengthening governance. This aspect of transparency is a new frontier for procurement and there is still much to be done about the ‘ways and means’ necessary to develop and implement procurement regimes that include civil society monitoring.

**Exhibit 63: India scores low on transparency (Global Ranking: 95)**

Source: Transparency International Organisation
Technology can be a great tool to bring about transparency in the procurement system. In terms of technology, openness has been a long sought after goal. The adoption of an e-procurement system can expand transparency in the procurement system and also contribute to the prevention of corruption.

**Box 20: Defining E-procurement**

E-procurement is the use of integrated information technology for part of or all the procurement functions, from the beginning to the end, i.e. from searching, sourcing, negotiating, ordering, and receipt to post purchase review.

Source: WTO

### 5.2.1 E-procurement to help build a transparent procurement system

E-procurement stands out as the most commonly employed tool to improve transparency in public procurement. It also consolidates the data on procurement of various goods and services directly or indirectly which ultimately benefits in bulk purchases by negotiating prices.

Presently, the government has set up a Central Public Procurement Portal (CPPP) to tackle corruption and bring about transparency in the procurement system. This portal provides a single point access to the information on procurement across various ministries and departments.

The CPPP has acted as a catalyst to help enhance transparency, shorten the procurement cycles, and avoid human discretion or interference as also giving easy access to the remotest vendors. Even then, there are many challenges such as educating and creating awareness on the use of CPPP, simplifying procedures, etc. which need to be addressed.

The broad recommendations that can be implemented include making e-procurement mandatory; developing adequate control mechanisms to maintain secrecy; use of standard formats for e-tendering; educating both the public sector officials as well as bidders by conducting various training programmes, and so on and so forth.
Exhibit 64: E-procurement process for a better implementation of PPP

Source: Varhad Research
6. **Methodology**

Varhad Capital research has formulated detailed models to identify opportunities for the Indian MSME sector. We have studied in detail the past trends of procurement by analysing the annual reports of 116 companies and 74 departments/ministries. We have built integrated models for forecasting demand growth for MSMEs, the employment growth opportunity and the funding requirements for the Indian MSME post the mandatory implementation of Public Procurement Policy (PPP) in FY16.

Our model for MSMEs demand forecast can be divided in three parts:

- Demand Creation Model
- Fund Requirement Model
- Employment Generation Model

**Exhibit 65: Varhad Capital forecasting model**

6.1 **Demand Creation Model**

The public procurement policy targets 20% mandatory procurement from MSMEs from FY16 onwards. Thus, to forecast the fresh demand created by the PPP opportunity and the incremental demand thereof, we have analysed the procurement patterns of PSUs, government banks and other government held companies as well as the expenditure budget of departments/ministries. Due to lack of government data showing the current public procurement from SMEs, we have assumed a procurement of 5% currently.
The list of the companies and departments

<table>
<thead>
<tr>
<th>Maharatnas</th>
<th>Navaratas</th>
<th>Miniratnas</th>
<th>PSU Banks</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Coal India</td>
<td>1. BPCL</td>
<td>1. BEML</td>
<td>1. SBI</td>
<td>1. LIC</td>
</tr>
<tr>
<td>2. ONGC</td>
<td>2. HPCL</td>
<td>2. AAI</td>
<td>2. BOI</td>
<td>2. GIC</td>
</tr>
<tr>
<td>3. SAIL</td>
<td>3. MTNL</td>
<td>3. HCL</td>
<td>3. BOB</td>
<td>3. IFCI</td>
</tr>
<tr>
<td>4. NTPC</td>
<td>4. NALCO</td>
<td>4. KIOCL</td>
<td>4. PNB</td>
<td>4. IRFC</td>
</tr>
<tr>
<td>5. IOC</td>
<td>5. OIL</td>
<td>5. NFL</td>
<td>5. UBI</td>
<td>5. SIDBI</td>
</tr>
<tr>
<td>7. BHEL</td>
<td>7. REC</td>
<td>7. RCFL</td>
<td>7. IOB</td>
<td>7. Air India</td>
</tr>
<tr>
<td>And 4 other navaratas.</td>
<td>10. STC</td>
<td>10. PSB</td>
<td>10. PSB</td>
<td>10. FCI</td>
</tr>
</tbody>
</table>

And 37 other miniratnas.
And 11 other PSU Banks.
And 18 other Govt-owned companies.
Our projections of the incremental production for MSMEs are based on the actual procurement of 190 PSUs and government departments between FY11 and FY12. The total procurement consists of capital expenditure (Capex) and operational expenditure (Opex) which have been anticipated to grow by 5% and 20% for Maharatnas, 10% and 20% for Navaratnas and 20% and 30% for the Miniratnas respectively over FY12-FY20.

Exhibit 67: Capex and Opex assumptions for the incremental production model

Exhibit 68: Public procurement to reach INR28tn in FY20
Exhibit 69: Implementation of PPP would help SMEs gain INR17tn of additional opportunity during FY14-20 from the public sector

In the absence of PPP, we project that the cumulative turnover of SMEs to be INR150tn over FY14-20, growing at a CAGR of 11.5% as it did between FY08-FY12. With the additional opportunity provided by PPP, we estimate the cumulative turnover to reach INR167tn within the same period thus creating an additional demand of INR17tn for SMEs.

6.2 Fund Requirement Model

We have developed a proprietary model for the estimation of the total fund requirement for Indian MSMEs for green field and brown field expansion in the backdrop of an incremental demand of INR17tn, generated through the Public Procurement Process.

We estimate that the cumulative fixed investment required should be INR106tn over FY14-20 for a turnover of INR150tn if PPP is not implemented. However, with the implementation of PPP, we forecast that an incremental fixed investment of INR10tn would be required to meet the additional demand of INR17tn.

Similarly, we project that the working capital required to generate the turnover of INR150tn should be INR24tn, assuming an average working capital cycle of 60 days. We estimate that an incremental working capital of INR3tn would be required over FY14-20 to fulfill the demand of INR17tn created by PPP.

6.3 Employment Generation Model

Our analysis of the employment growth is directly linked to an increase in fixed investment as a result of the incremental demand of INR17tn. With the advent of PPP, we forecast the employment generation to reach 123m by FY20, which, otherwise would have been 117m.

We have arrived at this employment number, considering an average employee multiplier of 2.16 in the last four years. Employee multiplier is a derivation of growth in fixed investments by employee growth and subsequent productivity improvement.
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